ISDA Safe, Efficient Markets

April 18, 2013

Delivered Electronically

Jesse Eggert
Associate International Tax Counsel
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Steven Musher
Associate Chief Counsel (International)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

John Sweeney
Branch Chief (CC:INTL:B08)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

RE: ISDA Comments on Final FATCA Regulations

Dear Sirs:

I am writing on behalf of the North American Tax Committee (the "NATC") of the International Swaps and Derivatives Association ("ISDA"). The NATC recommends certain modifications and clarifications with respect to one aspect of the final regulations (the "Final Regulations") issued on January 17, 2013, by the Treasury Department pursuant to Sections 1471-1474 of the Internal Revenue Code of 1986, as amended (the "Code"),[1] commonly referred to as "FATCA."

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including

[1] Unless otherwise specified, section references are to the Code. References to regulations are to the Treasury regulations promulgated thereunder.

corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Background

The Final Regulations raise a number of issues that are important to ISDA and its members. In this letter, we will focus on one issue of particular importance – the treatment of securitization vehicles under the Final Regulations. Other market participants will be or have already submitted comments with respect to this and other issues, and ISDA may comment on other issues in the future as well.

The Final Regulations treat certain FFIs that are "limited life debt investment entities" (each, an "LLD") as certified deemed compliant FFIs through the end of 2016.[2] To be an LLD, the FFI must meet five specified requirements, which we understand generally were intended to be consistent with typical securitization vehicles in use in the market. The creation of this category of certified deemed compliant FFIs reflected appropriate recognition by the IRS and Treasury Department that relief was needed to prevent needless disruption to the securitization market. The reason the relief is necessary is that routinely used offshore securitization vehicles are likely to be treated as FFIs. It is highly problematic for vehicles set up prior to the enactment of FATCA (or the realization that FATCA may well cover these vehicles) to become participating FFIs. Virtually all are special purpose vehicles whose organizational documents severely constrain the authority of those who administer the vehicles. As a result, there is a high likelihood that a great many of these vehicles would become subject to withholding under FATCA at some point. Subjecting these vehicles to FATCA withholding would frustrate legitimate non-tax avoidance expectations of investors without otherwise promoting in any material way the purposes of FATCA, as explained further below.

Despite the intention to provide relief in the circumstances described above, the definition of LLD contained in the Final Regulations does not properly reflect the realities of typical securitization vehicles.[3] As a result, significant changes to the definition are needed for the intended treatment of LLDs to have any noticeable effect.

An additional FATCA-related issue for certain securitization vehicles arises from the fact that a significant number of securitization vehicles are organized as so-called "cell companies." The law relating to the treatment of cell companies is not entirely settled. In particular, depending on the facts and circumstances of a specific situation, it may be unclear whether generally for tax purposes a cell company should be treated as a single entity, or a collection of

[2] Reg. § 1.1471-5(f)(2)(iv).

[3] We describe each element of the definition of LLD and the practical problems associated with the definition in Appendix I.

multiple entities.[4] For example, in such a situation, it will be uncertain whether the entity as a whole or each individual cell would be treated as a separate FFI, with vastly different practical consequences regarding the procedure for becoming FATCA compliant.

Summary of Recommendations

We recommend:

- Modify the definition of LLDs to better reflect market realities. In particular, we recommend a definition the principal features of which are requirements for (1) the entity to have a limited life and (2) either (a) all non-de minimis interests in the entity are held through U.S. financial institutions or FFIs that otherwise have reporting obligations either under FATCA or an IGA, (b) payments on all non-de minimis interests in the entity are made by U.S. financial institutions or FFIs that otherwise have reporting obligations either under FATCA or an IGA or (c) the entity actually performs the reporting and withholding required by FATCA. The revised definition also should clarify that an entity that is made up of multiple cells can satisfy the definition on a "cell by cell" basis.

- Permit LLDs (under our modified definition) to be certified deemed compliant FFIs unless the LLD undertakes its own FATCA withholding and reporting, in which case the entity should be permitted to be a registered deemed compliant FFI.

- Permit LLDs (under our modified definition) that were not in existence on or before the later of December 31, 2013, or 90 days following the publication of regulations to be deemed compliant FFIs, only if their operative documents contain provisions that would require the entity to meet the specific requirements for being treated as LLD.

