

**New York State Bar Association
Tax Section**

Report on Credit Default Swaps

September 9, 2005

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NEW YORK STATE BAR ASSOCIATION TAX SECTION

Report on Credit Default Swaps^{*}**I. Introduction.****A. Overview.**

This report responds to a request for comments on the taxation of credit default swaps (“CDS”) made in Notice 2004-52.¹ The Notice requests comments on, among other things, CDS contractual terms, CDS pricing and price dissemination, CDS hedging practices, and the regulatory capital and GAAP treatment of CDS. The Notice also requests any other comments market participants may have. This report responds to the request for factual information and then urges the Treasury Department and Internal Revenue Service (the “Service”) to issue guidance addressing the U.S. federal income taxation of CDS.

As discussed in more detail below, there are two broad tax issues raised by CDS. The first is how to determine when a CDS may appropriately be taxed as a derivative financial instrument, as compared to possible taxation under the rules applicable to traditional forms of credit protection, most notably insurance. The second is how those instruments that qualify as derivative financial instruments should be taxed. We recommend that the Treasury Department and the Service issue guidance that addresses both of these questions. The need for guidance is most pressing with respect to cross-border transactions, because of the deal-breaking effect of the application of withholding tax or U.S. net-basis income tax to payments made to foreign persons.

Section I.B of the Report sets out our recommendations.

The next few parts of the Report discuss various aspects of the market for CDS. Because CDS are a relatively new financial instrument and the CDS market has been changing rapidly, the Report attempts to provide a description that is reasonably comprehensive in its breadth, accompanied by citations to references to additional materials that provide more detail. The descriptions in Parts II through IV are taken primarily from materials that are publicly available, rather than from the experience of the members of the Tax Section that participated in this Report (although it is not inconsistent with that experience). Accordingly, the Report responds to the Notice’s questions about market practice with publicly available information based on a range of standard terms and practices. Market participants are better suited to provide information about highly negotiated or tailored transactions. A bibliography of useful references is attached as an appendix.

* The principal author of this report is Erika W. Nijenhuis. Substantial comments were provided by David P. Hariton, David S. Miller and W. Kirk Wallace. Helpful comments also were received from Kimberly S. Blanchard, Micah Bloomfield, Dickson G. Brown, Robert Cassanos, Linda E. Carlisle, Samuel J. Dimon, Stephen B. Land, Charles Morgan, Yaron Z. Reich, Michael L. Schler, and Andrew P. Solomon. Very helpful materials and information also were provided by some market participants and in-house lawyers at a number of banks and investment banks.

¹ Notice 2004-52, Request for Information about Credit Default Swaps, 2004-32 I.R.B. 168.

Part II of the Report provides an overview of common types and uses of CDS. It includes a discussion of (a) single-name CDS, which are the most common form of CDS, (b) the role of CDS in collateralized debt obligation transactions, (c) several types of CDS on portfolios of debt securities, many of which pass through only part of the risk of the portfolio, and (d) CDS on indices, a relatively new and increasingly popular form of CDS.

Part III of the Report then describes other, more traditional forms of credit protection – letters of credit, guarantees and insurance. This Part of the Report focuses primarily on financial guarantee insurance, because the term “insurance” can be read broadly for U.S. federal income tax purposes, because there is an active market for financial guarantee insurance, because insurance companies are significant participants in the CDS market and because there are Congressionally-mandated rules addressing the tax treatment of insurance.

Part IV of the Report describes the principal participants in the CDS market – banks, insurance companies, securities dealers and hedge funds – and the regulatory framework, if any, that governs these parties insofar as it relates to CDS. Part IV also briefly describes the accounting rules that apply to CDS.

Part V of the Report addresses the U.S. federal income tax issues relating to CDS. It is divided into three parts. The first summarizes the consequences of various possible characterizations of CDS. The second discusses the policy and technical issues applicable to distinguishing between credit protection instruments that should be taxed as derivative financial instruments, and those that may be taxed as insurance, including trade or business and sourcing considerations. The last section addresses timing and character issues relevant to those CDS that are taxed as derivative financial instruments.

B. *Recommendations.*

1. Any guidance that is issued should either directly or by analogy characterize a conventional CDS for U.S. federal income tax purposes as a type of financial instrument for which there is a well-developed body of law, such as a notional principal contract, or indicate that a conventional CDS will be taxed under the rules applicable to such an instrument absent further guidance.

2. Specifically, guidance should provide a safe harbor under which a conventional single-name or portfolio CDS is treated as a derivative financial instrument – rather than as an insurance policy, guarantee, letter of credit or similar contract – subject to the condition discussed in #4 below (such a CDS, a “qualifying CDS”). For this purpose, we recommend that a qualifying CDS be defined as a contract

- a) that transfers credit risk with respect to debt instruments of one or more reference entities between parties not related to each other or to the reference entity(ies);
- b) that is documented using ISDA standardized documentation;
- c) under which the protection buyer makes one or more payments to the protection seller based on a specified notional principal amount;

- d) under which the protection seller in turn agrees that in the case of a standard ISDA credit event with respect to a reference name the protection buyer may require cash or physical settlement terminating exposure to that reference entity, based on one of multiple potential obligations of that reference entity selected by the protection buyer in a manner determined under standard ISDA rules, and that does not provide for other payments; and
- e) that states that the protection buyer is not required to have suffered a loss on, or to have owned, the reference obligations at any time in order to receive payment.

3. The premise of the recommendation above is that it is possible to identify a class of CDS that should not be taxed as an insurance policy, guarantee, letter of credit or similar contract. There should be no implication that CDS other than qualifying CDS are properly taxed as an insurance policy, guarantee, letter of credit or similar contract.

4. A CDS should be outside the safe harbor if the reference obligation is the only available measure of settlement value and is effectively immobilized in the hands of, or for the benefit of, one of the parties. This exclusion is intended to address situations where the “insurable interest” test discussed in the text below is in substance met because the nature of the transaction is such that the protection buyer must hold a particular underlying obligation for the duration of the transaction and there is no practical alternative to using that obligation as the deliverable or valuation obligation under the CDS.

5. Either presumptions or factors should be provided for assessing whether CDS other than qualifying CDS should be excluded from insurance, guarantee or similar treatment and should be treated as derivative financial instruments. Such presumptions or factors should include, as determinative or highly probative indications, (a) the lack of an insurable interest and (b) the lack of risk distribution.

6. In determining whether a taxpayer that engages in transactions in CDS treated as derivative financial instruments is engaged in the conduct of a trade or business within the United States, the regulations and proposed regulations under section 864 applicable to securities and derivative transactions should apply.²

7. The source of income and expense from CDS treated as derivative financial instruments should be determined under the sourcing rules applicable to notional principal contracts. Under those rules, a payment made under such a CDS by a U.S. person to a foreign person generally would not be subject to U.S. withholding tax.

8. CDS treated as derivative financial instruments should be treated as swaps qualifying as notional principal contracts rather than as options. The definition of notional principal contract should be modified to the extent necessary. The proposed regulations on

² All sections cited herein are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations promulgated or proposed thereunder.

notional principal contracts with contingent nonperiodic payments should be modified to provide that CDS treated as derivative financial instruments are outside their scope.

Accordingly, the timing rules for taxing such CDS should provide that (a) periodic payments are taken into account on a current basis, under the rules of Treasury regulation section 1.446-3(e) for periodic payments, (b) an initial lump-sum payment made in lieu of such periodic payments should be taken into account over the term of the CDS, under the rules of Treasury regulation section 1.446-3(f) for nonperiodic payments, and (c) no current accrual should be required for potential settlement payments.

9. We recommend that the anti-abuse rule of Treasury regulation section 1.446-3(g)(2) be expanded or clarified to address transactions involving non-“related party” pass-through entities and to address transactions where there is a lack of correspondence between nominal and actual risks taken on by parties to a CDS. In addition, we recommend that the anti-abuse rule of Treasury regulation section 1.446-3(i) be supplemented with an example addressing certain CDS as to which the risk of a deferred settlement payment is high. A significant minority of our members believe more generally that the timing rule described in recommendation #8 should not apply to CDS as to which the risk of a settlement payment is high.

10. There is a compelling case for treating settlement payments on CDS treated as derivative financial instruments as giving rise to capital gain or loss. We reluctantly conclude, however, that if the Service continues to take the position that payments on other notional principal contracts determined by reference to the change in value of a capital asset constitute ordinary income or expense, it is preferable for such CDS to be subject to the same rules as other notional principal contracts rather than to a special regime of their own.

II. Description of Types of CDS.

A. *Growth of the CDS Market.*

A CDS is one type of credit derivative. Trillions of dollars of notional principal amount of credit derivatives are now outstanding, with CDS representing the single largest component of the market. The market for credit derivatives generally, and CDS in particular, have been growing at an extremely rapid pace. For example, one authoritative survey concluded that outstanding single-name CDS doubled over the one-year period ending September 2004. Another survey concluded that credit derivatives have grown six-fold over a three-year period ending June 2004. It appears likely that this rapid pace of growth will continue for some time.³

This growth in volume has been accompanied by a growth in the types of transactions in which credit derivatives play an essential part. As the market has developed, there has on the one hand been increasing standardization of transactions of a kind that are widely used. There also is on the other hand on-going development of different types of credit

³ For current survey information, see the BIS 2004 Survey, BIS 2004 Update Survey, Fitch 2004 Survey and ISDA 2004 Mid-Market Survey cited in the attached Bibliography. For a comparison of data sources on credit derivatives, see the BIS 2002 Review, page 38.

derivatives to serve different purposes and different market participants. The principal markets for credit derivatives are based in London and New York, but parties to credit derivatives are located in many different jurisdictions.

B. *Single-Name CDS.*

1. Description. A conventional single-name CDS is a financial contract to transfer credit risk with respect to debt instruments, such as bonds or loans, of a single named issuer (the “reference entity”) for a five-year term. A typical CDS is documented using the standardized documentation for derivatives transactions developed by the International Swaps and Derivatives Association (“ISDA”).

The parties to the contract are referred to as the “protection buyer” and the “protection seller.” The contract frequently but not invariably refers to a specific senior debt instrument (the “reference obligation”) of the reference entity.⁴ The protection buyer makes one or more payments to the protection seller based on a specified notional principal amount. Often but not invariably the payments take the form of a stream of periodic payments in a fixed amount, generally referred to as fixed or “premium” payments.

The protection seller in turn agrees that in the case of a default on the reference obligation, or in the case of other specified credit events indicating a decline in the creditworthiness of the reference entity, it will buy from the protection buyer an obligation of the reference entity for its face value (“physical settlement,” by delivery of a “deliverable obligation”) or will make a cash payment to the protection buyer in an amount that represents the decline from par in the fair market value of such an obligation as a result of the credit event (“cash settlement,” by reference to the value of a “valuation obligation”).⁵ The protection buyer is not required to have suffered a loss on, or to have owned, the reference obligation at any time in order to receive payment. In the case of cash settlement, a valuation obligation’s fair market value is determined through bids from dealers in that obligation under standard procedures. The notional amount for a conventional CDS has been described by different commentators as either in the \$5 to \$20 million or the \$20 million to \$50 million range for CDS on investment-grade reference entities.

One important aspect of the settlement provisions for a conventional single-name CDS is that the protection buyer may designate any obligation of the reference entity for delivery or valuation that meets specified criteria, for example, any senior, major currency-denominated, non-contingent, non-bearer, transferable bond or loan of the reference entity with a term no longer than 30 years. The protection buyer’s right to select any qualifying debt obligation of the

⁴ An electronic data vendor active in the CDS market offers a standardized list of reference obligations for more than 2000 reference entities. *See* Markit RED, described at www.markit.com.

⁵ More technically, the determination of whether a credit event has taken place is determined by reference to any “Obligation” of the reference entity, which term includes but need not be limited to the reference obligation. ISDA documentation permits the parties to specify an Obligation as any of the following types of obligations: (i) bond, (ii) loan, (iii) borrowed money, (iv) payment obligation, (v) bond or loan, or (vi) reference obligation only. Thus, if “bond” is specified, a failure to pay only on a reference entity’s loans will not trigger a credit event under the CDS. An Obligation may include obligations guaranteed by the reference entity. In the North American market, the typical choice for Obligation is borrowed money.

reference entity – rather than solely the reference obligation – sometimes is referred to as the “cheapest-to-deliver option,” because the protection buyer is free to select the debt instrument that is trading at the lowest price. That option has a value to protection buyers, and a corresponding cost to protection sellers, because it permits a protection buyer to recover the maximum possible amount under the CDS under circumstances where different obligations of a reference entity are trading at different prices.

There are a number of common variations in the terms of conventional CDS, depending on a number of factors including the nature of the reference entity and the local CDS market. Such variations include:

- The list of credit events. Standard ISDA credit events include Bankruptcy and Failure to Pay. The principal variation in the market relates to Restructuring, which may or may not be included and as described below may take different forms. Standard ISDA forms of confirmation for CDS provide that Repudiation/Moratorium (for sovereign reference entities) rather than Bankruptcy may be used for sovereigns in certain geographic areas and not for others.⁶
- The definition of Restructuring. A Restructuring includes events such as a reduction or deferral of payments that results from an issuer’s weakened financial condition. The ISDA Credit Definitions provide three different definitions for Restructurings, reflecting developments in the markets over time. Standard ISDA forms of confirmation for CDS provide that different definitions apply depending on whether the transaction is European, North American or Asia-Pacific.
- Physical vs. cash settlement. One recent survey reports that more than three-fourths of credit derivatives settle through physical settlement.⁷ While we have not found statistical information specifically with respect to single-name CDS, it appears likely that a high proportion of conventional single-name CDS use physical settlement, except when entered into by CDO issuers (described below) for whom market convention is cash settlement. Physical settlement appears to be favored because of concerns about the timing of cash settlement and the manner in which a cash settlement amount is determined, as discussed in more detail under Section II.B.3(e), below.

2. The Notice’s Questions on CDS Contractual Terms. The Notice requests information on CDS contractual terms, both standard and negotiated, particularly with respect to credit events, subrogation rights, security interests in collateral, and collateralization requirements in general. Standard credit events are described above. Conventional CDS do not include subrogation rights. Rather, as described above, they provide for either physical or cash

⁶ Repudiation/Moratorium may also be used for emerging market corporate reference entities. Other credit events that may be, but generally are not, included are Obligation Acceleration and Obligation Default. Obligation Default refers to a non-payment default on an obligation, for example as a result of a violation of a covenant. Obligation Acceleration refers to an acceleration of an obligation triggered by a non-payment default.

⁷ BBA 2003/2004 Executive Summary.

settlement, each of which has characteristics that are different from subrogation. This issue is discussed further under Section III.C.2, below.

Conventional collateralization arrangements broadly fall into two types. First, CDS may be subject to the same kinds of collateralization requirements that apply to other types of derivative financial instruments, often but not invariably documented under the ISDA Credit Support Annex. Generally, collateral may be required from one or both parties when the fair market value of the other party's aggregate exposure under all of the transactions documented under the same master agreement and nettable in bankruptcy exceeds a specified limit. Permissible collateral ordinarily consists of cash or government (or agency) securities, which ordinarily may be rehypothecated by the secured party. ISDA provides a standardized list of and definitions for the most common forms of such collateral.

An alternative arrangement is one in which 100 percent collateral is provided by the protection seller initially and throughout the term of the CDS. Such a transaction may be one where the protection buyer is not otherwise willing to take the risk that the protection seller may be unable to perform. A CDO issuer (described below) may be required to set aside or post such collateral, for example.

A very different type of 100 percent collateralized transaction is a synthetic credit-linked note ("CLN") – that is, a security the payments on which are linked to the performance of a reference entity's debt. CLNs may be structured in a variety of ways. One straightforward structure is for a creditworthy financial institution to issue a legal-form debt obligation that pays coupons that reflect the assumption by the investor of credit risk of the reference entity, and that reduces the principal owed to the investor if there is a credit event with respect to that reference entity. For balance sheet and other reasons, however, it is more common to see a structure in which a special purpose vehicle issues a note or other security to an investor, enters into a CDS as protection seller and acquires highly-rated assets with the investor's cash that are then pledged as collateral to the protection buyer. This structure is described in more detail in Section II.B.3(e), below.

3. Common Purposes for Entering into CDS. Market participants report a variety of reasons for entering into credit derivatives.⁸ Different sources categorize those reasons differently. The most common reasons given are summarized below. As discussed in more detail below, different types of market participants weight some purposes more heavily than others. There may also be wide variations within any one type of market participant.

(a) Management of individual capital lines. Certain market participants, like commercial banks, regularly extend credit to individual borrowers in the form of loans and loan commitments. Traditionally, banks could shift some of the credit risk on funded loans to others through the form of loan assignments or participations. Both of those techniques have the effect of transferring all risk with respect to the loan and thus are somewhat blunt techniques for managing pure credit risk. That is, a loan may be decomposed into several types of risk components: (i) an advance of funds that earns a return at the risk-free rate, which

⁸ See Fitch 2004 Survey, Fitch Sept. 2003 Report and FSA 2002 report. The surveys cited herein do not always distinguish between CDS and other credit derivatives.

compensates the bank for the cost of money and for inflation, (ii) if the loan is a fixed rate loan (or a loan with a floating rate different from the rate at which the bank raises money), interest rate risk, and (iii) credit risk, for which the bank receives a credit spread that is usually quoted as a spread over a Treasury bond with the most relevant maturity (that is, as a spread over the risk-free rate). A loan assignment or participation does not permit the bank to transfer to third parties the last of these risks without transferring the first two risks as well. Loan assignments also may interfere with a bank's relationship with its borrowers, both because the borrower is aware of an assignment and may draw negative inferences about the bank's commitment to the borrower, and because borrowers may prefer to limit the number of lenders holding their loans to a small group of creditors with on-going relationships with the borrower, who can be expected to be more willing to work things out with the borrower in the case of financial difficulties. Loan assignments and participations also do not permit a bank to shift the risk of unfunded loan commitments such as the undrawn portion of a revolving credit facility.

