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Derivatives Update: What You Should Know As We Enter 2017

This year has been full of surprises in the global markets with Brexit, the Republicans' win of the executive branch and continuing control of the legislative branch in the U.S. and the impact of the privatization of energy markets in Mexico. In this *GT Alert*, we are simply going to address two critical proposals and an update regarding Article 55 of the EU Bank Recovery and Resolution Directive (BRRD), which are material for the buy side and sell side. While there is a great deal of uncertainty surrounding EMIR and the UK, and the Dodd Frank Act and the President-elect Trump transition team, it is important to remain in compliance. The following will cover: The Proposed Modernization of Derivatives Act of 2016, the Proposed Regulation Automated Trading, and finally, Article 55 BRRD.

Part I - The Proposed Modernization of Derivatives Act of 2016

The Modernization of Derivatives Act of 2016 (MODA, or the Proposal) legislation recently proposed by Senator Ron Wyden (D, OR), would drastically change the way derivatives and "investment hedging units" (IHUs), as defined, are taxed. Although the bill is still only a proposal, it enjoys bipartisan and bicameral support, and could become law.

1. **Rules and Definitions**

In general terms, the Proposal does two things, *i.e.*, it requires taxpayers to mark positions in derivatives to market for tax purposes, and it requires taxpayers to mark positions in IHUs to market for tax purposes. Built-in gain or loss at year end would be taken into account in the current tax year and treated as ordinary gain or loss. A taxpayer is required to recognize any built-in gain (but not loss) with respect to an IHU when a position in an IHU is initiated, and gain and loss are taken into account when an IHU is adjusted or terminated.

Example 1: Taxpayer, an investment fund that is not a securities dealer, purchases a put option on 100 shares of ABC stock for $100 on Jan. 15, 2016. The option is worth $150 on Dec. 31, 2016. The taxpayer sells the option for $120 in March of 2017.

Under current law, the taxpayer would not recognize gain or loss with respect to the option in 2016. The taxpayer would recognize $20 of capital gain in 2017. Because the option was held for more than 1 year, this gain would be long-term capital gain, taxed at a top rate of 20 percent.

Under MODA, the taxpayer would recognize $50 of ordinary gain in 2016, and $30 of ordinary loss in 2017. Ordinary gain would be taxed at a top rate of 39.6 percent, and ordinary loss would reduce ordinary income in the applicable tax year.

Example 2: The facts are the same as in Example 1, except the taxpayer purchases 100 shares of ABC stock for $100 simultaneously with the put, and the put has a delta of .75. The stock and the put constitute an IHU. The stock is worth $33 on Dec. 31, 2016, and $73.33 in March of 2017. The taxpayer sells the stock and the put simultaneously.

Under current law, no gain or loss would be recognized in 2016. Assuming the positions are not part of a larger straddle, the taxpayer would recognize a net capital loss of $6.67 in 2017.

Under MODA, the taxpayer would have a net capital loss of $17 in 2016, and net ordinary gain of $10.33 in 2017.

a. Definitions

i. **Derivative –** For purposes of MODA, a derivative is defined as "[A]ny contract (including any option, forward contract, futures contract, short position, swap, or similar contract) the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following:

1. Any share of stock in a corporation;
2. Any partnership or beneficial ownership interest in a partnership or trust;
3. Any evidence of indebtedness;
4. Any real property;
5. Any commodity that is actively traded (within the meaning of section 1092(d)(1);
6. Any currency;
7. Any rate, price, amount, index, formula, or algorithm; or,
8. Any other item as the secretary may provide.

ii. **Underlying Investment** – Items 1-8 listed above may constitute an underlying investment with respect to any derivative. For example, euros constitute an underlying investment with respect to a forward contract in euros, and shares of ABC stock constitute an underlying investment with respect to an option to purchase shares in ABC stock.

Because a derivative is any contract whose value is determined "directly or indirectly" with respect to any underlying investment, it may be unclear in certain instances whether an item is an underlying investment with respect to a contract. No guidance has been issued on point, but drafters of the proposal have stated that they favor a broad interpretation of the term.

Example 3: A taxpayer purchases a forward contract on an ETF that references shares in gold mining companies. The value of the forward contract has a correlation coefficient of .9 with the value of spot gold.