Explanation of Recommendations

The definition of LLD in the Final Regulations is very restrictive and complicated to test. The practical effect of the limitations in the definition would be to exclude a vast number of common securitization vehicles that we believe the Treasury Department and IRS intended to fall within the definition. As drafted, the requirements would prevent the vast majority of vehicles used for securitizations from qualifying as LLDs under the Final Regulations.[5]

These problems inherent in the definition of LLD under the Final Regulations in theory could be addressed by extensive and detailed changes to the specific language of the definition.

[4] *See* Prop. Reg. § 301.7701-1. This proposed regulation generally provides that a cell of a cell company established under a domestic series statute is treated as a separate entity for Federal tax purposes. A transition rule allows a cell and a cell company to continue to be treated as a single entity provided that, amongst other requirements, the cell was established prior to September 14, 2010. The proposed regulation, however, provides no guidance on the treatment of cells that are established after September 13, 2010 and prior to the date that the final regulations are published, and does not address the treatment of cell companies organized under non-US law.

[5] A detailed discussion of the issues that arise under the LLD definition appear in Appendix I.

We do not believe that attempting to do so would be fruitful, or for that matter necessary, to achieve the objectives of the Final Regulations, however. Appropriate modification of the specific language would need to be broad enough to capture all or at least nearly all transactions worthy of relief, while not being overly broad. Because of the myriad variations that exist from one securitization vehicle to another, doing so would involve a very painstaking process with no assurance of an appropriate outcome. Moreover, given the enormous number of securitization vehicles in existence, it would be extremely costly and otherwise burdensome for market participants to undertake diligent review of multiple factors with respect to each vehicle in order to determine if the definition of LLD under the Final Regulations (or similarly detailed revision thereof) is satisfied with no related benefit.

Rather, for the reasons discussed below, it is our recommendation to define an LLD more simply as an entity that meets the following requirements:

> (A) The FFI is a collective investment vehicle that issues one or more classes of interests pursuant to a trust indenture or similar fiduciary arrangement and that is an FFI solely because it is an investment entity that offers interests to one or more investors.
>
> (B) The FFI's organizational documents require that on or before a specified date, the entity pay to investors representing substantially all of the interests in such FFI, all amounts that such investors are entitled to receive. In the case of an entity that comprises one or more separate cells, the entity satisfies the requirements of this paragraph (B) if each cell, viewed separately, satisfies the requirements of this paragraph, whether or not each such cell otherwise is treated as a separate entity.
>
> (C) All payments made to the investors in the FFI are either (i) cleared through a clearing organization that is a participating FFI, reporting Model 1 FFI or U.S. financial institution, (ii) made through a trustee, fiscal agent, custodian or similar paying agent that is a participating FFI, reporting Model 1 FFI, or U.S. financial institution, or (iii) reported by the FFI or a paying agent in the manner described in sections 1.1471-4(a)(3) and sections 1.1474-1(c) and (d), and withheld upon by the FFI as required by section 1.1471-4(b).[6] For this purpose, the holder of a de minimis interest in the FFI is not treated as an investor in the FFI.

[6] Clause (C) is based on the provision for a collective investment vehicle to be treated as a deemed compliant FFI in Annex II, Part II(B) of the Model 2 IGA. Agreement Between the United States of America and [FATCA Partner] for Cooperation to Facilitate the Implementation of FATCA of November, 14, 2012. This clause has been adopted in all FATCA agreements entered into subsequent to the release of the Model 2 IGA. See Agreement Between the Government of the United States of America and the Government of the Kingdom of Denmark to Improve International Tax Compliance and to Implement FATCA of November 19, 2012, Annex II, Part II(B); Agreement Between the Department of the Treasury of the United States of America and the Ministry of Finance and Public Credit of the United Mexican States to Improve International Tax Compliance Including with Respect to FATCA of November 19, 2012, Annex II, Part II(E); Agreement Between the Government of the United States of America and the Government of Ireland to Improve International Tax Compliance and to Implement FATCA of January 23, 2013, Annex II, Part II(C); Agreement Between the United States of America and Switzerland for Cooperation to Facilitate the Implementation of FATCA of February 14, 2013, Annex II, Part II(C).