Credit derivatives provide an alternative and far more precise means for a bank or other holder of a loan or loan commitment to manage credit risk. They may be used to separate the credit risk of such transactions to the extent that the risk exceeds internal ceilings for credit exposure to individual names from the customer relationship, by transferring that risk to other parties in exchange for a premium that can be thought of as stripping out the credit spread on the loan.⁹ In bank regulatory parlance, such transactions fall within the "banking book" (as opposed to the "trading book").¹⁰

Banks (in their trading book) and other derivatives dealers also take on credit risk to customers through their derivatives dealing activities. Other market participants may take on credit risk through other ordinary course transactions, such as holding receivables derived from the sale of goods and services. Credit derivatives can be used to manage these credit risks as well.

It should be noted that while CDS may be the best means currently available for a bank or other market participant to hedge credit risk, they are not perfect hedges. That is true for a number of reasons, including (i) the limited types of events generally treated as credit events and in particular the on-going divergences in different markets in the use of one or another of the Restructuring credit event definitions, (ii) the standardized maturity of conventional CDS, which may or may not match the maturity of the particular extensions of credit on a bank's book, (iii) the standardized terms for deliverable or valuation obligations, which may refer to bonds, loans or senior debt obligations but do not include other banking products that give rise to credit risk, such as revolving credit facilities or letters of credit, or to non-banking exposures such as derivatives exposure or trade receivables, and (iv) the fact that the bank is taking on credit

⁹ See Fed 2003 Loan Survey (most commonly reason cited by banks surveyed for buying credit protection on bank loans is that CDS is superior to selling a loan because it preserves the bank's relationship with the borrower).

¹⁰ A trading book is defined for bank regulatory purposes as positions in financial instruments that must either be free of any restrictive covenants on their tradability or able to be hedged completely. Positions should be frequently and accurately valued and the portfolio should be actively managed. Positions held with trading intent are those held intentionally for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits. Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* Part II, Section VI.A, paragraphs 685-87 (June 2004).

exposure to the CDS counterparty (a point of particular interest to bank regulators, as discussed in Section IV.A.2, below).

(b) Regulatory capital management. Regulated entities such as commercial banks, investment banks and insurance companies are required by their regulators to set aside capital against the risk positions on their books, in order to protect depositors, customers and policyholders. While the regulatory rules governing credit derivatives are still developing, existing rules generally permit such entities to reduce the amount of regulatory capital they must set aside to the extent they hedge their positions with credit derivatives. Different regulatory rules for different kinds of financial institutions (notably, banks vs. insurance companies) also have led to transfers of risk between those sectors in order to shift risk to the institution that can bear it with the least capital charge. The applicable regulatory rules are discussed in more detail in Sections IV.A.2 and V.B.4, below.

(c) Economic capital management. Both regulated and unregulated entities that regularly engage in financial transactions have internal models for evaluating and setting limits on the amount of risk that they take. These models are used for a variety of critical business purposes, including setting limits on the amount of risk that a particular business group (“desk”) may take on, monitoring a firm’s overall risk exposures, allocating a firm’s capital in the most efficient manner, and reducing the volatility of operating results. Major banks and securities firms invest very substantial amounts in modeling different kinds of risk, such as market risk (including changes in credit spreads), credit risk, operational risk, and a long list of other types of risk. Multiple models are used in order to measure different types of risks, for example expected versus unexpected losses, or behavior in normal versus abnormal markets, or risk/reward over different time horizons. These internal models often give rise to results that differ from regulatory capital models. Firms consequently must set aside capital based on the greater of their regulatory capital and their economic capital requirements.

To give one example, one means of limiting risk exposures is to require an allocation of capital to risk positions, in amounts determined under that entity’s proprietary risk management models. An entity’s internal guidelines thus may limit the amount of exposure to a particular sector of the economy, or to issuers with specified credit ratings. By shifting credit risk to others, credit derivatives permit such entities to reduce the economic capital that they allocate to credit exposures taken on.

(d) Trading/Arbitrage transactions. Hedge funds and other market participants use credit derivatives as part of arbitrage transactions to short risk synthetically, and/or to unbundle the risks of financial instruments they have acquired in order to isolate the risks they wish to take. For example, market participants regularly sell credit protection under CDS as a way of “shorting” the credit risk of a particular reference entity under circumstances where doing so is easier than engaging in a traditional short sale of the entity’s debt. Such transactions may include ones where a hedge fund wishes to be “long” one part of the credit profile of an issuer and to be short another (*e.g.*, long equity, short debt, or the reverse).¹¹ They

¹¹ Recent events relating to the downgrade in General Motors Corporation’s credit rating (causing GM bond prices to fall) and a large investment in GM stock (causing GM’s stock price to rise) gave rise to a number of reports about trades illustrating the variety of strategies that market participants can use to take long and short positions in an issuer’s securities. They include (a) purchasing GM bonds and shorting GM equity, (b) purchasing the equity

may also include transactions in which a hedge fund has acquired a financial instruments with multiple risks but wishes to isolate and trade only one of those risks (*e.g.*, hedging a purchased convertible bond with a CDS in order to isolate and trade the embedded equity option).

Major banks and some hedge funds now also trade “correlation” risk, meaning that they trade long and short credit positions or offsetting credit and equity option positions based on perceived correlations in their performance. As discussed in more detail below, this development has been spurred by the development of dynamic hedging strategies for credit risk and the related creation of CDS on baskets of reference obligations that transfer only a non-linear portion of the risk of the basket, such as single-tranche CDS.

(e) Portfolio Management/Alternative Investments. CDS are widely used in order to make synthetic investments that differ in various ways from the underlying reference obligation. For example, CDS permit access to maturity exposures not available in the cash market, and to foreign currency-denominated credits without taking foreign exchange risk. CDS also permit investors to gain exposure to credit risk not available in the cash market due to a limited supply of the underlying bonds.¹² Conversely, as noted above, investors can use CDS to take short positions even when the underlying bonds are not available.

One of the more significant aspects of CDS is that the CDS market permits investors to take long and short positions in credit risk without having to make a cash outlay to buy the bonds, thus allowing diversification not otherwise available. For example, CDS allow investors with a relatively high cost of funds to take on exposure to lower-risk reference obligations than otherwise would be economically rational (because the interest paid on a low-risk debt obligation would not cover the investor’s cost of funds and other allocable costs). CDS also allow taxpayers with strong balance sheets and favorable regulatory regimes, such as certain insurance companies, to take on risk more cheaply than other market participants that may have a weaker balance sheet or less favorable regulatory regime, such as banks, again without requiring an outlay of cash.

CDS also are commonly used to create synthetic credit-linked notes that permit investors to make synthetic investments in reference obligations or baskets thereof under circumstances where it is not possible or practical to invest directly in the underlying obligations. For example, a common structure in the U.S. market is a special-purpose grantor trust that holds AAA-rated floating rate assets (“term assets”) and that sells protection under a CDS. The trust

tranche of a CDO issuer that holds GM debt, and shorting by buying protection on GM in the single-name CDS market, and (c) purchasing the equity tranche of a CDO issuer, and shorting by buying protection on the same CDO issuer’s mezzanine securities. *See* Derivatives Week 2005 GM hedging articles.

¹² This point was recently demonstrated vividly, when auto parts manufacturer Collins & Aikman declared bankruptcy in May 2005. Collins & Aikman is a reference entity in several high yield CDS indices. The company’s most recent financial statements show about \$500 million dollars of senior bonds outstanding, as well as \$400 million of subordinated bonds and several hundred million dollars of secured loans. According to market reports, it became apparent when parties began to consider the mechanics of physically settling their obligations under CDS on the relevant indices that there were many billions of dollars of outstanding notional amount of CDS on Collins & Aikman bonds, and that in principle the same \$500 million of senior bonds would have to change hands multiple times in order to satisfy all of the outstanding CDS obligations. (The subordinated bonds did not qualify as deliverable obligations, and the loans were not considered deliverable for other reasons.) An alternate cash settlement mechanism was devised in order to address this problem.

issues trust certificates or notes that pay coupons equal to the floating rate on the term assets and the premium on the CDS. Term assets are sold as necessary to pay in the case of a Credit Event on the CDS. The CDS may reference either a single reference entity, in which case the investor has synthetically bought a bond of that reference entity, or may be a “single-tranche” or other structured CDS of a kind discussed in Section II.D, below. Structures of this kind are in a sense the reverse of the use of CDS to hedge bank loans described in Section II.B.3(a), above. Those transactions separate credit risk from funding, and these transactions repackage the credit risk with other funded assets.

Just as a CDS does not constitute a perfect hedge of a loan or bond for the protection buyer, it also does not perfectly create a synthetic investment in the underlying reference obligation for the protection seller. Some of the reasons are similar to those described above in Section II.B.3(a), and can be summarized as resulting from the fact that a conventional CDS has standardized terms that may not correspond to those of the reference obligation, including with respect to currency, cash flow and maturity. A CDS protection seller also has no direct relationship with the borrower, and thus cannot participate in an amendment to the terms of a bond or loan or, prior to the time if any that the reference obligation is delivered to the protection seller, a work-out or restructuring.

In addition, in the case of a cash-settled CDS of the kind often used in credit-linked note structures of the type described above or collateralized debt obligation transactions of the kind described in Section II.C, below, there may be a significant mismatch between the occurrence of a credit event and any actual loss to a holder of the reference entity.¹³ Because the protection seller must make a cash settlement payment shortly after receiving notice of a credit event, it is forced in effect to terminate its exposure to the reference obligation at a time that may not be optimal and that may result in a greater loss than if it held the reference obligation directly and could wait for the market to settle down before disposing of the obligation or could participate in the restructuring of the reference entity’s debt. This point is particularly relevant in the case of a restructuring, where it is possible that a holder of the underlying reference obligation will ultimately receive full payment. It arises more generally, however, because the standard credit event definitions are broader than the standard definitions of default. A cash-settled CDS protection seller also is exposed to moral hazard risk – that is, the risk that the party holding the underlying reference obligation will act in its own interest (for example, maintaining an on-going customer relationship in the hope of future business) rather than in a way that maximizes the return on the reference obligation – and to the risk of inaccuracies in the cash valuation process for determining the loss in a reference obligation’s fair market value.

(f) Market-Making. By far the largest category of transactions captured by available public surveys is represented by market intermediation transactions and dealer-to-dealer transactions by banks and broker-dealers. (Hedge funds to date have not participated in these surveys, however, and some less significant categories of participants also may not be fully represented.) A few statistics illustrate this point. End-2004 data is described as showing \$6.3 trillion of outstanding CDS, of which \$2.7 trillion were between reporting dealers.¹⁴ Data for 2003 is reported as \$2.8 trillion of gross protection sold and \$2.6 trillion of

¹³ See Moody’s 2001 CDS Risks Report.

¹⁴ BIS 2004 Update Survey.

gross protection bought (disregarding cash CDOs), of which banks and broker-dealers represented \$2.4 trillion and \$2.6 trillion, respectively.¹⁵ Finally, banks that participated in the 2003 survey reported that 93 percent of their credit derivatives positions were in their “trading” rather than “banking” book.

C. *Collateralized Debt Obligations.*

The term “collateralized debt obligation” (or CDO) is a generic term for a variety of transactions that generally involve (a) the creation of a special purpose vehicle, (b) the acquisition by the SPV of a portfolio of bonds, loans, or other kinds of (usually) debt obligations, and (c) the funding of this pool of assets through the issuance of various tranches of debt and a junior class treated as equity for U.S. federal income tax purposes to foreign and domestic investors.¹⁶ The pool of assets is managed by a collateral or portfolio manager, subject to detailed diversification, credit and other constraints. The SPV often is organized in the Cayman Islands or is otherwise structured in a manner intended to operate without being subject to U.S. net income tax. To achieve that objective, the SPV ordinarily is subject to tax-related restrictions, such as prohibitions on originating loans or acting as a dealer in derivatives.

Each security issued by the SPV is entitled to payments based on its place in a sequential “waterfall” of payments that are made by the SPV, and therefore represents a different slice of the credit risk of the portfolio held by the SPV. The most senior security generally is AAA rated. The equity, mezzanine and senior classes of securities typically are sold to different types of investors, depending on the investor’s appetite for risk and the returns it seeks.

CDOs have had an enormous impact on the market for CDS, for two reasons. The first reason is that CDOs by their nature are investors in credit risk positions, and have made active use of CDS in order to broaden the nature of their investments and to take on credit positions in forms that otherwise are not available, as described above under Section II.B.3(e). Because CDO issuers are investment vehicles, CDS positions held by them ordinarily are “long” positions (that is, the CDO issuer sells protection and thus takes on the credit risk of the reference entity), and are entered into with financial institutions that are dealers in CDS. Selling protection under a CDS thus may be used as a supplement to a portfolio of assets that otherwise consists of physical bonds or loans.

There also is an active and growing market in CDOs that invest solely through CDS (so-called “synthetic CDOs,” because the asset class is synthetic). That is, substantially all of the CDO’s risk exposure comes through entering into one or more CDS. The cash raised by the SPV through the issuance of debt and equity is not invested in physical bonds and loans of the kind described above. Instead, the cash is invested in term assets or other highly-rated, liquid

¹⁵ Fitch 2004 Survey.

¹⁶ Market convention is to describe collateralized bond obligations (“CBOs”) and collateralized loan obligations (“CLOs”) as separate from mortgage-backed securities (“MBS” transactions) and asset-backed securities (“ABS” transactions). As their name indicates, the obligations held by a MBS issuer generally are mortgages and other real estate-linked loans. The assets held by an ABS issuer may include credit card or other receivables, leases, loans other than bank loans, and other instruments that have debt-like characteristics. The lines between these types of securitization transactions are not hard-and-fast, but each has its own conventions for deal structures and terms that are based in part on the different economic characteristics of different asset types.

floating rate investments, which serve as collateral for the CDS protection buyers that are the counterparties to the SPV. This structure very generally is similar to that described above in Section II.B.3(e) for synthetic credit-linked notes issued by trusts, except that the portfolio of CDS is managed by a portfolio manager in the same way that the portfolio of bonds and loans is managed in a cash CDO.¹⁷ That is, if the manager wishes to take on exposure to a particular company, the CDO issuer will sell protection on that reference name, and if the manager wishes to terminate exposure to that company, the CDO issuer will terminate the CDS. In these transactions, there often is an unfunded risk tranche senior to the AAA-rated security (the “super senior” tranche), which generally is backed by an insurance company or other financial enterprise through a financial guarantee insurance policy, letter of credit or other arrangement in respect of a CDS on the super senior tranche. CDS entered into by CDOs ordinarily are cash-settled.

The second reason that CDOs have had an impact on the CDS market has to do with the tranching of risk resulting from the issuance of securities with different priorities of payment. As described above, each security issued by a CDO issuer occupies a particular place, or tranche, in the allocation of the risk of the entire CDO portfolio. That tranche is non-linear, in the sense that it represents not a fixed percentage of the risk of loss of each asset in the portfolio, but rather 100 percent (usually) of the risk of loss on the portfolio between \$X and \$Y, where \$X represents the amount invested by more junior securities and \$Y equals \$X plus the amount invested by the holders of the security in question. To give an example, assume a CDO issuer holds a \$100 million portfolio and has issued \$10 million of stock or the equivalent, and \$8 million, \$30 million and \$52 million, respectively, of Class C, Class B and Class A notes. The Class C notes will absorb losses on the portfolio to the extent those losses exceed \$10 million and are no more than \$18 million; the Class B notes will absorb losses on the portfolio to the extent those losses exceed \$18 million and are no more than \$48 million; and the Class A notes will absorb any losses in excess of \$48 million. Each of these classes of notes is, in a sense, a class of credit-linked notes, but notes linked to only a single tranche of risk (*e.g.*, for the Class B notes, the tranche between \$18 million and \$48 million).

An underwriter of this CDO’s securities may find that there is more demand for certain classes of the securities than others, and consequently may be forced to hold for a period of time a portion of, for example, the Class B notes while it seeks customers to buy them. During that time, the underwriter is exposed to the Class B tranche of risk. Investment banks consequently developed techniques for hedging these non-linear tranches of risk. Having done so, they then applied those techniques to hedging single-tranche CDS of the kind described below, which similarly transfer a tranche of risk on a portfolio of assets, but in unfunded form.

D. *Single-Tranche CDS; nth to Default CDS; CDO-Squared CDS.*¹⁸

As the description above suggests, a single-tranche CDS transfers from the protection buyer to the protection seller one tranche of the risk on a portfolio of obligations of a list of reference entities. To continue with the example above, assume that a \$100 million

¹⁷ For a more detailed description of synthetic CDOs, see Moody’s 2000 Synthetic CDO Report.

¹⁸ Much of the description in the following sections of this Section II.D is taken from Annex 1 of the Joint Forum 2005 Report and from the S&P 2004 Synthetic CDOs Report.

notional portfolio consists of \$4 million of exposure to the obligations of each of 25 named reference entities, and that the single-tranche CDS represents credit exposure similar to that of the Class B notes described above, except that it is unfunded (a CDS) rather than funded (a note). The protection buyer will make premium payments to the protection seller as described above under Section II.B.1. The protection seller is required to make one or more payments to the protection buyer to the extent that losses from credit events on the notional portfolio exceed \$18 million but do not exceed \$48 million. As this description indicates, in the case of a portfolio swap, the protection seller may be required to make more than one payment in respect of a credit event during the life of the CDS. Each such payment would be determined in the same manner as if the CDS had been written on the obligations of the relevant reference entity, except that the first and last payments may be less as a result of the \$18 million and \$48 million thresholds.