Shares in the ETF are clearly an underlying investment with respect to the forward contract. It is unclear whether (i) a basket of shares comprising the ETF's portfolio, or (ii) a position in spot gold, or gold futures, would be an underlying investment with respect to the forward contract. A broad reading of the definitions of "derivative" and "underlying investment" would favor this approach.

iii. **IHU –** An investment hedging unit held by a taxpayer consists of each derivative with respect to an underlying investment that by itself, or in combination with one or more other derivatives, has a delta with respect to the underlying investment equal to or greater than 0.7. For these purposes, "delta" means, with respect to any derivative and any underlying investment, the ratio of expected change in the fair market value of the derivative per unit of change in the fair market value of the underlying derivative. For the sake of administrative simplicity, a taxpayer may also elect to treat all derivatives with respect to an underlying investment, and all positions in the underlying investment, as a single investment hedging unit without regard to the delta thereof.

b. **Exceptions –** Several types of transactions are excluded from the definition of derivative. These include physically settled derivatives on real estate, securities loans and repos (to the extent mandated by the Service), compensatory options, insurance contracts and annuities, derivatives on affiliate stock, physically-delivered derivatives on commodities entered into in the ordinary course of the taxpayer's trade or business, or ADRs.

2. **Potential Problems and Traps for the Unwary –** Ambiguities and potential problems include the following:

a. **Definition of "Derivative" and "Underlying Investment."** As discussed above, it is unclear how broad the definition of "underlying investment" is meant to be. Clarification as to whether mere correlation may qualify an asset as an underlying investment with respect to a derivative, or whether the derivative must directly reference an asset for it to constitute an underlying investment, would be useful.

b. **Speculative Cash Positions Not Marked to Market.** Cash positions that are not part of an IHU are not marked to market under the Proposal. This leads to the anomalous result that economically equivalent transactions (say, a forward contract on the S&P 500 index and shares of an ETF that references the same index) could be subject to disparate tax treatment.

c. **Derivatives with Nonpublicly Traded Underliers.** The Proposal requires that derivatives on nonpublicly traded derivatives be marked to market. This could create valuation problems for individual investors who would not receive broker statements regarding these assets, and who do not produce financial statements.

d. **Two Percent Floor.** As currently drafted, the Proposal would treat loss on derivatives and underlying investments as miscellaneous itemized deductions, subject to a "floor" equal to 2 percent of adjusted gross income in the case of individual taxpayers. This is a seemingly unjust result – if taxpayers are required to recognize gain and loss on these positions as ordinary income, they should be permitted to fully utilize any loss to offset other gain or income.

e. Securities Lending and Repos. As currently drafted, the Proposal treats securities lending transactions and repos as derivatives, but delegates authority to the Service to issue regulations. Although regulations excluding securities loans and repos from the scope of the definition of "derivative" would be welcome, a legislative exclusion would likely be better, in order to ensure that similar positions are similarly taxed.

f. **Gain (but not Loss) Recognition.** As discussed above, a taxpayer is required to recognize built-in gain (but not built-in loss) with respect to a component of an IHU when the IHU is initiated. Deferral of loss does not make sense if the loss position is a derivative – which would be marked to market at year end regardless, if the taxpayer continued to hold it outside of an IHU.

Part II - Reg AT Past, Present, and Future

One year ago this month, the CFTC unanimously proposed Regulation Automated Trading (AT). The proposed rule consisted of various risk controls, data collection, transparency, and other measures intended to improve the CFTC's information gathering and oversight of trading in commodity futures and options, swaps, and derivatives conducted by automated electronic systems.

Among other things, the proposed rule would create a new category of market participants defined as "AT Persons." Although the rule contained a number of other provisions, it was the requirement that AT Persons not otherwise registered would be required to register with the CFTC and become NFA members that generated the greatest industry response. In particular, there is great concern about the requirement that proprietary traders engaged in algorithmic trading through direct electronic access to a designated contract market (DCM) would be required to file a copy of the source code for their trading algorithms with the CFTC.

In response to comments filed with CFTC, on Nov. 4 the CFTC issued a supplemental notice of proposed rulemaking containing various amendments to the rule proposed one year ago. Among other things, the new proposal sought to reduce the number of firms subject to the source code filing requirement, establish a way for third party software developers to satisfy certain of the AT Persons requirements, and created a process for the CFTC to obtain source code information without issuing a subpoena. The original proposal would have required registrants to file copies of source code with a repository accessible to the CFTC and this has been removed in the revised proposal.

The revised rule can be grouped broadly into four major areas: (i) risk controls; (ii) revised AT Person definition; (iii) trading source code; and (iv) reporting.

I. Risk Controls

Pre- and post-trade risk controls would be established at two levels: the DCM on which the instrument is traded, and either the futures commission merchant (FCM) carrying the account or the AT Person for whom the trade is entered. Risk controls must be maintained by the AT Person unless the FCM agrees to accept this responsibility. In addition, CFTC's revised proposed rule would subject all electronic trading to CFTC's control and not only trading that qualifies as algorithmic trading.