Securitization vehicles that satisfy the requirements above should be considered to be low risk entities relative to the purposes of FATCA. By definition, all of the interests in the vehicle would be held by entities that already have tax reporting obligations. The fact that the reporting will occur, along with the extra costs and other hurdles to establish a vehicle that would satisfy the recommended requirements would make such a vehicle unattractive to anyone who is seeking to hide income from the IRS. We submit that a securitization vehicle meeting these three requirements is highly unlikely to be used for purposes of U.S. tax avoidance.

Moreover, a vehicle that meets these requirements (just like an LLD within the meaning of the Final Regulations), if required to undertake FATCA reporting would not in any case supply information to the IRS that would be useful to identify tax avoidance. To the extent that the interests in the securitization vehicle (or LLD under the Final Regulations) by definition are nominally held by and payments made to US financial institutions, or FFIs with FATCA reporting obligations, the IRS would receive only information naming these entities, which will be all but meaningless. Moreover, paying agents that are US financial institutions, or FFIs with FATCA reporting obligations would be performing FATCA reporting and withholding, which would make any such reporting or withholding by the securitization vehicle redundant and unnecessary. In light of the costs and other burdens that would be imposed on market participants and the nonexistent benefit to the IRS of requiring registration and other FATCA compliance of entities that meet our suggested requirements, we do not believe that requiring FATCA compliance at any time during the existence of these entities would be justified.

In general, we believe that meeting the requirements to be an LLD in the manner proposed and supplying a certification to that effect should provide a sound basis for permitting an entity to be treated as a certified deemed compliant FFI, especially taking into account the administrative burden that would be involved in registering many, many thousands of existing vehicles. In what we believe to be relatively infrequent cases where the LLD would make payments to investors without the assistance of a paying agent and otherwise undertakes to perform FATCA reporting and withholding on its own, the LLD should be permitted to be a registered deemed compliant FFI. As an extra measure of protection, we also would recommend as an additional requirement to qualify as an LLD, that entities not in existence on or before the later of December 31, 2013, or 90 days following the publication of regulations that revise the definition of LLDs, have organizational documents that provide for the entity to meet the specific requirements of the revised LLD definition.

We thank you for the opportunity to comment on the Regulations and would be happy to discuss with you further either by phone or in person the issues presented in this letter.

With best regards.

Sincerely yours,

Thomas Prevost

Thomas S. Prevost

APPENDIX I

Limited Life Debt Investment Entities Under the Final Regulations

Regulation section 1.1471-5(f)(2)(iv) treats certain FFIs that are LLDs as certified deemed compliant FFIs through the end of 2016. To be an LLD, the FFI must meet the following requirements:

(A) The FFI is a collective investment vehicle formed pursuant to a trust indenture or similar fiduciary arrangement that is an FFI solely because it is an investment entity that offers interests primarily to unrelated investors.

(B) The FFI was in existence on December 31, 2011 and the FFI's organizational documents require that the entity liquidate on or prior to a set date, and do not permit amendments to the organizational documents, including the trust indenture without the agreement of all of the FFI's investors.

(C) The FFI was formed for the purpose of purchasing (and did in fact purchase) specific types of indebtedness and holding those assets (subject to reinvestment only under prescribed circumstances) until the termination of the asset or the vehicle.

(D) All payments made to the investors of the FFI are cleared through a clearing organization that is a participating FFI, reporting Model 1 FFI or U.S. financial institution, or made through a trustee that is a participating FFI, reporting Model 1 FFI, or U.S. financial institution.

(E) The FFI's trust indenture or similar fiduciary arrangement only authorizes the trustee or fiduciary to engage in activities specifically designated in the trust indenture, and the trustee or fiduciary is not authorized through a fiduciary duty or otherwise to fulfill the obligations that a participating FFI is subject to under §1.1471-4 absent a legal requirement to fulfill them, even if the consequence of the trustee failing to fulfill these obligations is to cause the FFI to be withheld upon. Further, no person has the authority to fulfill the obligations that a participating FFI is subject to under §1.1471-4 on behalf of the FFI.

We refer to the foregoing as Requirements A through E, respectively.