The risks arising from single tranche CDS described above are measured through the application of complex models beyond the scope of this report to describe. They measure, among other things, the sensitivity of a tranche's value to the credit spread on the names in the reference portfolio, the tranche's expected loss from defaults in the reference portfolio, and a measure of unexpected losses. In computing these risks, the pricing model will take into account current credit spreads on the reference portfolio, assumptions about default correlations (for example, correlations between companies in the same industries, or companies sensitive to similar economic factors) and other modeling assumptions.

A dealer in a single tranche CDS will hedge its position by entering into single-name CDS or, increasingly, index CDS, which are described below.¹⁹ Since the single tranche CDS represents only a portion of the risk of the underlying portfolio, the dealer will enter into hedges on a much smaller notional amount than the notional principal amount of that portfolio. Moreover, because the factors taken into account in a model of the kind described above change constantly, dealers also adjust their hedges on a regular basis, taking into account the model-driven ideal hedge position ("delta"), the liquidity of the CDS market for the particular names, the desirability of being hedged against both small moves in credit spreads ("spread risk") and unexpected defaults ("jump-to-default risk"), and changes in correlation assumptions.

Another CDS transferring non-linear risk is a "first (or second, third, fourth – generically "*n*th") to default" swap, which as its name suggests depends on the sequence of credit events in a portfolio. A common structure is a "first-to-default" CDS on a basket of five reference entities. A "first-to-default" CDS provides for premium payments by the protection buyer, and for a payment by the protection seller once the first credit event takes place, which terminates the transaction. The protection seller's payment would be determined in the same manner as if the CDS had been written on the obligations of the first defaulting reference entity alone. The amount of the premium payments will be higher than the credit spread for any single name in the basket but lower than the sum of the credit spreads for all names, with the pricing dependent on the extent to which defaults on the reference entities are viewed as correlated. Like single tranche CDS, *n*th-to-default swaps are complex products the value of which depends heavily on correlation assumptions.

¹⁹ For an introduction to the hedging of tranche transactions, *see* Derivatives Week 2004 Delta article.

The dealer also may hedge with physical securities. Anecdotally such hedges seem to be uncommon, perhaps because for the reasons described in Section II.B.3(a), above, physical securities do not provide exposure solely to credit risk and require funding.

A third type of correlation CDS is a “CDO-Squared” CDS. The risk exposure taken on by a protection seller in a CDO-squared CDS economically is analogous to the risk to which an investor would be exposed if it purchased Class B notes issued by a CDO issuer that itself invests in the mezzanine debt (say, Class C notes) of other CDO issuers. In such a transaction, an investor in the Class B notes of the upper-tier CDO issuer would suffer a loss of principal only if (a) the losses suffered by the lower-tier CDO issuers were sufficient to reduce the payments on or principal of the Class C notes held by the upper-tier CDO issuer, and (b) the losses on the Class C notes held by the upper-tier CDO issuer in aggregate reached (using the same example as above) \$18 million. That is, the investor benefits from two layers of subordination – the equity beneath the Class C notes of the lower-tier CDOs, and the equity and debt beneath the Class B notes issued by the upper-tier CDO.

The difference between that transaction and a CDO-squared CDS is that in the CDS transaction there are no CDO issuers – all reference assets are notional -- and the CDS is unfunded. To look at this another way, the distinguishing characteristic of a CDO-squared CDS as compared to other CDS is that the reference portfolio consists of one or more notional CDO tranches. As with the Class B notes investor described above, an investor in a CDO-squared CDS benefits from two levels of subordination, one at the level of the underlying reference CDOs (*e.g.*, only losses in excess of \$X on the lower-tier notional portfolios can potentially affect the CDO-squared CDS), and one at the level of the notional upper-tier CDO (*e.g.*, only when those losses on the notional upper-tier portfolio total more than \$Y will the protection seller be required to make payment).

Among the variations in these products are that the CDS may be offered in either in unfunded form, as a swap, or in funded “single-tranche CDO” form, meaning as a note issued by a SPV structure similar to that described above in Section II.B.3(e); and that the portfolio may be either a static pool or a managed pool. Another variation is that settlement payments may be made as credit events arise, or may be made in a single payment at the maturity of the instrument (or, if earlier, when the notional principal amount of the CDS is reduced to zero).

E. *Index CDS.*

A relatively new and rapidly growing type of CDS is a CDS on a publicly disclosed standardized index of names that is selected to include the large and liquid names in particular segments of the CDS market and to provide diversity within the particular index segment. Those segments may be organized by geography, by market sector, by seniority (investment grade vs. high yield) or by CDS maturity (five year vs. ten year). New subcategories of indices are being developed. These products are attractive to investors because the portfolio of reference entities is transparent (that is, defined in advance and adjusted based on pre-agreed rules), investors can easily obtain diversification because they are exposed only to small losses on a large number of credits, index products are very liquid because of the number of parties transacting in the same contract, and index-linked products are flexible because they are offered in a variety of formats of interest to investors (funded vs. unfunded, tranching vs. untranching, subsectors or regions, and varying maturities). Index CDS also are used by dealers to hedge their risks arising from single-tranche CDS.

F. ***Other CDS-Related Products.***

Other mostly relatively new CDS-related products include the following. This list is not exhaustive.

- Ten-year single-name or index CDS.
- CDS on high yield bonds. High yield CDS generally do not include restructuring as a credit event.²⁰ They thus may be both less effective hedges for a protection buyer and a less risky way to take a position in high yield bonds for a protection seller. High yield CDS are growing rapidly as a portion of the total CDS market.²¹
- Digital default or recovery CDS. A digital default or recovery swap is a CDS where the payment to the protection buyer following a credit event is a percentage of the notional principal amount of the CDS that is fixed at the outset.²²
- CDS on ABS securities, or “pay-as-you-go” swaps. PAYG (or sometimes “PAUG”) swaps have been stimulated by a significant excess of demand over supply in the ABS market, both on the part of would-be investors in ABS securities and on the part of would-be short sellers of those securities. Unlike other single-name CDS, PAYG swaps generally do not terminate on a credit event but instead provide for payments that keep the protection buyer whole on an on-going basis, for example by compensating the protection buyer for a shortfall in interest paid on the reference obligation, as determined by reference to data from third party data providers. PAYG swaps generally have a stated maturity equal to that of the reference security.
- CDS options. A CDS option is an option to buy or sell CDS protection on a specified reference entity at a fixed spread on a future date.²³ The option may be written either on a single name or on a CDS index.
- Equity default swaps. An equity default swap triggers a payment by the protection seller when the underlying equity price falls below a predetermined level, often 30 percent of then-fair market value.²⁴ Interest in equity default swaps is driven by correlations between the performance of an issuer’s equity and debt securities. They represent one part of a larger growing convergence between the equity and fixed income markets.

²⁰ See Fitch 2004 High Yield CDS Report.

²¹ The Fitch 2004 Survey reports a jump in non-investment grade and unrated CDS from 8 percent to 18 percent in a one-year period.

²² See Fitch 2005 Recovery Swap Report.

²³ See Fitch 2004 CDS Options Report.

²⁴ See Fitch 2004 Equity Default Swap Report; Derivatives Week 2004 Equity Default Swap article.

G. *The Notice's Questions on CDS Pricing.*

The Notice requests information on (a) CDS pricing, particularly with respect to guarantees, contingent options and insurance, and (b) operation of the CDS market, particularly with respect to price quotation and dissemination.

1. Pricing. A number of rating agency studies and academic papers have examined liquidity and pricing in the CDS market.²⁵ A fundamental assumption lying behind those analyses is that the CDS market is, like markets for other derivative financial instruments, an independent market that is linked to the market for the underlying securities from which the derivative derives its risks. That is, it is an independent market in the sense that there is a market demand and supply for credit derivatives that is the primary determinant of liquidity and pricing. These analyses do not address the pricing of guarantees or insurance. Although the reasons for that silence are not stated, it appears that these analysts consider the connection to the bond or loan market to be the primary relevant related market affecting CDS pricing. That is consistent with the description below of CDS pricing models.

Some of the conclusions drawn from these analyses are as follows:

(a) Liquidity, which has a direct effect on pricing, is significantly greater for a limited group of well-known issuers, although the size of that group as well as the overall liquidity of the market are growing rapidly. The development of index products also has increased liquidity in single-name CDS;

(b) Bond spreads and CDS spreads tend to move in the same direction – for example, widening when an issuer announces bad news – but in the short-term spreads in those two markets do not necessarily move the same amount or at the same time.²⁶ In some cases the bond market for an issuer is more liquid than the CDS market, and in other cases the CDS market for an issuer is the more liquid market;

(c) Like the models used to value and price options, the models used to value and price CDS and other credit derivatives are highly mathematical. The mathematics in question has been developed in order to address the particular features that distinguish credit derivatives.²⁷ Important variables that are taken into account are the likelihood of default by the reference entity and the expected recovery rate (because creditors expect to recover something). Academics and financial institutions continue to develop these models further. As the discussion of correlation and index products above suggests, much attention currently is being given to accurately measuring and predicting default correlations.

²⁵ See, e.g., Fitch 2005 GM Report, Fitch 2004 Liquidity Report, and Rule 2001 article.

²⁶ See, e.g., S. Iyer, *Wagging the Dog*, INVESTMENT DEALERS DIGEST 28 (Nov. 15, 2004) (describing a situation where spreads in an issuer's credit derivatives tightened by 60 basis points in an hour, while spreads in the issuer's bond tightened by 40 basis points over the course of the day).

²⁷ A very brief summary of the history of modern finance mathematics, including that of options and credit derivatives, can be found in the Risk 2005 article (stating that Black-Scholes-based option models are not widely used, and describing an alternate financial model). An introduction to the mathematics can be found in Anson & Fabozzi et al. 2004 book chs. 8-10 (describing several different models for assessing credit risk and for pricing CDS). A list of and very brief discussion of papers on CDS pricing models can be found in Appendix 5 (Literature review), section III.4 (pricing CRT instruments) of the BIS 2003 paper.

One authoritative study of the credit derivatives market reports that banks and insurance companies price credit risk differently. It suggests that a part of that difference may be attributable to the fact that they use different types of pricing models. Other possible factors affecting the differences in pricing listed in the study include accounting differences and the long-term view of risk taken by insurance companies vs. the mark-to-market mentality and a concern about liquidity on the part of banks.²⁸

2. Price Dissemination. Prices for CDS are disseminated in a number of ways. According to one study of the CDS market, a number of large intermediaries publish indicative two-way CDS prices for the most-traded companies and sovereigns on their websites and on electronic data vendor screens. There is also an interdealer market that takes place through voice and internet-based brokers.²⁹ Prices also may be obtained by calling a dealer in CDS.

III. Description of Other Credit-Protection Instruments.

The traditional list of credit-protection instruments includes loan participations, letters of credit, surety bonds, guarantees and financial guarantee insurance. Each of these products has attributes that differ from the others.³⁰ The same financial institution or other person may offer multiple products. Historically, these products have been offered to customers of a financial institution, usually a bank or insurance company (or, in the case of guarantees, to investors in an affiliate's debt). More recently, there have been reports that hedge funds and other entities active in the CDS market also are entering into such products.³¹

A. *Letters of Credit.*

A basic letter of credit transaction involves three separate transactions: (1) the underlying commercial transaction, pursuant to which one party agrees to pay another party; (2) the letter of credit, which is a definite and primary obligation of a bank or other entity (issuer) to honor a demand for payment by the second party (beneficiary) made in accordance with the letter of credit's terms and conditions; and (3) the transaction whereby the first party (applicant) agrees to reimburse the issuer in return for the issuer's issuance of the letter of credit to the beneficiary. Each of these transactions gives rise to a separate relationship between the relevant parties.

²⁸ FSA 2002 paper, pages 31-21. A follow-up to this paper lists the following as possible reasons for pricing differentials: differences in accounting, regulatory models, economic capital models, return on equity thresholds, modeling horizons, the attitude of insurers to types of risk that are difficult or impossible to model, the treatment of uncorrelated risk, and liquidity premiums. FAS 2002 follow-up paper, page 9.

²⁹ Rule 2001 article. Prominent credit default swap brokers include GFI Group Inc. (www.gfigroup.com) and Creditex (www.creditex.com). According to their websites, they provide both voice and Internet services.

³⁰ Appendix 3 of the BIS 2003 paper provides a summary of differences between the following means of transferring credit risk: single-name CDS, single-name total return swap, single-name CLN, credit insurance, financial guaranty insurance, surety bond, bank guarantee or letter of credit, loan participation and loan sale.

³¹ See Sheppard 2005 (reporting a PricewaterhouseCoopers representative as saying that hedge funds make cash advances on letters of credit as well as taking the risk side of CDS). A different type of entity is Primus Guaranty, Ltd., a Bermuda holding company that, according to its 2004 annual report, owns one subsidiary that trades and invests in credit default swaps and another that offers credit insurance protection to companies that prefer insurance products to credit swaps. The annual report is available from the SEC or at www.primusguaranty.com.

A distinctive feature of a letter of credit, as compared to a guarantee or insurance policy, is that the issuer undertakes to honor a draft or demand for payment presented to it under the letter of credit provided solely that the required documents are presented and that the terms and conditions of the letter of credit have been complied with. The issuer's obligations under the letter of credit are original rather than secondary. Accordingly, disputes over the underlying commercial transaction are irrelevant as a matter of law to the duty of an issuer to honor the letter of credit when conforming documents (typically, a statement that the applicant has defaulted or otherwise failed to perform) are presented to it by the beneficiary.

Letters of credit are governed primarily by the Uniform Commercial Code, as enacted into state law. Several international bodies also have developed standardized customs and practices that may be adopted by parties.

B. *Guarantees.*

A basic guarantee involves three relationships: (1) the underlying commercial transaction, pursuant to which one party (primary obligor) agrees to pay another party; (2) the guarantee, which is a contract pursuant to which the second party (beneficiary) has recourse against a guarantor to satisfy the obligations of the primary obligor to the beneficiary; and (3) the guarantor's right of subrogation, which gives the guarantor the rights of the beneficiary against the primary obligor. If the party seeking the guarantee is the primary obligor, ordinarily the guarantor also will have (4) a right of reimbursement against the primary obligor.

Unlike a letter of credit, a guarantee is a contingent and secondary obligation. The guarantor ordinarily is obligated to perform only if the primary obligor fails to make a required payment. Guarantees may take various different forms. In modern practice, guarantors often waive many of the conditions and defenses available to them, for example the requirement that the beneficiary pursue remedies against the primary obligor before turning to the guarantor. Absent such waivers, a guarantor may assert any defense against payment to the beneficiary that the primary obligor could have asserted, for example that the underlying agreement is void.

The right of subrogation arises as a matter of law, as described below. It gives the guarantor the rights of the beneficiary against the primary obligor, including rights to collateral pledged by the primary obligor to the beneficiary. Because the guarantor is asserting the rights of the beneficiary rather than independent rights that the guarantor has against the primary obligor, the guarantor is subject to whatever defenses the primary obligor had against the beneficiary. For example, if the beneficiary separately owes money to the primary obligor and the primary obligor would be entitled to offset its right to collect from the beneficiary against its obligation to pay the beneficiary, the guarantor's claim against the primary obligor is subject to the primary obligor's offset right against the beneficiary.

Because guarantees are contracts, they are governed principally by contract law. There is a well-developed body of common law addressing guarantees, under which, for example, the rights of subrogation and reimbursement are presumed to exist unless modified by

contract. Under certain circumstances, a guarantee also may be subject to the Uniform Commercial Code.³²

C. *Financial guarantee insurance.*

1. In General. Insurance generally involves two relationships: (1) an underlying transaction that gives rise to material risk to a party, and (2) the insurance policy, pursuant to which another party (insurer) agrees to pay the first party (insured) if the insured suffers injury as a result of that risk. In the case of financial guarantee insurance, the underlying risk must be a financial risk. If the policy is one of property and casualty insurance, the insurer also will have right of subrogation against the party causing injury to the insured.

Under New York state law, for example, an insurance contract is defined as any agreement or other transaction by which one party (insurer) is obligated to confer a benefit of pecuniary value upon a second party (insured) dependent upon the happening of a fortuitous event in which the insured has, or is expected to have at the time of such happening, a material interest that will be adversely affected.³³ Financial guarantee insurance is defined as a contract of a specified type under which loss is payable, upon proof of occurrence of financial loss to the insured, as a result of the failure of an obligor on a debt instrument or other monetary obligation to pay, or as a result of changes in interest rates, currency exchange rates, or changes in the value of specified assets, commodities or prices.³⁴ Financial guarantee insurance under this definition includes contracts that may not otherwise constitute insurance, such as a surety bond or, if written by an insurer, a guarantee.

A property and casualty insurance contract ordinarily constitutes a contract of indemnity. As described by one authority, under indemnity principles the insured is entitled to payment from the insurer only if the insured has suffered a loss and only to the extent of the financial loss sustained. The most important means by which these restrictions are implemented are (i) the requirement that the insured have an insurable interest in the risk insured (the “insurable interest” rule), (ii) the requirement that the insurance compensate the insured only to the extent of the actual loss to the insured, even if the face amount of the insurance is greater (the “actual cash value” rule), (iii) a prohibition on collecting more than once for the same loss under multiple insurance policies, and (iv) the right of subrogation, which prevents the insured from collecting both from the insurer and from the party causing injury.³⁵

The insurable interest rule and the actual cash value rule are related, but they are two separate rules. Under New York law, a property insurance policy is void unless there is an insurable interest in the property insured, and can be enforced only by the person with that

³² Restatement of the Law: Suretyship and Guaranty, section 4 (1996) (if a guarantor is a party to a note, the guarantor is treated as a surety and the transaction is subject to the Uniform Commercial Code).

³³ New York Insurance Law, section 1101(a)(1).