II. AT Person

The definition of an AT Person would include proprietary traders not otherwise registered that trade 20,000 or more contracts across all markets on an average daily basis during the preceding six months. Traded contracts only include completed transactions and not unexecuted bids or offers. Any person who trades on both a proprietary and customer basis would be required to aggregate trading volume for both categories across all products on all electronic trading facilities.

III. Trading Source Code

The CFTC originally proposed establishing a special repository into which AT Persons would be required to maintain their algorithmic trading source code. The revised proposal eliminated the repository and instead would require AT Persons to provide a copy of the source code directly to the CFTC upon request. CFTC defines algorithmic trading source code very broadly to include, at a minimum, computer code, embedded logic, scripts, parameters entered into an algorithmic trading system, formulas, and configuration files.

IV. Reporting

Under the revised proposal, the chief compliance officer or chief executive officer of AT Persons and FCMs would be required to provide each DCM on which they trade an annual certification. The certification would cover requirements applicable to the category of filer, *e.g.*, compliance with pre-trade risk controls and algorithmic trading system development and monitoring for AT Persons, and compliance with risk management provisions for FCMs. Each DCM receiving this information could in turn be required to periodically review and evaluate the certifications.

Although industry response to the initial proposal largely focused on the source code issue, two broader aspects of both the original and revised proposals are the scope of registration and due process considerations. Persons who trade for their own account off the exchange floor have been traditionally exempt from registration, provided they were not acting on behalf of customers or managing third party money. Floor traders were required to be registered, on the theory that they enjoyed a special position vis-à-vis access to information and the ability to react rapidly by virtue of being on the exchange floor. For the first time, the CFTC now proposes to use the level of electronic trading as a proxy to justify requiring larger traders to register. Interestingly, the CFTC chose to categorize such persons as floor brokers and not floor traders for registration. It is at least arguable whether high-volume electronic traders have a unique position equivalent to being on an exchange floor that warrants registration. What was previously regulated as a difference in kind has been replaced by a difference in degree.

The proposed inspection authority over trading source code raises other issues. Although the CFTC already had authority to issue subpoenas without court order when conducting investigations, subpoenas are subject to certain due process safeguards including judicial review. It is not clear why the CFTC believes it is necessary or appropriate to bypass this avenue and require production of source code without procedural safeguards, nor is it clear why the CFTC initially proposed creating a data repository. The CFTC could have included source code in the books and records provisions of Regulation 1.31, and thereby compel such information to be turned over to the CFTC or the Department of Justice upon request without creating a new procedure.

Whatever the fate of Regulation AT, the CFTC is viewing this area as a work in process. In the revised Nov. 4 proposal, the CFTC indicated that it plans to consider a "second phase of rules" at a later time. These include greater transparency in electronic matching platforms and tools to prevent order matching by participants. The CFTC also intimated that it might make certain other changes to the rule as first proposed, such as eliminating non-compliance with an AT Person's internal rules from the definition of "algorithmic trading compliance issue," and that the CFTC believes it can undertake such changes without additional rule submissions.

Whether through Regulation AT (in whatever form) or some other statutory or regulatory initiative, it seems clear that traders using electronic systems should be prepared for greater oversight and monitoring of their trading activities.

Part III - Article 55 BRRD

The European Bank Recovery and Resolution Directive (BRRD) is the European Union's (EU) implementation of the Financial Stability Board's Key Attributes on Effective Resolution Regimes for Financial Institutions. The directive is aimed at minimizing the systemic risk of another large institution's insolvency and the effect on the European economy and its taxpayers. The implementation date for EU member states was Jan. 1, 2015 (with the exception of the part on the bail-in resolution tool, which entered into force on Jan. 1, 2016). The BRRD has been fully implemented in most EU member

states and mostly implemented in a few other EU member states. Following slow implementation in some Member States which had created uncertainty for market participants, the European Commission had taken legal action against six member states in October 2015. Timing of implementation for the member states of the European Economic Area (Iceland, Liechtenstein, Norway and Switzerland) still requires further formal steps, although Switzerland has already introduced a regime with similar characteristics to BRRD.

In order to comply with Article 55 of the BRRD, if an EU investment bank or firm has contractual liability where the contract is not governed by the laws of an EU member state, and the counterparty is not an EU investment bank or firm, the non-EU entities must contractually agree that such contractual liability may be subject to the exercise of write-down and conversion powers (bail-in) under the BRRD and the non-EU party must agree to be bound by any such bail-in, provided that such liability is not an excluded liability.