Issues Arising Under the Final Regulations

The specific issues and practical problems arising under Requirements A through E are discussed below.

Requirement A

Under Requirement A, a securitization vehicle literally must be "*formed* pursuant to a trust indenture or similar fiduciary arrangement . . . ." (Emphasis added.) Although certain securitization vehicles are organized as trusts, most securitization vehicles that would be FFIs are organized as foreign corporations or partnerships. These vehicles typically would employ a trust indenture to issue one or more classes of debt interests. Nevertheless, the trust indenture (or similar fiduciary arrangement) is merely the tool used for creation of certain (sometimes most) interests in the securitization vehicle, and the vehicle, if organized other than a trust cannot be said to be "formed" pursuant to the trust indenture (or similar fiduciary arrangement).

Moreover, it should be noted that it would be *atypical* for all of the interests created in the vehicle to be issued pursuant to a trust indenture or similar fiduciary arrangement. Virtually every securitization vehicle organized as a corporation will have a class of common shares that has nominal value. The vehicle is required to have such a class of shares under local law, and the holder of these shares usually is an accommodation party. All voting or other rights that might be associated with these common shares are effectively conferred upon other holders of interests in the securitization vehicle under its organizational or other documents. The interests in the vehicle that represent its real equity (residual) interests would be represented either by a subordinated class of debt securities (which likely is issued under a trust indenture) or as a class of preference shares (which likely is issued under the vehicle's organization documents, but not a trust indenture (or similar fiduciary arrangement)).

It is unclear what the term "unrelated investors" in Requirement A refers to. As written, "relatedness" is not described in reference to any particular party. Accordingly, it is possible that the term is intended to refer alternatively to whether the investors are related to the vehicle itself, the sponsor of the vehicle or to each other. Regardless of which meaning was intended, we do not believe that any such requirement would be necessary or serve a useful purpose under the approach that we recommend in this letter, which assures that there will be tax reporting regardless of who owns the interests in the vehicle. Given the reporting that will be required, it should not matter what relation investors have to the entity, the sponsor or each other. Moreover, we note that if the investors' relationship to each other were the intended meaning, it would be extraordinarily difficult for a vehicle to be certain it has met this requirement. As a practical matter, the vehicle would have to receive representations from all investors about their relationship to all those who were offered interests in the vehicle (which would be highly objectionable from a commercial standpoint), and the vehicle would remain at risk of the incorrectness of any representations received.

Requirement B

Requirement B is problematic in two respects. First, the requirement is satisfied only if the Securitization Vehicle is "required" to "liquidate" on or prior to a set date. In fact, most securitization vehicles are not required to liquidate but simply have a "legal final" maturity for all of the securities they issue, aside from de minimis shares of common equity held by an accommodation party (for non-tax reasons). Although such a securitization vehicle may be expected to (and routinely would) liquidate after all of its non-de minimis securities are paid off, it is not "required" to do so and will not satisfy this aspect of Requirement B.

Second, virtually no securitization vehicle will satisfy the requirement that its organizational documents may be amended only with the agreement of "all" of its investors. In general, typical documents will provide that agreement of all investors in any class of securities is necessary for specified material amendments that would adversely affect that class. Majority vote of one or more classes of interests typically is required for less material amendments. The "all investors" requirement appears to have two purposes. One is to provide some leniency for a securitization vehicle that has inherent difficulty in amending its organizational document and cannot reasonably be expected to make amendments that would permit it to register as a participating FFI and otherwise comply with FATCA's requirements to avoid withholding. Nonetheless, even though a securitization vehicle's organizational documents may permit certain amendments to be made with less than unanimous agreement among investors, it does not follow that amendments that would permit FATCA compliance could be made without approval of all investors. Moreover, even if amendments to permit FATCA compliance could be made without unanimous agreement, it is difficult to overestimate the practical difficulty in achieving any amendment to organizational documents due to widely experienced inattention to amendment requests on the part of investors.

The other apparent purpose of the "all investors" requirement is to prevent abuse of the granted ability to be treated as a certified deemed compliant. A securitization vehicle should not be able to enjoy grandfathering beyond the period in which the securitization vehicle is used for its originally intended, limited life, purpose. Amendments made to organizational documents that would extend the life of the securitization vehicle or permit a change to the nature of its investments, in either case a significant departure from its originally intended purpose, can act in effect to "recycle" a "used" securitization vehicle. Other kinds of amendments to organizational documents would not invoke the same kind of concern, however, and there should be no concern if such other changes are permitted without the agreement of all investors.