³⁴ New York Insurance Law, section 6901(a)(1).

³⁵ See Vaughan 1999 Insurance textbook, pages 161-67. The authors of this textbook are described as an insurance professor and the Commissioner of Insurance for the state of Iowa.

interest.³⁶ The insurable interest must exist at the inception of contract, and, if the contract is one of indemnity, must also exist at the time the loss occurs.

Some property and casualty insurance contracts do not adhere to the actual cash value rule, and therefore are not contracts of indemnity, although they are still contracts of insurance provided that the insurable interest requirement is satisfied. They instead set out an agreed value for the property insured, and pay the full value of the property if a total loss of the property (for example, a work of art) occurs.³⁷ Contracts also may pay out based on an estimate of loss. A common example of a non-indemnity insurance contract is a weather insurance contract, under which an insurer pays a pre-agreed amount if a specified weather condition affecting the insured takes place, as determined by reference to an objective third party data provider such as a local weather station.³⁸ A competitor to weather insurance is a weather derivative, such as the temperature futures and futures options traded on the Chicago Mercantile Exchange or over-the-counter contracts on various weather-related risks.³⁹ The New York Insurance Department has advised that weather derivatives do not constitute insurance under New York state insurance law because the terms of a weather derivative do not provide that payment to the purchaser is dependent upon that party suffering a loss (that is, the insurable interest requirement is not satisfied).⁴⁰

³⁶ New York Insurance Law, section 3401. Section 3401 states: “No contract or policy of insurance on property made or issued in this state, or made or issued upon any property in this state, shall be enforceable except for the benefit of some person having an insurable interest in the property insured. In this article, ‘insurable interest’ shall include any lawful and substantial economic interest in the safety or preservation of property from loss, destruction or pecuniary damage.”

We have not investigated the insurance law of other jurisdictions. A recent ISDA letter addressing the differences between insurance and credit derivatives asserts that statutes in California, Connecticut, Indiana, Kentucky, Nebraska and North Carolina require as a fundamental element of insurance that the insurer must indemnify the insured against loss suffered by the insured, and that courts in other U.S. jurisdictions have similarly found the elements of insurable interest and loss to be fundamental to insurance. ISDA 2004 Weather Derivatives letter.

A well-known opinion of Queen’s Counsel (Robin Potts) obtained by ISDA concluded in May 1997 that a CDS does not constitute an insurance contract under U.K. law as a result of the fact that a payment obligation arises regardless of the lack of an insurable interest and the lack of any actual loss suffered by the protection buyer. The FSA 2002 report notes a number of circumstances under which the Potts opinion might not apply, such as a case where it is virtually impossible for a credit event to happen without the protection buyer suffering a loss because the reference obligation is a nontransferable loan held by that party. The report also states that it is not clear law that only contracts that respond to (and so provide indemnity against) actual loss can be contracts of insurance. FSA 2002 report, Annex B, page 2. This statement is not further explained.

³⁷ Vaughan 1999 Insurance textbook, page 164; *see also Home Title Ins. Co. v. United States*, 50 F.2d 107 (2nd Cir. 1931) (stating that a contract does not constitute insurance unless the insured has some interest at risk, but that insurance can pay an insured more than its actual loss, and giving the example of fire and marine insurance as paying in full and taking over the physical remains of the property destroyed).

³⁸ An example of a common type of insurance that bases payments in part on estimates is motor vehicle repossession insurance. *See* NYID 2000 MVRI opinion (stating that contract that pays auto loan provider for loss on repossession of motor vehicle based on the greater of the sale proceeds or the trade-in value provided by the appropriate edition of the National Auto Dealer Association less a discount constitutes insurance).

³⁹ These instruments are described in Banks 2004 book, pages 156-67.

⁴⁰ NYID 2000 Weather Derivatives opinion. In 2003 a draft white paper under the auspices of the National Association of Insurance Commissioners suggested that weather derivatives should be regulated as insurance. The paper was strongly criticized by the Weather Risk Management Association and by ISDA as failing to take into account the differences between weather insurance and weather derivatives and as inconsistent with the New York

Unlike letters of credit and guarantees, financial guarantee insurance legally may be written only by an insurance company. A non-insurance company that writes an insurance contract may be subject to penalties or may find that its contract is void. New York and most other states require that financial guarantee insurance be written only by an insurance company that specializes in that form of insurance, generally referred to as a “monoline” insurance company.⁴¹

2. Comparison to CDS. As discussed in Section IV.B.2, below, financial guarantee insurers have developed structures under which they effectively write insurance policies on CDS. In 2001 a leading rating agency consequently published a report on the risks involved in writing financial guarantee insurance versus those arising from writing credit default swaps. The report and a follow-up report noted the following principal differences to a writer of such instruments.⁴²

- The timing of loss on a CDS is uncertain. Under financial guarantee insurance, if a reference obligor fails to pay, the insurer is required to make payment only in accordance with the regularly scheduled debt service payment schedule. The likelihood that such payment will be required can be predicted, to a great extent, by the reference entity’s credit rating. By contrast, in the case of a CDS, the payment obligation is accelerated at the time of a credit event.
- The quantification of loss on a CDS is uncertain and potentially inaccurate. Under financial guarantee insurance, the amount payable by the insurer is the amount of the missed payment. Under a CDS requiring cash settlement, by contrast, the amount payable will depend on the market value of the valuation obligation, which will vary over time and often increases after the immediate decrease at the time of default. The time when the amount to be paid is determined thus can significantly affect the amount to be paid. The process for determining the cash settlement value also may be more, or less, objective.
- Unlike financial guarantee insurance, the risk of payment on a CDS cannot be accurately predicted by the credit rating of the reference entity. This results from the fact that credit ratings measure the likelihood of default, but the

Insurance Department ruling. See WRMA 2004 letter; ISDA 2004 Weather Derivatives letter. According to the NAIC website, a NAIC insurance securitization working group also commented on the paper and discussion of the white paper was subsequently tabled.

Another category of risk covered by both insurance and derivatives products is catastrophe risk. See NYID 1988 Cat Options opinion (catastrophe options do not constitute insurance); see generally Hammer 2003 article; Humphreys 1998 article. A computer-based electronic market for the exchange of catastrophe-related reinsurance risks among insurance companies and reinsurers known as CATEX has existed since 1995. Information on CATEX can be found at www.catex.com. The Hammer and Humphreys articles also discuss other types of insurance-like derivatives, as do the IAIS 2003 Securitisation Paper, part 4 of the FSA 2002 report and the Sigma 2003 ART report.

⁴¹ New York Insurance Law, Article 69.

The principal monolines are Ambac Financial Group, Inc.; Financial Security Assurance Inc., a subsidiary of Dexia bank; FGIC Corporation; MBIA Inc. and CIFG, a subsidiary of Groupe Caisse d’Epargne.

⁴² Moody’s 2001 CDS/FGI Comment; Moody’s 2001 CDS/FGI Comment #2.

definition of the term “credit event” under a CDS is broader, and may, if Restructuring is used, be much broader, than an event of default. As a result, a CDS protection seller may be obligated to make payment when a financial guarantor insurer would not. These “non-default” credit events give rise to risk of a kind that a financial guarantor insurer ordinarily would not bear.

- The accounting treatment of CDS and financial guarantee insurance differs. Under FAS 133, as amended by FAS 149, derivatives generally must be marked-to-market for U.S. financial accounting purposes. Insurance (and guarantees) are not marked to market.

For this purpose, an instrument is classified as insurance, a guarantee or a derivative based on its characteristics. A contract is treated as insurance “because [it] entitle[s] the holder to compensation only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk.”⁴³ A contract is treated as a guarantee only if (i) it requires that the guaranteed party have direct exposure to a referenced asset both at the inception of the contract and throughout its life, either from owning it directly or from a back-to-back arrangement with another party required to maintain direct ownership of the asset, (ii) the compensation paid under the contract to the guaranteed party does not exceed amounts necessary to reimburse the guaranteed party for the debtor’s failure to make required payments on the referenced asset; and (iii) payment under the contract is made to the guaranteed party only if the amount that the debtor on the referenced asset owes to the guaranteed party is past due.⁴⁴

This list is not exhaustive. Additional important differences between financial guarantee insurance and CDS include the following:

- As described above, insurance requires that the insured have an insurable interest in the risk being insured. In the case of financial guarantee insurance, under New York law the insured also must demonstrate proof of occurrence of

⁴³ Statement of Financial Accounting Standards No. 133, paragraph 281 (June 1988).

⁴⁴ Statement of Financial Accounting Standards No. 149, paragraph 7(c) (amending FAS 133, paragraph 10(d)), paragraphs A20-A23 (explaining that revised definition of financial guarantees was intended to more closely align rules for financial guarantees with rules for insurance contracts) (April 2003).

The International Accounting Standards Board has issued standards for issuers of credit-protection instruments that generally classify such instruments into two categories – insurance, on the one hand, and derivatives, on the other -- rather than three. The distinction between insurance and derivatives turns in part on the requirement that an insurance contract require an adverse effect on the policyholder as a precondition for payment. See International Financial Reporting Standard 4 *Insurance Contracts*, paragraphs B8-B17; International Accounting Standard 39 *Financial Instruments: Recognition and Measurement*, paragraphs 3, AG4-A, BC21-BC23 (prior to Aug. 18, 2005). On August 18, 2005, IASB amended IFRS 4 and IAS 39 to provide that guarantees, while classified as insurance under IFRS 4 if they require as a precondition to payment that the holder be exposed to an actually incur a loss, generally are subject to the rules of IAS 39 relating to the measurement of an issuer’s liability. IASB intends to revisit the treatment of guarantees as part of its continuing development of the international accounting rules for insurance.

financial loss. We understand that, under New York law, while these terms are subject to some interpretation, it is generally believed that a contract will not be treated as coming within these requirements unless the buyer of the insurance must hold, or be expected to hold, the underlying property at the time of an insurable impairment thereof.⁴⁵

No insurable interest requirement applies to a CDS. Rather, like other financial derivative instruments, the party that is “short” the underlying risk – here, the protection buyer – may hedge in a variety of ways, including by holding the reference obligation, holding a different security expected to perform in a similar manner, entering into a CDS or other credit derivative on the reference obligation or other security, or not hedging at all. As described above, the ability to hedge CDS like other derivatives (i.e., by hedging an overall portfolio of risks using delta hedging techniques) has been critical to the development of the CDS market. It is not unusual, and in fact common in some parts of the CDS market, for a dealer to be long and short via offsetting CDS without any party holding the reference obligation. Of course, it is also not unusual for a protection buyer to enter into a CDS in order to hedge a credit risk to which it is exposed, which as described above could include a bond, a loan, an unfunded loan commitment or exposure to a customer on other derivatives transactions.

A CDS also does not require that the protection buyer demonstrate that it has suffered a loss. Indeed, the “cheapest-to-deliver” option – that is, the protection buyer’s right to identify after a credit event has taken place which obligation of the reference entity will be the deliverable or valuation obligation – may allow a protection buyer to obtain compensation under a CDS for an amount greater than any loss the protection buyer may have suffered.⁴⁶ The New York state insurance department has advised that a CDS is not insurance, because payment is not dependent on the buyer having suffered a loss.⁴⁷

⁴⁵ See, e.g., NYID 1988 Cat Options opinion (“Indemnification of loss is an essential indicia of an insurance contract which courts have relied upon in the analysis of whether a particular agreement is an insurance contract under New York law. Absent such a contractual provision, the instrument is not insurance.”)

⁴⁶ This feature of CDS was highlighted in 2000, when Consec restructured its bank loans by extending their maturity in exchange for a higher coupon and collateral. While not treated as a default by rating agencies, this restructuring constituted a credit event on as much as \$2 billion of CDS. Protection buyers holding the loans took advantage of the cheapest-to-deliver option by buying and then delivering long-dated senior unsecured bonds, which traded at a substantial discount to the shorter-term senior secured loans, resulting in payouts far greater than the losses actually suffered by the protection buyers on the loans. ISDA has modified the definition of Restructuring since that time in an effort to prevent a similar result. The Consec restructuring and the evolution of ISDA documentation is described in the BIS 2003 Paper, page 20.

⁴⁷ NYID 2000 CDS opinion. The core paragraph of the letter states: “The credit default swap which you have described does not meet the definition of an insurance contract in N.Y. Ins. Law Section 1101(a)(1) (McKinney 1985) because, under the terms of the transaction, the seller will make payment to the buyer upon the happening of a negative credit event and such payment is not dependent upon the buyer having suffered a loss” (citation omitted).

- The settlement mechanisms for CDS are different from subrogation. As described above, under subrogation an insurer steps into the shoes of the insured. A CDS that provides for cash settlement is similar to financial guarantee insurance in the sense that the contract calls for a cash payment (subject to the discussion above about timing and quantification of loss). In the case of a conventional CDS, however, once that payment is made the transaction is completed. If the protection buyer owns the reference obligation, it can seek full compensation from the reference entity without regard to the fact that it has obtained payment under the CDS, and the protection buyer is under no obligation to reimburse the protection seller if it does obtain compensation from the reference entity. Unlike an insured, therefore, a protection buyer can collect twice. In the case of a CDS that provides for physical settlement, the protection seller will, like an insurer, be able to pursue claims against the issuer of the reference obligation. Unlike an insurer, however, it pursues those claims in its own right, not as a surrogate for the insured. As a result, for example, offsetting claims that the issuer may have against the protection buyer are irrelevant to the protection seller's claims against the issuer.
- There are other legal and contractual differences between a financial guarantee insurance policy and a CDS. Such differences include: (i) under ISDA documentation, ordinarily if there is an event of default with respect to either party, a CDS would be accelerated along with all other contracts under the same master agreement, and a net payment would be due; a financial guarantee insurance policy ordinarily is irrevocable once issued, even if the policyholder fails to make premium payments; (ii) under ISDA documentation, either party may be required to post collateral as the market value of a CDS changes; collateral is not ordinarily provided for financial guarantee insurance; (iii) insurance policies are freely terminable by an insured, but not by an insurance company; while market practice for CDS, as for the derivative financial instrument market generally, is that a customer ordinarily can terminate the contract at any time at fair market value, regardless of whether the customer is the protection buyer or protection seller.

IV. *Participants in the CDS Market.*

Historically the most significant participants in the CDS market have been banks and insurance companies. As described below, on a net basis the CDS market transfers many billions of dollars of risk from the banking sector to the insurance sector. Institutional investors and hedge funds play increasingly important roles in the CDS market, however, and it is believed that their share of the market will continue to grow. Participation by insurance companies is reported to have dropped somewhat in the most recent surveys for which detailed reporting is available (covering 2003), but it is not clear whether that is temporary or permanent.

A. **Banks.**⁴⁸

1. **Bank Usage of CDS.** The CDS market is often described as originating from the desire by large commercial banks to lay off credit risk with third parties for commercial and regulatory capital management reasons. As the statistics cited earlier under Section II.B.3(f) indicate, by far the primary reason for banks to enter into CDS now appears to be trading/marketmaking rather than hedging, although hedging transactions continue to be significant on an absolute basis. The pattern may, however, vary considerably from bank to bank.

Market surveys indicate that the largest, global banks are the most active buyers of credit protection. One report concludes that 83 percent of all CDS are on the books of 17 U.S., European and Asian commercial and investment banks. Individual banks and broker-dealers, particularly in the United States, showed significant swings in net positions in one year's time (2003 to 2004), however, with many banks shifting from net protection buyers to net protection sellers, apparently as a result of large correlation books of credit risk. Banks that regularly sell net protection tend to be smaller, regionally oriented European banks that appear to be accessing the CDS market as a form of alternative investment. Their participation means that some CDS are transferring risk within the banking sector, rather than out of the banking sector.

The net amount of protection sold by banks globally in 2003 is estimated variously at \$100 billion to \$260 billion. This amount is described as small relative to bank's overall credit exposures. One study reported that one large bank reported that it had hedged 15 percent of its investment-grade exposure, while other banks reported that their hedges constituted less than 10 percent of their exposure. In the case of U.S. banks, another study reported that most use hedging for less than 4 percent of their total commercial and industrial loan exposure.⁴⁹ It has also been noted that the notional amount of credit protection bought does not provide an accurate picture of the actual amount of risk shifted, for several reasons. One is that risk may be shifted in a non-linear fashion, as described in Section II.D, above. To the extent that banks retain the first-loss position, they retain substantial risk of loss. Another is that the CDS market to date has been primarily a market for investment grade reference entities, so that banks have not been able to use the CDS market to hedge their more significant high yield credit risks.

The 2004 credit risk management activities of JPMorgan Chase & Co., one of the largest U.S. banks and a leading originator of bank loans, illustrate a number of these points.⁵⁰ JPMorgan Chase reported over \$1 trillion notional amount of credit derivatives outstanding at year-end 2004. Of that amount, approximately \$500 billion was reported as protection bought in

⁴⁸ Much of the description in this section is taken from the Joint Forum 2005 Report, the Fitch 2004 Survey, the Fitch 2003 Survey and the S&P 2003 Bank CDS report.

⁴⁹ Fed 2003 Loan Survey. The survey states that of the thirty-six largest U.S. banks that participated in the survey, about 35 percent use CDS to hedge risk in their commercial and industrial loan portfolio. Of those, the majority did so for less than 4 percent of their outstanding loans plus lines of credit. A higher percentage of foreign banks surveyed used CDS to hedge, and did so for a higher percentage of their total loans and loan commitments. As noted above, the most commonly cited reason for hedging with CDS rather than selling a loan was to preserve the bank's relationship with the borrower. U.S. banks cited risk diversification and relative profitability as the primary reasons for selling protection via CDS.