The European Banking Authority has published final draft standards under Article 55 listing the requirements of contractual recognition provisions, including express acknowledgment, agreement, and consent by a counterparty that an EU financial institutions' liability to it may be subject to the exercise of write-down and conversion powers by the relevant resolution authority, together with a description of those powers as set out in national law and the potential effects in terms of liability under the agreement. Various bodies have considered the contents of standard contractual recognition terms relating to different areas of application. With respect to derivatives, there are essentially two ways to implement BRRD, which is the addition of a Bail-in Recognition Clause (BRRD Clause) in light of Article 55 of the BRRD or by protocol. The International Swaps and Derivatives Association, Inc. (ISDA) published the ISDA 2016 Bail-in Article 55 BRRD Protocol (Dutch/French/German/Irish/Italian/Luxembourg/Spanish/UK entity-in-resolution version) (ISDA Bail-in Protocol).

The ISDA Bail-in Protocol offers market participants an efficient way to amend the terms of certain ISDA Master Agreements and certain other master agreements, framework agreements, and give-up and execution agreements (as further described in the ISDA Bail-in Protocol) to reflect the requirements of Article 55 of the BRRD as implemented in the relevant jurisdiction, but this approach eliminates all Non-EU Entities' rights to narrow the scope of the recognition. All parties should note that any time an amendment to an existing "covered agreement" executed prior to January 1, 2016 takes place, this would likely trigger the need to incorporate the recognition clause.

Note that the decision to proceed with a transaction where the documentation addresses the Article 55 BRRD requirements must be addressed on a case-by-case basis. Depending on your deal, the inclusion may pose limited liability risk in contrast to the lost opportunity of the deal or inability to transfer your exposure freely.

In any matter involving BRRD exposure, please consider the following:

1) BRRD covers all contractual liabilities with a number of narrow exemptions for items such as insured deposits, secured liabilities, employment contracts (except variable remuneration such as bonuses), certain liabilities to commercial trade creditors, tax and social services liabilities and liabilities in relation to depositor protection schemes;
2) BRRD requires all EU financial institutions and banks to amend all of their non-EU law governed contracts that subject them to liability risk. Parties to the contract must agree to contractually accept BRRD which alleviates the risk that the non-EU entities will seek to enforce their rights under the contract against the EU financial institution or investment firm;
3) BRRD allows the EU regulators to "step into" a deal/contract if the EU financial institution or bank is approaching insolvency, and the EU regulators may put a "stay" on the other parties' early termination rights, write-down liabilities, or convert the liabilities into equity which may very well be common stock of the same EU bank or financial institution (bail-in tool);
4) BRRD requires that if EU banks or financial institutions amend an outstanding deal after Jan. 1, 2016 (BRRD effective date), they have to use this opportunity to add the Bail-In recognition clause. You should note that a contract that is outstanding but has a new liability develop post Jan. 1, 2016 may fall under BRRD. To the extent that any outstanding deal is materially amended, it too will have to include the Bail-In Recognition Clause. Note that "materially" amended is broadly drafted;

5) It is unclear whether the US will opine on this rule and how it can or will be enforced in US courts. The US and EU have historically battled over which jurisdiction's rules govern on cross border deals and have a different perspective on another potential bail-out evident in the US' bail out rule;
6) For ISDAs with covenants, representations and warranties that would be interpreted to create contractual liabilities for the EU bank or investment firm, you will likely be asked to amend the documentation to add the Bail-In Recognition Clause. Furthermore, if the ISDA or trade confirm has assignment or transfer rights, the transferee may require this language if they are an EU bank or investment firm. The potential risk of not including this language is that if the EU regulators fine the EU bank or investment firm, they may want to "pass through" these charges to their non-compliant counterparties; and
7) The contractual liability covered by BRRD would include any letters of credit, guarantees, clearing, and settlement agreements.

When considering how to proceed given the aforementioned, Non-EU entities should note a few things about the current state of BRRD: a) Several Delegated Regulations entered into force in the last few months; b) talk to your counterparty about adding certain economic terms that provide for early termination or a most favored nations clause if you are required to add this Bail-in Recognition Clause; c) discuss mitigation obligations and procedures with your counterparty; d) coordinate with your counsel on any US opinions or guidance on BRRD enforceability; e) remember that adhering to BRRD does not guarantee that the EU Regulators will actually bail-in the EU institution; f) your ISDA may or may not be terminated if you refuse to add the Bail-in Recognition Clause; g) it is the EU bank or investment firm that may be charged the fine or lose certain licenses; and h) from a pricing perspective, legal and trading must have a meeting of the minds since non-EU entities rightfully believe that BRRD puts them in a position where they are taking on sizable risk and such risk should be reflected in price adjustments.

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