Accordingly, the "all the investors" requirement is both too broad and too narrow to achieve its intended purposes. It is too narrow because it becomes theoretically possible for all the investors to agree to allow the trustee to take the necessary steps to comply with FATCA or to extend the life of the vehicle and/or change its permitted investments, effectively allowing recycling of the securitization vehicle's preferential ability to be treated as a certified deemed compliant FFI. The rule also is too broad because typical organizational documents provide for many kinds of amendments that do not require consent of all the investors, which amendments would in no way imply the practical ability to take steps to comply with FATCA or to implicate the "recycling" concern.

Requirement C

Requirement C fails to capture the description of a typical securitization vehicle in several respects. First, in a number of cases where a sponsor "warehouses" assets prior to the formation and/or funding of the securitization vehicle, the contribution of the warehoused assets technically may occur in a transaction that is tax-free under Code section 351, rather than in a "purchase." Second, typical securitization vehicles will be permitted to dispose of their assets under limited circumstances, such as default or other credit impairment, and thus will not be required to hold those assets until their "termination."[7] Third, a Securitization Vehicle

[7] The parenthetical exception to the hold-until-termination requirement for "reinvestment only under prescribed circumstances" is not broad enough to allow a securitization vehicle to dispose of an asset and distribute, as opposed to reinvest, the proceeds, where the securitization vehicle is beyond the period in which it may reinvest.

frequently will be permitted to acquire assets other than indebtedness, such as swaps and equity interests (e.g., money market funds) which would not be permitted under Requirement C.

Requirement D

Senior classes of interests in securitization vehicles are almost always held by investors through established clearing organizations that we would expect either to be treated as U.S. financial institutions or participating FFIs. However, subordinated classes (i.e., those treated as equity for tax purposes) typically are created in certificated or physical form in order to monitor holdings of those classes by qualified plans (to avoid the so-called "plan asset" rules of ERISA). Payments on the certificated interests most typically would not be made by a "trustee" as required under Requirement D, but by a "paying agent" under a "fiscal agency agreement." There is no reason to distinguish between a paying agent and a trustee for this purpose, since both a trustee and a paying agent would have FATCA reporting and withholding responsibilities. We also note that it would be unusual for securitization vehicles that have de minimis equity interests to make payments, if any, to these equity interests through a clearing organization, fiscal agency agreement or other arrangement with a third party.

Requirement E

Similar to Requirement B, the purpose of Requirement E appears to be to identify securitization vehicles whose operative documents are too restrictive to expect the vehicle to be take measures to comply with FATCA. In practice, however, Requirement E is too narrow. A typical trust indenture for a Securitization Vehicle will contain a catch-all provision permitting the trustee to take necessary or appropriate actions consistent with the purposes of the trust indenture. Assuming that the correct interpretation of Requirement E is that the catch-all provision would not be considered to provide for "specifically designated" activities, such an indenture would not satisfy Requirement E. Moreover, even if such a catch-all were considered both to satisfy Requirement E and to permit the trustee to cause the securitization vehicle to undertake compliance with FATCA, it must be recognized that the indenture nonetheless will not *require* the trustee to take actions that are not specified in the indenture or directed by investors in a specified manner, and that it is not practical to expect the trustee to initiate measures for FATCA compliance on its own.[8] Finally, it is reasonable to expect that provisions not drafted with FATCA in mind may well be subject to varying interpretations, resulting in ambiguity or doubt about whether a trustee is authorized to take actions required for FATCA compliance. Under these circumstances a trustee cannot be expected to take action where the basis for its doing so in the trust indenture is not entirely clear and where taking action could expose the trustee to the risk of accusations of acting beyond its authority.

[8] Where investor direction of the trustee is possible, it is not reasonable to expect the conditions specified for investor direction to be met to permit investor direction of FATCA compliance, or for that matter if the conditions for investor direction theoretically could be met, that the necessary coordinated action of investors could be achieved.