⁵⁰ JPMorgan Chase's 2004 annual report is available at www.jpmorganchase.com. It contains a detailed discussion of JPMorgan Chase's credit risk management policies and positions.

the bank's dealer business and \$530 billion as protection sold in that business, with the difference attributable to selling protection on large, diversified investment grade portfolios and then risk managing those portfolios by buying protection on the most subordinated tranches of those portfolios (that is, this difference is attributable to transactions in synthetic CDOs). JPMorgan Chase also reported about \$37 billion of protection bought to hedge loans and loan commitments, and \$37 million of protection sold in order to diversify its portfolio. Of the \$37 billion protection bought, \$25 billion were hedges of wholesale loans and loan commitments and \$12 billion were hedges of other derivatives. By comparison, JPMorgan Chase reported \$135 billion of wholesale loans outstanding and \$309 billion of wholesale loan commitments. Both the maturity profile and the investment grade vs. high yield distribution of the loan book hedges differed from those of the loan book itself.

The Notice requests information on market practice regarding hedging, the management of basis risk, and the timing of CDS transactions relative to the assumption and disposition of analogous risks. Publicly available information does not address those issues except as described above.

2. Regulation.⁵¹ U.S. banks are subject to regulation by one or more of the four federal banking agencies and/or state banking regulators, under which banks are subject to minimum regulatory capital requirements that require, among other things, that banks set aside capital based on risk-based capital ratios. At the federal level, current law is based on a 1998 international banking accord (Basel I).

Different rules apply to positions in a bank's banking book vs. trading book. The rules assign risk weightings to assets by classifying them into a number of broad categories (*e.g.*, government obligations vs. corporate obligations). A bank that sells protection through CDS in its banking book will incur a capital charge as if the bank had funded a loan to the reference entity. A bank that buys protection through CDS for a position in its banking book may reduce its capital charge for that position by an amount that takes into account the risk profile of the protection seller, subject to various limitations.⁵² Trading book CDS are subject to a different set of rules applicable to all trading book derivatives, under which the amount of capital required to be set aside is determined by reference to the market and credit risk of the position on a mark-to-market basis and may be reduced in part or whole by hedging.

Risk management techniques have developed significantly since 1988, with the result that regulatory and economic capital management may diverge in ways that distort banks' economic lending practices and encourage banks to move assets off-balance sheet to reduce their regulatory capital charges. The risk-based capital rules are expected to change in the near future,

⁵¹ The Joint Forum 2005 Report contains a useful discussion of current and pending regulatory rules for banks, securities dealers and insurance companies in Annex 3. This discussion is based in part on that report.

An earlier report by the Joint Forum provides a detailed discussion of the differences in the types of risks most commonly faced by banks, securities firms and insurance companies, the consequent differences in risk management tools that each sector has developed, and related differences in regulatory capital requirements. See Joint Forum 2001 Report.

⁵² For example, a loan to a corporate borrower is classified as a 100 percent risk-weighted asset. A loan to bank in an OECD country is classified as a 20 percent risk weighted asset. If the bank buys protection on the corporate loan from an OECD bank, it may reduce its risk weighting for the corporate loan from 100 percent to 20 percent, in effect transforming the corporate loan into a loan to an OECD bank for capital purposes.

as the federal banking agencies implement the so-called Basel II Framework or New Accord, developed by the Basel Committee on Banking Supervision.⁵³

Under the New Accord a bank will be required to calculate capital requirements for exposure to both credit risk and operational risk (and market risk for institutions with significant trading activity). One of the principal innovations of the New Accord are the methodologies provided for determining capital requirements for credit risk. There are two general approaches, one of which is essentially a modified form of the 1988 accord, and the other of which uses a bank's internal estimates of key risk drivers to derive capital requirements.

One of the principal questions still being considered by U.S. bank regulators is how to properly account for the risk mitigation provided by the "double default" aspect of credit derivatives – that is, the fact that a fully hedged protection buyer will lose money only if both the reference entity and the protection seller default.⁵⁴ One study notes that the pricing of CDS is "fundamentally linked to four main factors: (i) the credit risk of the reference entity; (ii) the expected recovery rate associated with the reference entity and the protection seller; (iii) the credit risk of the protection seller; and (iv) the default correlation between the reference entity and the protection seller." Very generally, the Basel II Framework proposes to account for credit derivatives by allowing a bank that obtains credit protection for a loan to substitute risk parameters associated with the protection seller for those associated with the reference entity based on the credit rating of the parties.⁵⁵ Some commentators believe that the New Accord will reduce incentives for banks to transfer credit risk to third parties, including insurance companies, because banks will not need to set aside as much capital against highly-rated assets that they hold.

B. *Insurance Companies.*⁵⁶

1. Insurance Company Participation in the CDS Market. As described in more detail below, insurance companies participate in the credit derivatives market through a number of different avenues. Market surveys combine funded and unfunded participation, so that determining the amount of "pure" CDS activity is difficult. For example, the surveys treat the writing of a single-name CDS as comparable to investing in a CLN linked to the same single reference entity, because both give rise to a "long" position in the reference entity's debt. Insurance companies may take on exposure to CDOs in various ways, for example, including purchasing notes (generally highly rated) issued by cash CDOs or by synthetic CDOs, or by selling protection for the "supersenior" tranche of CDOs as described below. Insurance

⁵³ The Basel II Framework is formally termed "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," and was published in June 2004.

⁵⁴ See BIS 2005 Double Default Paper; Fed 2003 Double Default Paper.

⁵⁵ For a discussion of the Basel II Framework as applied to credit derivatives, see, e.g., Fed 2003 Double Default Paper; Gregory 2003 book ch. 21; Bomfim 2001 article; ISDA/TBMA July 2003 comment letter; ISDA/TBMA November 2003 comment letter. Annex 3 of the IAIS 2003 CRT Paper includes an example showing the effect of a CDS hedging a position in a bank's banking book under both the current and new rules.

⁵⁶ The most comprehensive discussion of the participation of insurance companies in the credit derivatives market is in the Joint Forum 2005 Report. That discussion is based in part on the Fitch 2004 Survey and the Fitch 2003 Survey. However, the Joint Forum numbers and the Fitch numbers are not wholly comparable. The IAIS 2003 CRT Paper also discusses the cross-sector credit risk transfer activities of insurance companies. The description in the text comes from those sources.

companies may enter into CDS through non-insurance subsidiaries, or may acquire synthetic CLNs through “replication (synthetic asset) transactions,” as described below. Depending on the form and purpose of these transactions and the legal status of the entity (insurance company vs. non-insurance affiliate) that enters into the transaction, the transaction may be classified as an insurance regulatory matter as insurance, as an investment or as a derivatives transaction.

The most complete market data that breaks out the activities of insurance companies in the credit derivatives market is from the fall of 2003. While out of date, it gives a sense of the relative types of exposure that different kinds of insurance companies have to different types of credit risk products. Insurance companies other than financial guarantee insurers (that is, life, health, property and casualty, and reinsurance companies) were reported as having \$126.5 billion of net “protection sold” exposure to synthetic CDOs, \$22 billion of exposure to cash CDOs, and \$7.6 billion of exposure to single-name CDS or CLNs.⁵⁷ As noted above, it appears that some, and perhaps a large portion, of this exposure is in the form of investments in notes that would constitute debt for U.S. federal income tax purposes. It also appears that reinsurance companies and a few large property and casualty insurance companies are the principal types of companies active in this market. Financial guarantee insurance companies were reported as having \$166 billion of net “protection sold” exposure to credit derivatives, primarily through synthetic CDOs, and another \$56 billion of such exposure through wrapping of cash CDOs. As with banks, it is reported that a relatively small group of insurance companies and insurance company affiliates, on the order of 15-20, dominate insurance participation in the credit derivatives market.

2. Transformers. As the numbers cited above indicate, by far the largest form of exposure by insurance companies to the credit derivatives market is through providing protection to synthetic CDOs, primarily the “supersenior” tranche. A structure that is used from time to time for providing this protection is through a “transformer” vehicle, that is, a special purpose vehicle that (a) writes a CDS to the synthetic CDO issuer, or to the bank sponsoring the synthetic CDO, on the supersenior risk, and (b) purchases protection via an insurance policy on the CDS from a financial guarantee insurance company.⁵⁸ The SPV may pledge its interests in the CDS to the insurance company, and the insurance company may waive subrogation and certain other standard terms and conditions. For example, while insurance contracts normally provide for payment after a loss is suffered and proof thereof has been made, a transformer policy may provide for payment shortly prior to the date on which the SPV is required to make payment on the CDS. In some cases, the insurance policy incorporates ISDA terminology and documentation, in order to avoid mismatches between the protection provided by the CDS and the policy backing it.

⁵⁷ The Joint Forum 2005 Report provides much lower numbers for non-financial guarantee insurance companies (a total of about \$30 billion of net exposure). It is not clear why these numbers differ so significantly from the numbers referred to in the text, which come from the Fitch 2003 Survey. It is possible that the Joint Forum numbers do not include the activities of non-insurance subsidiaries of insurance companies.

⁵⁸ Bermuda transformer structures and related structures are described in the IAIS 2003 CRT Paper, Annex 2 and in the Banks 2004 book, pages 168-170. One important related structure is a “protected cell company” (PCC). A PCC is a company that enters into multiple transformer-type transactions, with each transaction booked in a separate “cell” that functions like a separate series of a mutual fund in the sense that the parties to that transaction can look only to the assets and contracts related to that transaction. The IAIS 2003 CRT Paper states that several U.S. states have enacted PCC legislation.

This structure is described as satisfying various non-tax goals of each of the institutions involved. For the financial guarantee insurance company, it is preferable to write an insurance policy rather than a CDS, because insurers may not be permitted to sell protection via CDS or are subject to regulatory restrictions on derivatives, and because CDS are, but insurance is not, required to be marked to market for GAAP purposes. Financial guarantee insurance companies are described as viewing these transactions as a bona fide part of their insurance business, meaning that they constitute potential liabilities to which the companies apply customary insurance underwriting standards. For the bank sponsor, on the other hand, the use of a CDS rather than insurance to acquire protection allows the bank to reduce its regulatory capital requirements and to mark the hedge to market for financial accounting purposes, as described in Section IV.A, above. The bank views the transaction as a capital markets/derivatives transaction.

3. RSATs. Another structure through which insurance companies participate in the credit derivatives market is the replication (synthetic asset) transaction (RSAT). A RSAT is defined as a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments.⁵⁹ An example is the sale of protection through a CDS on a BBB-rated reference entity coupled with a funded investment in a U.S. Treasury obligation. In other words, a RSAT is a type of CLN, as described in Section II.B.3(e), above. RSATs may be used to make synthetic investments in single-name reference entities, indices and baskets.

4. Negative Basis Trades. A type of transaction that seems to be unique to financial guarantee insurance companies is a “negative basis” trade. In such a trade, a dealer acquires at origination an entire, AAA-rated tranche of an asset-backed securities offering, and enters into a CDS with a monoline for the entire life of the security. The parties view the transaction as a means for the insurance company to acquire the security on an unfunded basis.⁶⁰ In such transactions, the dealer will grant the voting rights on the ABS security to the monoline. It appears that this type of transaction is the only common transaction in which a CDS counterparty is granted voting rights, because protection buyers ordinarily do not expect to hold the underlying security and therefore cannot not agree to transfer voting rights they do not have.⁶¹

⁵⁹ Purposes and Procedures Manual of the NAIC Securities Valuation Office (SVO), December 2001 Edition, Part Thirteen, Section 1(a)(viii), as quoted by Driscoll 2001 RSAT article.

⁶⁰ To put it differently, the CDS effectively functions like a total return swap on the security minus the time-value-of-money components of each side of the swap, or a 100 percent leveraged investment in the security with netting of interest components. For example, assume that an ABS security pays a coupon equal to LIBOR plus 10 basis points, and that if the insurance company entered into a total return swap on the security, it would be entitled to receive an amount equal to the ABS security coupon, and would be required to pay LIBOR multiplied by the notional principal amount of the security. If the two LIBOR components are netted, the insurance company would simply receive 10 basis points multiplied by the notional principal amount of the security. This amount would be the periodic payment on the CDS.

⁶¹ See Derivatives Week 2005 Monolines CDS ABS article #1 (monolines object to new draft general template for pay-as-you-go CDS on ABS because, in part, of lack of provision allowing them to have voting rights); Derivatives Week 2005 Monolines CDS ABS article #2 (as a result of dealer unwillingness to negotiate on voting issue, monolines intend to develop own template for CDS on ABS).

5. Regulation.⁶² For purposes of this brief summary, it is useful to distinguish between the monoline financial guarantee insurance companies and other insurance companies. Very generally, insurance company regulation draws a sharp distinction between underwriting (of insurance) activities and investment activities, although insurance company regulators are aware that credit risk transfer may take place in each and that the boundaries are not clear. Underwriting activities give rise to potential liabilities, for which insurance companies must set aside various kinds of reserves, in addition to their equity capital (termed “surplus”). Reserve obligations for property and casualty insurance companies generally are measured by reference to the amount of premiums earned. Insurance companies may not insure a single transaction in an amount, net of reinsurance and in some cases collateral or other forms of risk mitigation, that exceeds certain limits.

Monoline financial guarantee insurance companies initially provided insurance for municipal bonds. They subsequently expanded their business to CDOs, and then to other types of credit protection. As compared to other insurance companies, they are subject to different (higher) minimum capital requirements. They are AAA-rated and manage their business in order to maintain that rating. One important reserve (the contingency reserve) is set by reference to the principal amount of outstanding obligations insured rather than on premiums earned, and must be allocated to insured risks in amounts that vary depending on the size and type (which may depend, for example, on the rating of the obligation and whether it is secured) of risk insured.

The limit on the amount of exposure (total liabilities) a financial guarantee insurance company may take to a single risk is measured by reference to an issuer rather than a single bond issuance. Total liabilities for any single risk are reduced by the amount of any collateral or reinsurance. “Collateral” generally means investment grade securities of a kind approved by the Securities Valuation Office of the National Association of Insurance Commissioners. Collateral is defined to include mortgage-backed securities and asset-backed securities, including CDOs, and, as described above, RSATs. Unfunded derivative financial instruments, by contrast, historically did not qualify as collateral. However, New York insurance law recently has been amended to treat credit default swaps that meet certain criteria as collateral for this purpose.⁶³

C. *Securities Dealers.*

Available market data does not break out information about securities dealers separate from information about banks. One study reports that major U.S. securities firms are in the top echelon of counterparties in the global credit derivatives market (four in the top ten list),

⁶² This description is based on provisions of the New York insurance law and on the NAIC 1988 Model Act article. For other, more international, descriptions of insurance regulation, see OECD 2005 Insurance Permanent Establishment Report; Joint Forum 2001 Cross-Sector Report.

Annex 4 of the IAIS 2003 CRT Paper contains a worked example comparing the current and proposed bank regulatory rules under the Basel II Framework with the current insurance regulatory rules. It concludes that the current bank regulatory rules generally require a significantly higher amount of regulatory capital for investment grade risks than do the insurance regulatory rules, and that the New Accord will diminish somewhat but not eliminate that difference.

⁶³ New York Insurance Law, section 6901(g)(5), available at <http://public.leginfo.state.ny.us/menugetf.cgi> by selecting ISC, Article 69, 6901.

acting primarily as intermediaries. U.S. securities dealers are subject to net capital rules that generally require daily mark-to-market of positions and that require a protection seller to set aside capital as if it held the underlying obligation. Different rules apply to securities dealers subject to consolidated regulatory supervision and to over-the-counter derivatives dealers.⁶⁴

D. *Hedge Funds.*

Information about the extent of participation of hedge funds in the CDS market is imprecise, because hedge funds to date have not participated in general market surveys. Studies of the market thus rely primarily upon information obtained from the financial institutions that are the counterparties to hedge funds. That information indicates that hedge fund participation in the market is growing markedly, and represent a very significant fraction of the customer activity for some intermediaries. One survey reports that hedge funds may represent as much as 30 percent of the global credit derivatives market, a market that includes but is not limited to CDS.⁶⁵ Hedge funds are reported to be particularly active in certain market segments and activities.⁶⁶

V. *U.S. Federal Income Tax Issues.*

As described above, this Part V of the Report is divided into three parts. The first summarizes the consequences of various possible characterizations of CDS. The second discusses the policy and technical issues applicable to distinguishing between credit protection instruments that should be taxed as derivative financial instruments, and those that may be taxed as insurance. The last section addresses timing and character issues relevant to those CDS that are taxed as derivative financial instruments.

One preliminary question is how the analysis of CDS should proceed. Possibilities include (i) a comparison of the terms of CDS to other instruments in an effort to determine whether those terms are so close to those of another instrument that CDS ought to be taxed like that other instrument, (ii) a contextual approach that examines whether a CDS participant is acting like an investor, trader, dealer, insurer or other recognized category of actor, or (iii) an a priori examination of the policy issues involved in taxing CDS. Each of these approaches can bring some valuable insights to bear. The discussion below contains some attributes of each.

Our current tax rules apply primarily by characterizing a financial contract as a type of financial instrument or asset (*e.g.*, debt, stock, partnership interest), and then by taking context into account (*e.g.*, issuer vs. investor, domestic vs. cross-border, trader vs. dealer). For systemic reasons, we believe the same approach should be used for CDS. Tax policy and context

⁶⁴ See Joint Forum 2005 Report, pages 20, 69-70.

⁶⁵ Fitch 2005 Hedge Fund Report, quoting a survey by Greenwich Associates titled "Hedge Funds: The End of the Beginning?" (Dec. 10, 2004).

⁶⁶ See Joint Forum 2005 Report, pages 22-23 (hedge funds reported to be increasing buyers of equity tranches of synthetic CDOs as part of larger hedged transactions; report also lists private asset managers as another significant source of risk-taking); Fitch 2005 Hedge Fund Report (hedge funds are understood to be significant buyers of subordinated and equity tranches of CDOs, as well as investing in CDO squared structures); Fitch 2003 Report (information requested from 50 large hedge funds; all declined to respond); Fitch 2004 Report (for a number of the more active credit derivatives intermediaries, 20-30 percent of trading volume is with hedge funds).

should be used as guides in determining how CDS should be characterized.⁶⁷ More specifically, we strongly recommend that any guidance that is issued either directly or by analogy characterize a conventional CDS for U.S. federal income tax purposes as a type of financial instrument for which there is a well-developed body of law, such as a notional principal contract, or indicate that conventional CDS will be taxed under the rules applicable to such an instrument absent further guidance.

The reasons for this recommendation are several. First, CDS bear a sufficient resemblance to existing types of financial instruments that it is feasible to adapt the rules applicable to one of those instruments to CDS. (We recognize that adaptation may in fact be necessary, and address that issue in Section V.C, below.) We do not believe that any policy of U.S. federal income taxation calls for the development of an entirely new category of financial instruments. Moreover, and importantly, this approach would enormously reduce the amount of time and energy that both Treasury and the Service, on the one hand, and taxpayers, on the other, will need to spend in developing rules, in applying them, and in dealing with audits. In view of the government's limited resources, it is highly desirable to limit the amount of future guidance that will be necessary before taxpayers and auditors have a roadmap to dealing with essential tax questions pertinent to CDS.

A. *Consequences of Different Tax Characterizations of CDS.*

The U.S. federal income tax consequences of the potential characterization of CDS as insurance, guarantees, notional principal contracts or options have been discussed at length in a number of articles published in recent years, and are referred to in Notice 2004-52.⁶⁸ They consequently are summarized only very briefly here.

Before turning to that summary, one important issue is whether that list of four possible characterizations is exhaustive. As described above, there are, for example, other credit risk-assumption products, such as letters of credit. We think it very unlikely that a conventional CDS would be treated as a letter of credit or as anything other than one of the four types of transactions already listed. We also note that while there is a well-developed body of U.S. federal income tax law relating to the taxation of insurance, notional principal contracts and options, and sufficient law with respect to guarantees to answer many questions, there is no similar breadth and depth of tax law with respect to other potential analogies.

⁶⁷ One commentator has argued strongly that an approach that focuses on the four corners of a CDS contract is misguided, primarily because the core activities that distinguish insurance from other forms of risk shifting contracts are risk distribution and pooling (that is, risk management strategies), which cannot be determined by looking at the contract terms. He argues for a functional approach based on whether a contract is one that can be hedged in the marketplace, noting that a functional approach is less subject to gaming and inadvertent errors. Kleinbard 2003 article. We think that this approach would be extremely difficult to implement absent a more fundamental rewriting of the U.S. federal income tax rules for financial instruments. The growth of capital markets products such as CAT (catastrophe) bonds and more recently "mortality" bonds that allow insurance companies effectively to hedge traditional property and life insurance risks also could make these distinctions difficult to implement.

⁶⁸ A number of these articles are listed in the Bibliography. The list is not exhaustive. The most recent comprehensive articles discussing these issues are the Kayle 2004 article, the Miller 2002 Insurance article and the Miller 1995 Guarantees article, which this summary is in part based on.

1. Rules Applicable to Foreign or Cross-Border Transactions.
 - (a) *Excise tax and regular withholding tax.*
 - (i) Insurance: An excise tax is imposed on each policy of insurance or reinsurance by any foreign insurer or reinsurer, at a rate of 4 percent of the premium paid by a U.S. insured for insurance against U.S. risks and 1 percent of the premium paid for reinsurance on insurance contracts subject to the excise tax.⁶⁹
 - (ii) Guarantees: Periodic guarantee premium payments constitute “fixed or determinable annual or periodical” income within the meaning of section 871(a)(1), and may be U.S. source under the principles of the *Bank of America* case or otherwise.⁷⁰ U.S. source guarantee payments to a foreign person are subject to U.S. withholding tax, absent an overriding tax treaty.
 - (iii) Notional principal contracts. Payments on a notional principal contract generally are not subject to regular withholding tax.⁷¹ A payment may, however, be subject to such tax if characterized as interest, subject to exceptions or reduced rates under domestic or treaty rules.⁷²
 - (iv) Options. Option premiums are not subject to regular withholding tax.⁷³
 - (b) *U.S. trade or business.*
 - (i) Insurance and guarantees. The determination of whether a foreign entity engaged in selling insurance or providing guarantees to U.S. persons is engaged in the conduct of a trade or business within the United States is determined under standards set primarily by case law.⁷⁴
 - (ii) Notional principal contracts and options. Trading in securities or commodities by a foreign person (other than a dealer) for its own account is not treated as the conduct of a trade or business within the United States. This rule includes trading in options. Under proposed regulations, the same rule applies to trading in derivatives, other than by a dealer.⁷⁵

⁶⁹ Sections 4371, 4372.

⁷⁰ *Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1982).

⁷¹ Treasury regulation section 1.1441-4(a)(3)(i) (withholding agent has no obligation to withhold on amounts paid under terms of notional principal contract); Treasury regulation section 1.863-7(b) (source of notional principal contract income generally determined by reference to residence of recipient).

⁷² Treasury regulation section 1.1441-4(a)(3)(i) (no-withholding rule not applicable to payments treated as interest); Treasury regulation section 1.446-3(g)(4) (interest characterization for certain payments).

⁷³ Treasury regulation section 1.1441-2(b)(2)(i).

⁷⁴ For a summary of case law addressing the sale of insurance by foreign persons to U.S. persons, *see* Miller 2002 article, note 56.

⁷⁵ Section 864(b)(2); Treasury regulation section 1.864-2(c)(2)(i); proposed Treasury regulation section 1.864(b)-1.

(c) *PFIC rules.*

- (i) Insurance. Passive income does not include income derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business and would be subject to tax under subchapter L if it were a domestic corporation.⁷⁶ It appears that insurance premiums (but not, for example, interest) derived by a corporation that does not meet these tests would not be treated as passive income in any event.⁷⁷
- (ii) Guarantees. It appears that guarantee premiums are not treated as passive income.⁷⁸
- (iii) Notional principal contracts and options. Passive income does not include income derived in the active conduct of a banking business by a U.S.-licensed bank, or income from transactions in derivative financial instruments derived by a dealer in such instruments, or qualified banking or financing income of a controlled foreign corporation, subject to various limitations.⁷⁹ Income from notional principal contracts or options that does not satisfy these conditions is treated as passive income.

(d) *Subpart F rules.*

- (i) Insurance. Special rules apply to treat a foreign corporation as a controlled foreign corporation if more than 25 percent of the vote or value of its stock is owned by U.S. shareholders that own stock with 10 percent or more of the corporation's voting power, and the gross amount of the corporation's insurance or reinsurance income from (re)insuring U.S. risks exceeds 75 percent of its total insurance or reinsurance income, subject to certain other conditions.⁸⁰
- (ii) Guarantees. It appears that guarantee income is not treated as foreign personal holding company income subject to the subpart F rules, unless it is treated as insurance income.⁸¹

⁷⁶ Section 1297(b)(2)(B). The legislative history of this provision limits this rule to foreign corporations that do not maintain financial reserves in excess of the reasonable needs of its insurance business. *See* Miller 2002 Insurance article, page 504.

⁷⁷ Section 1297(b)(1) ("passive income" generally means foreign personal holding company income as defined in section 954(c)).

⁷⁸ *Id.*

⁷⁹ Section 1297(b)(2)(A); section 954(c)(2)(C); section 954(h).

⁸⁰ Section 957(b); section 953. In addition, in the case of related party insurance income earned by a captive insurance company, the ownership test is broadened further to eliminate the 10 percent voting power threshold, and other rules apply so as to expand the scope of subpart F as applied to such companies. Section 953(c).

⁸¹ Section 952(a) (subpart F income generally means insurance income and foreign base company income); section 953 (insurance income); section 954 (foreign base company income).

- (iii) Notional principal contracts and options. Subpart F income does not include income from transactions in derivative financial instruments by a dealer in such instruments, or qualified banking or financing income of a controlled foreign corporation, subject to various limitations.⁸² Income from notional principal contracts or options that does not satisfy these conditions is treated as foreign personal holding company income subject to tax under subpart F.

2. Rules Applicable to All Transactions.

(a) *Timing*.

- (i) Insurance. Periodic insurance premium payments generally are deductible when paid by the beneficiary.⁸³ Insurance premiums received by a non-life (that is, property and casualty) insurance company are taken into account under complex rules that effectively spread most of the income over a period of time.⁸⁴ Such insurance companies also may deduct estimates of their futures losses.⁸⁵
- (ii) Guarantees. Periodic guarantee premium payments generally are deductible when paid by the beneficiary and taxable when received by a guarantor. Neither party is required to accrue income or expense in respect of a possible payment in the case of a loss. The guarantor generally is entitled to a bad debt deduction when it makes a payment to the beneficiary under the guarantee.⁸⁶

Insurance and guarantees generally are not treated as eligible for hedging or integration rules. Insurance and guarantees may be treated as reducing the risk of loss on a hedged position for purposes of the straddle rules of section 1092 and other provisions dealing with risk reduction.

- (iii) Notional principal contracts. Periodic payments are deductible or includible on a current accrual basis.⁸⁷ Proposed regulations would require accrual of income or expense in respect of contingent nonperiodic payments on certain swaps.⁸⁸ It is not clear whether these regulations would apply to CDS, and if so, how they would apply in view of the uncertain timing of credit events and therefore of payments by protection sellers.⁸⁹

⁸² Section 954(c)(2)(C); section 954(h).

⁸³ Treasury regulation section 1.162-1(a); *see also* authorities cited in Miller 2002 article, note 22.

⁸⁴ Section 832(a), (b).

⁸⁵ Treasury regulation section 1.832-4(b).

⁸⁶ Section 166; Treasury regulation section 1.166-9.

⁸⁷ Treasury regulation section 1.446-3(e).

⁸⁸ Proposed Treasury regulation section 1.446-3(g)(6).

⁸⁹ This issue is discussed in more detail in Section V.C, below. *See also* NYSBA 2004 NPC report, commenting on proposed Treasury regulation section 1.446-3(g)(6).

- (iv) Options. Option premium payments are not deductible or includible until the option is exercised, lapses or is otherwise disposed of.⁹⁰ No accrual is required in respect of a potential payment on exercise of an option. Note, however, that a series of options that constitute a cap or floor would be taxed under the rules applicable to notional principal contracts.

Options and notional principal contracts are eligible hedges for purposes of the hedging transaction timing rules.⁹¹ They also are eligible financial instruments for purposes of the debt integration rules, although commentators have taken different positions as to whether they can satisfy the requirement that one be able to calculate a yield to maturity on the integrated debt instrument.⁹² Options and notional principal contracts may be treated as reducing the risk of loss on a hedged position for purposes of the straddle rules of section 1092 and other provisions dealing with risk reduction.

(b) *Character*.

- (i) Insurance and guarantees. Periodic premium payments are ordinary income and ordinary expense items. A payment made by an insurer or guarantor in respect of a loss generally is treated by the payor as an ordinary expense or loss (for guarantees, only in the case of a guarantee by a corporation or that otherwise is a business guarantee), and as a payment with the same character as the payment it replaces (*e.g.*, interest or principal) to the recipient.⁹³
- (ii) Notional principal contracts. Periodic payments give rise to ordinary income and expense.⁹⁴ The character of a payment made in respect of a loss is uncertain, and depends on whether the payment is treated as attributable to the termination of a right or obligation with respect to a capital asset under section 1234A.⁹⁵

⁹⁰ See, *e.g.*, *Virginia Iron Coal & Coke Co. v. Commissioner*, 90 F.2d 919 (4th Cir 1938); Rev. Rul. 78-182, 1978-1 C.B. 265.

⁹¹ Treasury regulation section 1.446-4; see also Treasury regulation section 1.1221-2 (character).

⁹² Treasury regulation section 1.1275-6; see Kayle 2004 article, pages 210-11 (CDS cannot be integrated with reference obligation); Miller 1999 article, pages 11, 16 (discussing circumstances under which integration is possible).

⁹³ For insurance, see, *e.g.*, Rev. Rul. 72-134, 1972-1 C.B. 29 (financial guarantee insurance payment with respect to defaulted interest on tax-exempt bond is exempt from tax under section 103). For guarantees, see Section 166; Treasury regulation section 1.166-9 (payment made by guarantor); Treasury regulation sections 1.861-2(a)(5) and 1.862-1(a)(5) (guarantee payments received by beneficiary treated as interest).

⁹⁴ Treasury regulation section 1.446-3(e).

⁹⁵ See Proposed Treasury regulation section 1.1234A-1(a). The proposed regulation refers to the definition of “termination payment” in Treasury regulation section 1.446-3(h)(1), which generally is defined as a payment made or received to extinguish or assign all of the rights and obligations under a notional principal contract. The Service has interpreted this definition to exclude the final scheduled payment on an equity or other asset-based swap. It is not clear whether a payment made as a result of a credit event, which is not scheduled but is pursuant to the terms of the instrument, would be considered a termination payment. See the discussion in Section V.C.2, below.

- (iii) Options. All payments under an option are taken into account when the option is exercised, lapses or otherwise is disposed of, as either components of amounts paid in connection with the purchase and sale of property, in the case of physically settled options, or as capital gain or loss, in the case of cash-settled options.⁹⁶

Notional principal contracts and options that qualify as hedges under the hedging transaction rules of Treasury regulation section 1.1221-2 give rise to ordinary income or loss.

(c) *Other rules.*

- (i) Section 475 vs. Subchapter L. Domestic insurance companies and foreign companies carrying on an insurance business within the United States are subject to the special rules of subchapter L. Dealers in securities are subject to the special rules of section 475.
- (ii) Publicly traded partnerships. Income from notional principal contracts and options can qualify as passive income for purposes of the publicly traded partnership rules.⁹⁷ Insurance and guarantee income would not.
- (iii) Personal holding companies. Income from insurance, guarantees, notional principal contracts and non-equity options does not constitute personal holding company income but does constitute gross income for purposes of the personal holding company rules.⁹⁸ Special rules, however, apply to determine the gross income of a non-life insurance company.⁹⁹
- (iv) Tax-exempt investors. Income from notional principal contracts and options generally does not constitute unrelated business taxable income.¹⁰⁰ Income from insurance may be exempt from tax if the issuance of the insurance is related to the entity's tax-exempt purpose.¹⁰¹ Subpart F income from a foreign insurance company generally constitutes unrelated business taxable income to the extent derived from insurance income.¹⁰²
- (v) Tax-exempt bonds. Fees for guarantees are taken into account in determining the yield of a tax-exempt bond under the arbitrage rules. Swap expense is taken into account only to the extent that it is "interest-based."¹⁰³ A tax-exempt bond may not be integrated with a hedge.¹⁰⁴ In

⁹⁶ Section 1234; Rev. Rul. 78-182, 1978-1 C.B. 265.

⁹⁷ Section 7704(d); Treasury regulation section 1.7704-3.

⁹⁸ Section 543; Treasury regulation section 1.543-1.

⁹⁹ Section 543(c).

¹⁰⁰ Section 512(b)(1) & (b)(5); Treasury regulation section 1.512(b)-1(a).

¹⁰¹ Section 501(m). No comparable statutory rule applies to income from guarantees. The Service has ruled privately on a number of occasions that providing a guarantee is consistent with an organization's exempt purpose.

¹⁰² Section 512(b)(17).

¹⁰³ Treasury regulation section 1.148-4.

¹⁰⁴ Treasury regulation section 1.1275-4(b)(1)(i).

the case of insurance or a guarantee the characterization rules for payments received described above functionally provides a quasi-integration regime.

- (vi) Section 1256. Non-equity options listed on a qualified exchange are subject to the mark-to-market and 60/40 (60 percent long-term capital gain or loss, 40 percent short-term gain or loss) rules of section 1256.
- (vii) Wash sales. Under section 1091, a loss on the sale of a bond or other debt instrument is subject to the wash sale rules if the taxpayer enters into an option or contract to acquire the bond within 30 days before or after the sale.

B. *Insurance or Derivative Financial Instrument?*

This section of the report begins the discussion of which financial instrument it is most appropriate to use as the model for the U.S. federal income taxation of CDS. Except where explicitly stated, the remainder of the report addresses primarily conventional single-name CDS of the kind described in Section II.B, above, since those instruments represent the most common form of CDS and are the building block for other credit derivative products.

We believe that the description in Parts II through IV demonstrates that conventional single-name CDS are not the “same” as any pre-existing financial instrument. Because of the fundamental differences between the way insurance policies and insurance companies are taxed, on the one hand, and derivative financial instruments and dealers therein are taxed, on the other hand, this Section V.B addresses the question of which of those models is most appropriate for taxing CDS. It addresses first a number of tax policy considerations, and then discusses some of the tax cases and rulings dealing with insurance contracts and insurance policies in order to formulate recommendations as to how conventional CDS should be taxed.

1. Policy Considerations.

(a) Appropriate Application of the Rules Applicable to Insurance Policies and Insurance Companies. The Code and regulations contain explicit rules mandated by Congress for the taxation of insurance policies and insurance companies. The U.S. federal income tax rules for CDS should not permit taxpayers to avoid the application of those rules, where it is appropriate to apply them.

Conversely, in view of the fact that treatment as an insurance company may be favorable rather than unfavorable, the tax rules for CDS should not permit taxpayers to elect into insurance company treatment where not appropriate. Recent fact patterns that have been the subject of government scrutiny in this regard include: (i) captive insurance companies, which have been the subject of extensive litigation,¹⁰⁵ (ii) producer-owned reinsurance companies,

¹⁰⁵ See, e.g., *Amerco*, 96 T.C. 18 (1991) (contracts written by property and casualty insurance company that was owned by holding company for U-Haul rental system, and that wrote a substantial amount of insurance covering a wide variety of risks for U-Haul customers and independent fleet owners as well as writing insurance for holding company’s subsidiaries, were properly treated as insurance for U.S. federal income tax purposes), *aff’d*, 979 F.2d

which may take advantage among other things of the rules of section 501(c)(15) treating certain small insurance companies as tax-exempt,¹⁰⁶ and (iii) foreign companies operated in a manner intended to take advantage of the carve-out from the PFIC rules for insurance companies.¹⁰⁷ The potential for tax advantages arising from insurance company taxation is also illustrated by the fact that one of the best-known and most highly-admired investors in public companies has purchased a major insurance company as a vehicle for making his investments.

Some of the guidance referred to above has dealt with risk distribution, in particular whether a purported insurer has taken on a sufficient number of independent risks that it is managing its business pursuant to the “law of large numbers.” The most recent guidance issued by the Service addresses that issue in the context of an “insurer” that is not related to the parties insured, and requests comments from taxpayers on a range of issues affecting the characterization of a contract as insurance.¹⁰⁸ The application to some transactions involving conventional CDS of some of the risk distribution guidance the Service has issued is discussed below. The broader issues are outside the scope of this report.

(b) Legal Entity Taxation. An “insurance company” is defined as “any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.”¹⁰⁹ The conclusion that a type of contract is an insurance or reinsurance contract thus can transform an entity that is in the business of selling protection through such contracts into an insurance company.

162 (9th Cir. 1992); *Sears, Roebuck & Co.*, 96 T.C. 61 (1991) (payments made to Sears to subsidiary that was leading U.S. insurance company constituted insurance premiums), *aff’d in part and rev’d in part*, 972 F.2d 858 (7th Cir. 1992); *The Harper Group*, 96 T.C. 45 (1991) (payments made by Harper subsidiaries to insurance company subsidiary of Harper constituted insurance premiums where insurance company had substantial unrelated business), *aff’d*, 979 F.2d 1341 (9th Cir. 1992); *see also* Rev. Rul. 2002-89, 2002-2 C.B. 984 (amounts paid by parent to subsidiary organized and regulated as insurance company do not constitute insurance if 90 percent of subsidiary’s business is with parent, and do constitute insurance if less than 50 percent of subsidiary’s business is with parent); Rev. Rul. 2002-90, 2002-2 C.B. 985 (arrangements between 12 operating subsidiaries and insurance subsidiary constitute insurance, where insurance subsidiary is organized, regulated and operated as insurance company, each operating subsidiary’s coverage constitutes a limited part of insurer’s business and other conditions are met); Rev. Rul. 2002-91, 2002-2 C.B. 991 (group captive insurance company owned by a small number of unrelated businesses in same industry constitutes insurance company, where company is organized, regulated and operated as insurance company, each member provides a limited part of group captive’s business, there is real possibility member will sustain loss in excess of premiums paid and other conditions are met).

¹⁰⁶ *See* Notice 2002-70, 2002-2 C.B. 765 (describing grounds on which Service may challenge claimed tax treatment of off-shore reinsurance company whose sole business is to reinsure risks of taxpayer’s customers), *modified* by Notice 2004-65, 2004-41 I.R.B. 599.

¹⁰⁷ Notice 2003-34, 2003-1 C.B. 990 (describing grounds on which Service may challenge claimed tax treatment of off-shore insurance company that enters into contracts under which it assumes only limited risk and whose investment portfolio generates returns substantially exceeding the needs of its insurance business).

¹⁰⁸ Rev. Rul. 2005-40, 2005-27 I.R.B. 4 (describing four situations where purported insurance company insures risks of unrelated person(s)); Notice 2005-49, 2005-27 I.R.B. 14 (requesting comments on several different questions relating to the qualification of purported insurance contracts as insurance).

¹⁰⁹ Section 816(a) (life insurance companies); section 831(c) (other insurance companies); *see also* Treasury regulation section 1.801-3(a) (“insurance company” means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies). Section 831(c) was enacted in 2004. Prior to that time, the regulation provided the applicable standard for non-life insurance companies.

Banks, securities dealers and insurance companies are each subject to special U.S. federal income tax rules.¹¹⁰ Those rules should be administered in such a way that a single legal entity is subject to only one of those sets of rules. In practice, this may not be an issue for financial institutions, in view of the fact that a legal entity becomes an insurance company only if its predominant activity is insurance or reinsurance.

It is, however, an important question for other entities, in view of the fact that it is the character of business actually carried on, rather than the formal legal status of an entity under insurance regulatory law, that determines whether a company is an insurance company. For example, a synthetic CDO issuer that carries out its investment strategy by regularly selling protection under CDS presumably would be taxed as an insurance company if those CDS were treated as insurance contracts. Conceivably even a special purpose vehicle that has entered into a single CDS on a fixed index could be treated as an insurance company, because the CDS shifts risk to the SPV and the SPV could be viewed as managing that risk on a pooled basis because the CDS is on an index consisting of a diversified list of reference entities. One question raised by this latter transaction is what it means to be engaged in the “business” of issuing insurance contracts. This issue is discussed further below.

(c) U.S. Trade or Business Issues. The policy that foreign financial institutions should not be permitted to carry on their ordinary business activities in the United States without being subject to U.S. net income tax or a surrogate for that tax is pervasive throughout the Code. It applies to insurance companies, to banks and to securities and commodities dealers, for example.¹¹¹ Very different rules implementing that policy apply, however, in those various spheres. For the reasons described below, we recommend that guidance be issued providing that the rules and proposed rules applicable under section 864(b) to traders in securities and commodities apply to CDS that are treated as derivative financial instruments.

In general, the question of whether a foreign entity is engaged in the conduct of a trade or business in the United States is determined on a facts and circumstances basis as set out in case law. Resolving this question requires a determination of whether the entity is engaged in trade or business at all, and if so the nature of that trade or business and whether it is carried out in the United States. Each of these determinations is fact-dependent.

¹¹⁰ E.g., Section 582 (banks), section 475 (securities dealers), sections 801-848 (insurance companies).

One small note in this regard is that section 475(c)(2)(E) defines instruments within its scope as “an evidence of interest in, or a derivative financial instrument in ... [various types of assets including] a note, bond, debenture, or other evidence of indebtedness.” Because a conventional single-name CDS does not depend on the performance of any one identifiable debt obligations, a conceivable question is whether the CDS satisfies this definition. This point should be clarified. It is also relevant for purposes of other rules that are based on the section 475 definition, such as the proposed regulations that would extend the section 864(b) trading in securities safe harbors to trading in derivative financial instruments. See Proposed Treasury regulation section 1.864(b)-1(b)(2)(ii).

¹¹¹ See, e.g., Section 842 (foreign insurance companies taxable on effectively connected income); section 4371 (excise tax on premiums paid on U.S.-linked insurance policies written by any foreign insurer or reinsurer); section 881(c)(3)(A) (portfolio interest exemption not available for interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business); section 864(b)(2)(A)(ii) and (B)(ii) (trading in securities and commodities for own account rule not applicable to securities or commodities dealers).

In the case of insurance, a critical question is whether a foreign entity is an insurance company, which as described above turns on the entity's predominant activities. Under this rule, a foreign entity that writes insurance contracts to U.S. customers on U.S. risks through offshore employees may not be subject to U.S. net income tax as an insurer or to U.S. excise tax as long as its insurance activities do not constitute more than half of its business. That is, the "more than half" standard creates a cliff effect. It is not clear what happens if a taxpayer does not fall off the cliff. For example, we are not aware of any law addressing how to determine whether a hypothetical offshore company one-third of whose activities constitutes writing instruments treated as insurance to U.S. persons on U.S. risks is engaged in the conduct of a U.S. trade or business.

The most substantial relevant body of law consists of cases and some rulings addressing the question of whether entities that are engaged in a business of some kind are predominantly engaged in the insurance business. Generally those cases involve an entity that is engaged in part in writing insurance or reinsurance contracts, and in part in some other profit-making activity such as making loans or investments. They turn on facts and circumstances including the amount of premium vs. other income, the number of insurance contracts written and the size of the entity's reserves, and the presence or absence of an active sales staff.¹¹² The cases, as well as the series of Service rulings in recent years referred to in the notes to Section V.B.1(a), above, address primarily fact patterns under which the entity in question is organized and regulated as an insurance company, enters into contracts that have the form of insurance, and conducts its activities in a manner intended to be consistent with an insurance business. The cases and rulings also assume an on-going and regular assumption of new risks. As this description illustrates, the writing of insurance has always been considered to be a business activity. There is no law that we are aware of that provides standards for distinguishing between entities actively engaged in insurance business and entities that "invest" in insurance policies. This guidance therefore is of relatively limited use in the CDS context, where the facts are very different, for example when dealing with a CDO issuer that enters into CDS as a limited part of its investments or with an SPV used to issue a CLN.

By contrast, in the securities area, there are long-established standards for distinguishing between three different types of entities engaged in the purchase and sale of securities – dealers, traders and investors.¹¹³ Very generally, dealers transact with customers, while traders and investors act for their own account. For foreign entities, a special statutory rule provides that foreign entities that are traders or investors (but not dealers) in securities or commodities may carry on their securities activities in the United States without being subject to

¹¹² See *Inter-American Life Insurance Company*, 56 T.C. 497 (limited number of policies written and lack of active sales staff taken into account in determining that taxpayer did not qualify as insurance company), *aff'd per curiam*, 469 F.2d 697 (9th Cir. 1971); *Alinco Life Insurance Company v. United States*, 373 F.2d 336 (Ct. Cl. 1967) (captive reinsurance company constituted insurance company notwithstanding lack of office or employees and fact that all reinsurance was written to reinsure insurance issued to its parent, because company's sole business was reinsurance, risks taken on aggregated nearly \$1 billion and company held substantial reserves); Notice 2003-34, 2003-1 C.B. 990 (all relevant facts taken into account in determining whether foreign company qualifies as insurance company, including size and activities of its staff, whether it engages in other trades or businesses and its other sources of income, citing cases).

¹¹³ See, e.g., *Higgins v. Commissioner*, 312 U.S. 212 (1941) (affirming conclusion that investment activities do not constitute carrying on a trade or business); *George R. Kemon*, 16 T.C. 1026 (1951) (seminal case on dealer/trader/investor distinction).

U.S. net income tax, but subject to U.S. withholding tax applicable to investment flows. Pursuant to Congressional policy dating back to the 1940's, these safe harbor rules have been amended by Congress and interpreted by the Service in a manner that encourages offshore investors, including special purpose vehicles managed by U.S. investment advisors, to invest and trade in U.S. securities. Most recently, in 1998, regulations were proposed to expand the trading in securities or commodities safe harbors to trading in derivative financial instruments by non-dealers.¹¹⁴ These rules generally are considered clear and workable for transactions in stocks, bonds, currencies, commodities and, under the proposed regulations, derivatives therein.

One important question, therefore, is which set of rules offshore entities entering into CDS should be subject to in order to determine whether they are subject to U.S. net income tax. The functional distinction between an entity acting for its own account in taking on and laying off risks, on the one hand, and an entity that holds itself out to customers in the relevant market as regularly offering to sell or enter into specified types of financial instruments in the ordinary course of its business in order to serve a particular market, on the other hand, is one that should be relevant to the determination of whether a foreign entity should be taxed as a financial institution that is subject to U.S. net income tax in order to provide a level playing field for U.S. competitors. To say this more concisely, the tax system should distinguish between trader/investors in CDS on the one hand and insurer/dealers in CDS on the other hand. Further, we think that the same policy of encouraging foreign trader/investors to transact with U.S. financial institutions that the Service has adopted for derivative financial instruments on securities and commodities generally should apply to foreign trader/investors in CDS that are treated as derivative financial instruments.

Accordingly, we think the securities "trade or business" rules -- in particular, the proposed rules under section 864(b) dealing with trading in derivatives -- are preferable to the insurance business rules for CDS treated as derivative financial instruments. We discuss some additional considerations supporting that conclusion below.

As described in Parts II through IV, a conventional CDS is a capital markets transaction. A conventional CDS is documented and priced as a credit derivative, and is entered into directly between a dealer and a customer; by far the most significant financial institutions involved in offering CDS to customers are banks and broker-dealers; the CDS market is a two-way market, meaning that dealers offer both to buy and sell protection; and non-dealer CDS participants engage in CDS for a variety of "securities"-like purposes, including significant trading, arbitrage and portfolio management.

In addition to those market considerations, there are several reasons why we think the securities "trade or business" rules are preferable to the "insurance business" rules as a model for taxing CDS from a tax policy perspective. One is that we think it is more appropriate for entities that have an ordinary course business of dealing with customers to be subject to the

¹¹⁴ Proposed Treasury regulation section 1.864(b)-1. The regulations have remained in proposed form since 1998, and are proposed to become effective for taxable years beginning 30 days after the date final regulations are published in the Federal Register. The preamble to the proposed regulations states, however, that taxpayers may elect to apply the provisions of the final regulations for prior periods, and that taxpayers may take any reasonable position with respect to the safe harbors, including positions consistent with the proposed regulations, during that time. Notice of Proposed Rulemaking, *Trading Safe Harbors* (REG-106031-98), 1998-1 C.B. 1322, 1324.

rules described above for financial institutions, even if that business constitutes less than half of their overall business. A second reason is that, as described above, the rules for securities activities provide a well-understood framework for distinguishing between classes of actors that have different business strategies all of which involve the purchase and sale of securities – that is, traders, investors and dealers – while the rules for insurance activities do not. A third is that the securities trading rules apply in the same manner regardless of whether an entity is regularly selling protection or buying protection, while the insurance rules would treat an entity as an insurance company only if it is writing insurance or reinsurance contracts. Finally, we note that many foreign persons entering into CDS also enter into other types of derivative financial instruments, and that it is desirable, absent any other considerations to the contrary, to apply a single set of rules to all of those activities.

A question that may bear on the choice of an appropriate model for trade or business rules for CDS is whether foreign persons selling protection under conventional CDS engage in activities that could raise U.S. trade or business issues and that are different in kind from those of foreign persons entering into, for example, interest rate or currency swaps. A related issue may be that it is conceivable that CDS could be used to avoid the withholding tax rules applicable to interest on bank loans held by a foreign bank. We understand that there may be a concern, for example, about the extent to which persons representing offshore entities engage in negotiations over the terms of reference obligations (for example, covenants in loans or high-yield bonds) when entering into conventional CDS. We are not aware of such activities in connection with conventional CDS transactions. We note that the market practice of allowing multiple deliverable or valuation obligations means that there is no identifiable obligation associated with a CDS with such terms. In addition, CDS on high-yield bonds generally do not include Restructuring as a credit event, which should make protection sellers less concerned with the wording of covenants since such CDS are less likely to require settlement by protection sellers than would CDS that included Restructuring as a credit event.

It appears more likely that the types of possible fact patterns described in the paragraph above would arise in connection with total return swaps on loans or other fixed income obligations than with CDS. More generally, swaps of that kind may raise issues about which party to the swap in substance owns the underlying obligation, particularly if a swap counterparty directly or indirectly has other creditor-like rights or powers, such as voting rights or rights to confidential information of a kind ordinarily available only to actual creditors. It may be appropriate to develop rules addressing such possible fact patterns with respect to derivative financial instruments generally. We do not believe that it is appropriate to single out CDS for special treatment, particularly as CDS do not appear to be the type of financial instrument most likely to raise look-through or nominee/agent concerns.

(d) Sourcing Rules; Withholding Tax; Excise Tax. Insurance premiums are treated as U.S. or foreign source income by reference to the nature of the underlying risk.¹¹⁵ Insurance payments made in the event of a failure to pay on a debt obligation are treated like interest on the debt obligation, including for source purposes, to the extent they

¹¹⁵ Under section 861(a)(7), underwriting income (premiums) are treated as U.S. source income if they derive from the issuance of an insurance contract in connection with property in, liability arising out of an activity in, or in connection with the lives or health of residents of, the United States, or from certain related transactions. Section 862(a)(7) provides that other underwriting income is foreign source income.

compensate for missed interest or generally are treated as non-income receipts to the extent they compensate for a loss of principal.¹¹⁶ Payments received under notional principal contracts are subject to very different rules, under which the source of the payment is determined by reference to the residence of the recipient.¹¹⁷ There are no specific rules for sourcing payments received under an option. The source of income affects not only the application of U.S. withholding tax, but also the availability of foreign tax credits for U.S. taxpayers, because foreign tax credits can be used only to the extent of a taxpayer's foreign source income.

The current sourcing rules for insurance premiums were adopted in 1976 because it was thought that the source should derive from the location where the underlying income and activities took place, rather than (as under prior law) the place where the insurance contract was negotiated and executed.¹¹⁸ The excise tax that applies to insurance premiums paid to foreign persons in lieu of U.S. withholding tax applies a somewhat similar rule.¹¹⁹

The sourcing rules for notional principal contracts instead are based on the location where the activities relating to the notional principal contract itself took place.¹²⁰ That is, they are broadly similar to, although more sophisticated than, the pre-1976 rules for sourcing insurance premiums. They also are generally consistent with the rules that apply to gains from the sale of securities under section 865, which provide generally that gains are U.S. source income if U.S. activities produce them. The choice between these two approaches depends in part on whether a CDS is considered a replacement for, or incidental to, the holding of a reference obligation, or whether it is considered a financial instrument in its own right, as is the case with notional principal contracts.

As described in the factual sections above, conventional CDS are used both to buy protection on fixed income instruments held by taxpayers, which may be considered consistent with either derivative financial instrument or insurance treatment, and to take outright synthetic long or short positions in obligations of a reference entity, which is consistent only with securities/derivatives treatment. With respect to the former situation, the payments made on a conventional CDS if there is a credit event with respect to the reference entity – that is, cash or physical settlement that terminates the CDS -- are comparable to those made on other derivative financial instruments such as options, and unlike the payments made on insurance or guarantees. As described above, the resulting potential differences in the economic consequences to the parties between financial guarantee insurance and CDS have been identified as significant by one of the major rating agencies. It is evident that the market treats conventional CDS as separate

¹¹⁶ See, e.g., Rev. Rul. 72-134, 1972-1 C.B. 29 (payments in respect of missed interest); Rev. Rul. 70-254, 1970-1 C.B. 31 (payment in respect of principal); see also Treasury regulation sections 1.861-2(a)(5) and 1.862-1(a)(5) (guarantee payments sourced like interest on the underlying bond).

¹¹⁷ Treasury regulation section 1.863-7.

¹¹⁸ See Joint Committee on Taxation, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 254-55 (Dec. 29, 1976).

¹¹⁹ Insurance premiums that are subject to the section 4371 excise tax are not subject to U.S. withholding tax, because they do not constitute "premiums" within the meaning of sections 871(a)(1)(A) and 881(a)(1). See Rev. Rul. 89-91, 1989-2 C.B. 129.

¹²⁰ While Treasury regulation section 1.863-7 is often thought of as providing a rule that notional principal contract payments to a foreign person are foreign source, that is not true if the payments constitute effectively connected income. In that case, the payment is treated as U.S. source income. Treasury regulation section 1.863-7(b)(3).

financial instruments and that the developments chronicled above in the documentation, regulation, accounting and structuring of CDS are consistent with such treatment.

From a tax policy perspective, it is important that sourcing rules for CDS do not permit taxpayers to manipulate the source of income from a transaction. The legislative history of the 1976 amendment described above indicates that Congress believed the prior law practice of treating the source of insurance premiums as based on the location where the insurance contract was negotiated and executed was subject to manipulation by taxpayers, and inappropriate when a foreign insurance company issued an insurance policy to a foreign insured. The current underwriting income sourcing rules are intended to prevent that manipulation by looking to the nature of the risks insured. The notional principal contract sourcing rules also are intended to prevent manipulation, by assigning the source of income to the jurisdiction that earns it. Those rules are more consistent with the trend of the law when dealing with financial institutions that engage in cross-border activities to apply a functional and fact-based analysis of where assets are used and risks are assumed.¹²¹ For example, one effect of those rules would be to ensure that if U.S. persons negotiate a CDS, the income from that contract will be U.S. source income, even if the underlying securities are issued by foreign persons.

We also note that applying the notional principal contract sourcing rules would give rise to withholding tax results that are more analogous to the withholding tax treatment of corresponding payments on the underlying securities than would application of the insurance sourcing rules. As described above, CDS periodic payments in effect transfer some or all of the credit spread on the underlying obligation. The credit spread is one component of interest. Interest paid to unrelated foreign parties generally is not subject to U.S. withholding tax, as a result of the breadth of the withholding tax exceptions available under domestic law. A similar analogy applies to interest rate swaps, which provide for payments derived from a different component of a bond coupon. A rational approach would provide similar results for actual debt coupons and for the components thereof. It should not be possible, for example, to achieve different results by (i) selling protection under a CDS, or (ii) buying a bond on a leveraged basis and then using interest rate swaps and other derivatives to hedge away all of the risks other than credit risk. For these reasons, we think the sourcing rules applicable to notional principal contracts provide a more appropriate model than the rules applicable to insurance underwriting income.

Other considerations relating to the excise tax have been discussed above, in particular the point that it applies only when premiums are paid to an entity classified as an insurance company.

(e) Timing and Character. The timing rules for insurance in the hands of an insured are very generally similar to the timing rules for notional principal contracts – that is, current deduction for periodic payments – unless CDS would be subject to the proposed regulations with respect to notional principal contracts with contingent nonperiodic payments. The timing rules for options are completely different. This issue is discussed further under Section V.C.1, below, where we recommend a current deduction and inclusion regime for

¹²¹ OECD 2005 Permanent Establishment Insurance Report; OECD 2003 Permanent Establishment Banks Report; proposed Treasury regulation sections 1.482-8 and 1.864-4.

periodic payments under CDS treated as derivative financial instruments. The character of payments received upon the occurrence of a credit event would be either non-income receipts or capital gain (assuming that the underlying obligation would be a capital asset in the protection buyer's hands) if a CDS were treated as insurance. Their character under the rules applicable to notional principal contracts is less clear. This issue is discussed further under Section V.C.2, below.

(f) **Guarantees.** As mentioned earlier, the law relating to guarantees is much less fully developed in many regards than is the law relating to either insurance or derivative financial instruments.¹²² For example, we are aware of no law addressing what it means to be in the business of issuing non-insurance guarantees, and the sourcing rules for guarantee premiums are based on one case (*Bank of America*) that addresses only a limited set of facts. The cash or physical settlement terms of CDS, other than PAYG CDS, also are not comparable to the payment stream ordinarily provided by a guarantee when a guaranteed obligation fails to pay. While guarantees represent one of the possible characterizations of CDS, from a tax policy perspective they do not provide a useful model for considering what rules *should* apply to CDS.

2. **Definition of Insurance.** The seminal case on what constitutes insurance as a matter of U.S. federal income tax law is *Helvering v. LeGierse*.¹²³ *LeGierse* examined the question in the context of a life insurance policy purchased by LeGierse from a real insurance company. The Court identified four factors relevant to the analysis of whether the policy constituted insurance: (i) whether the contract constituted insurance “in its commonly accepted sense,” meaning for non-tax purposes, (ii) whether the transaction involved an actual “insurance risk” at the time the transaction was executed, (iii) whether the contract shifted risk from LeGierse to the insurance company, and (iv) whether the transaction involved “risk distribution” by the insurance company. The Court concluded that notwithstanding the form of the policy, the contract did not shift any insurance risk from LeGierse to the insurance company because LeGierse also purchased an annuity from the same company as part of the same transaction.

Subsequent authorities have treated the Court's four-part test in effect as a quasi-statutory definition of the term “insurance” for federal income tax purposes. The first leg of the test is an indicative but not a determinative factor, as subsequent courts and the Service have found – as did the Court in *LeGierse* – that contracts denominated as insurance and written by a regulated insurance company did not constitute insurance for tax purposes.¹²⁴ They also have held that contracts not denominated as insurance and not issued by a regulated insurance

¹²² A comprehensive article on the taxation of guarantees summarizes the state of the law as follows: “remarkably little statutory, regulatory, or judicial attention has been given to the federal income tax consequences of [guarantees], and the authority that does exist is undeveloped or splintered.” Miller 1995 Guarantees Article, page 105.

¹²³ 312 U.S. 531 (1941).

¹²⁴ See, e.g., *Allied Fidelity Corp. v. Commissioner*, 572 F.2nd 1190 (7th Cir. 1978) (surety bonds issued by regulated insurance company were more in the nature of service contracts).

company may be treated as such.¹²⁵ The treatment of a contract as insurance for insurance regulatory purposes remains, however, an important consideration.

By contrast, the other elements of the *LeGierse* test have been treated as critical. The insured must have an “insurable risk,” meaning a present or expected risk of economic loss arising from a fortuitous event. That risk must be shifted in whole or part to the insurer. And the purported insurer must manage that risk through the pooling of that risk with other similar risks. These elements have been summarized by the Service as follows:

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smoothes out losses to match more closely its receipt of premiums.¹²⁶

There has been extensive litigation over the years over whether particular contracts constitute or do not constitute insurance. Very generally, those cases have addressed whether particular types of risk constitute a risk of economic loss as opposed to other types of loss; whether the shifting of risk is the predominant attribute of the contract in cases where the contract is coupled with other elements such as the provision of services; and whether the contract in fact shifts risk away from the insured to the insurer, including in the context of contracts between affiliates.¹²⁷ The Service has issued five Revenue Rulings in recent years that also address some of these issues, as well as providing some guidance on what constitutes adequate risk distribution. Very generally, those rulings indicate that providing “insurance” in conventional form to one insured does not satisfy the risk distribution requirement, but providing roughly an equal amount of such “insurance” to each of 12 insureds does satisfy that requirement.¹²⁸ The requirement that the insured have an insurable risk has not, however, been the subject of any federal income tax dispute, although the issue has been litigated for insurance law purposes.

3. Application to Conventional CDS. The application of the *LeGierse* test to conventional CDS poses certain challenges.

¹²⁵ See, e.g., *Haynes v. United States*, 353 U.S. 81 (1957) (employer’s disability plan constituted health insurance although employer was not insurance company and plan did not require the payment of fixed periodic premiums and varied in other respects from conventional health insurance).

¹²⁶ Rev. Rul. 2002-89, 2002-2 C.B. 984 (omitting citations).

¹²⁷ These cases and the tax law of insurance and insurance companies are discussed in detail in the Miller 2002 Insurance article.

¹²⁸ See Rev. Rul. 2002-90, 2002-2 C.B. 985 (arrangements between 12 operating subsidiaries and insurance affiliate constitute insurance, where insurance affiliate is organized, regulated and operated as insurance company, each operating subsidiary’s coverage constitutes a limited part of insurer’s business and other conditions are met); Rev. Rul. 2005-40, 2005-27 I.R.B. 4 (similar conclusion, where insurance company is not related to insureds).

(a) Insurance in its commonly accepted sense (first requirement).

Conventional CDS do not constitute insurance in its commonly accepted sense, meaning that they are not written by insurance companies as insurance subject to insurance regulatory requirements. As described above, this first leg of the test is relevant but not determinative.

(b) Insurance risk (second requirement). The risk of failure to pay or loss on a debt instrument issued by a third party qualifies as an insurance risk.

(c) Shifting of risk (third requirement). CDS result in the taking on of risk by the protection seller. If the protection buyer directly or indirectly holds the obligations of the reference entity, then a CDS shifts risk. While risk transfer is critical to the existence of an insurance contract for U.S. federal income tax purposes, the existence of risk transfer does nothing to distinguish insurance from a derivative financial instrument, however, because both types of contracts can transfer risk.

Inherent in the concept of “shifting” risk, however, is the concept that one party is exposed to the risk in the first place. This is another way of saying that the existence of an insurable interest would appear to be essential to satisfying the third requirement. This point is discussed further below.

(d) Risk distribution (fourth requirement). The application of the risk distribution requirement (the fourth requirement) can be difficult, in part because it is fact-dependent and in part because of changes in the insurance industry and possibly in the law. As the quotation above indicates, risk distribution in the classic sense does not mean simply acquiring a diversified portfolio of risks. Rather, historically it involved the use of actuarial or similar techniques to charge enough for taking on a pool of similar risks to cover expected losses.

It appears that this model does not fully describe contemporary insurance practice. According to some reports, for example, financial guarantee insurance companies operate under a different model, under which they strive for no losses – an approach more comparable to that of an investor or lender.¹²⁹ They also, like other insurance companies, manage part of their risks through reinsurance, which is functionally similar to hedging. More generally, some property and casualty companies for some time have been taking on uncorrelated risks (for example, hurricane risk in Florida and earthquake risk in California). The Service has indicated an interest in re-examining the relevance of homogeneity of risks in determining whether risks are adequately distributed for an arrangement to qualify as insurance.¹³⁰ It may not be so easy, therefore, to distinguish the actual risk management strategies of at least some insurance companies from those of portfolio managers, or to provide certainty in the view of the possibility of an evolving standard.

A further practical consideration is that a protection buyer (and IRS agent) may not know enough about the risk management strategy of a protection seller to evaluate whether the risk distribution standard is satisfied. Where a protection seller carries out multiple CDS transactions on an on-going basis, therefore, it may be necessary to await further certainty in the

¹²⁹ See Kleinbard 2003 article, page 235.

¹³⁰ Notice 2005-49, 2005-27 I.R.B. 14.

law of insurance taxation before it will be possible to determine whether and how to apply that law to CDS.

In other cases, however, we think that there are strong arguments that the risk distribution requirement would not be satisfied. In the most recent published ruling, for example, X, a U.S. corporation, carries out a business that gives rise to a significant volume of independent, homogeneous risks, arising from the operation throughout the United States of an automobile fleet. For valid non-tax business reasons, X enters into arrangements with Y, an unrelated U.S. corporation, under which Y “insures” X against these risks, under conventional insurance contracts and in exchange for arm’s length premiums. Y is organized and regulated as an insurance company and there are no special arrangements between X and Y or special terms of the insurance that might otherwise call into question Y’s status as an insurance company. The ruling concludes that the contracts between X and Y do not constitute insurance for U.S. federal income tax purposes, because “although the arrangement may shift the risks of X to Y, those risks are not, in turn, distributed among other insureds or policyholders.”¹³¹ In lay terms, there is no possibility that Y can use X’s premiums to pay others’ losses, or vice versa.

If a SPV were to sell protection in the form of a single CDS on a single class of debt securities issued by a reference entity, and if the protection buyer was an investor holding those debt securities, the ruling’s conclusion would be directly on point. This fact pattern is in fact unlikely, because as described above CDS generally are entered into with dealers therein, who may or may not hold the underlying reference obligation. That difference makes a CDS less like insurance, however. In any event, the critical fact is that the SPV’s risk of loss on the CDS is not distributed in any fashion at the level of the SPV. The lack of risk distribution in such a transaction should be sufficient to conclude that the transaction does not constitute insurance.

(e) Insurable interest. The requirement that an insured have an insurable interest is a test of more general relevance.

First, the lack of an insurable interest requirement is probably the most significant economic difference between conventional insurance and conventional CDS. An insurance policy has historically been a contract that covers specified, individualized risks of specific insureds. Each company’s insurance policies are different; their terms are often complex and nontransparent to non-experts; they are not readily transferable; they are not easy for even a sophisticated insured to value; in short, they are unique to the parties thereto and the risks involved. A conventional CDS, by contrast, has standardized terms and a relatively simple template for setting out the core economic terms of a particular transaction; can be entered into and exited relatively quickly – that is, it can be traded; can be used a building block for more complex transactions; and has rapidly gained acceptance not only by market participants but also by regulators as a flexible and effective hedging device. What has made this possible is the delinking of a CDS from any specific asset or risk of one of the parties. Absent such delinking, for example, it would be impossible for more taxpayers to be “long” exposure to the obligations of a single reference entity than the total pool of such obligations. The presence or absence of an insurable interest therefore should be the critical factor in determining whether a CDS is potentially subject to treatment as an insurance contract.

¹³¹ Rev. Rul. 2005-40, 2005-27 I.R.B. 4.

Second, as described above, a test of this kind would bring some harmony between the U.S. federal income tax rules and the rules applicable for other purposes. Construing the risk shifting requirement in this manner would be consistent with what we understand to be an essential component of insurance from a U.S. legal/regulatory perspective. In addition, the presence or absence of an insurable interest is determinative for both U.S. and international accounting purposes when classifying a contract as a non-mark-to-market insurance contract or a (usually) marked-to-market derivative financial instrument. There are obvious benefits to having similar tax and accounting rules.

Third, there is a general understanding of what is necessary to satisfy it. A contract that does not require the protection buyer to hold the underlying obligation (and where there is no understanding between the parties that the protection buyer will directly or indirectly do so) is not a contract that satisfies the insurable interest requirement. Both parties to the contract, and the IRS when auditing, can readily ascertain whether this requirement is met.

4. Recommendations. For the policy and technical reasons set out above, we recommend that a safe harbor be adopted under which a conventional single-name or portfolio CDS (“qualifying CDS”) is treated as a derivative financial instrument – rather than as an insurance policy, guarantee, letter of credit or similar contract – subject to certain conditions discussed below. For this purpose, we recommend that a qualifying CDS be defined as a contract

- a) that transfers credit risk with respect to debt instruments of one or more reference entities between parties not related to each other or to the reference entity(ies);¹³²
- b) that is documented using ISDA standardized documentation;
- c) under which the protection buyer makes one or more payments to the protection seller based on a specified notional principal amount;
- d) under which the protection seller in turn agrees that in the case of a standard ISDA credit event with respect to a reference name the protection buyer may require cash or physical settlement terminating exposure to that reference entity, based on one of multiple potential obligations of that reference entity selected by the protection buyer in a manner determined under standard ISDA rules, and that does not provide for other payments; and

¹³² The recommendation that a qualifying CDS be defined as a contract between parties not related to each other or to the reference entity(ies) is intended both to require individualized consideration of related party transactions, and to address the possibility that the CDS might be characterized as a guarantee. It is of course possible although far less common for a party unrelated to the issuer of a debt obligation to provide a guarantee. In general, we think that the same reasons why conventional CDS transactions generally should not be treated as insurance contracts – in brief, because such CDS are actively traded capital markets transactions that do not satisfy the “insurable interest” requirement – also apply to the question of whether such transactions should be treated as guarantees.

- e) that states that the protection buyer is not required to have suffered a loss on, or to have owned, the reference obligations at any time in order to receive payment.

It is important to note that we are not attempting here to determine where the dividing line between contracts that should be taxed as insurance and those that are not should be. As described above, other non-credit-linked instruments exist that raise that question as well, and it is beyond the scope of this report to address the universe of such instruments or more generally to venture into the area of what is insurance. Rather, the premise of the recommendation above is that it is possible to identify a class of CDS that should not be taxed as an insurance, guarantee or similar contract. Accordingly, there should be no implication that CDS that do not satisfy the conditions described below are properly taxed as an insurance policy, guarantee, letter of credit or similar contract.

In order to police the no-insurable-interest test, a CDS should be outside the safe harbor if the reference obligation is the only available measure of settlement value and is effectively immobilized in the hands of, or for the benefit of, one of the parties. This condition is not intended to exclude a CDS simply because it is used by a protection buyer as a hedge of its credit exposures, which as described in Section IV.A.1, above, may take a variety of forms. Rather, it is intended to address situations where the insurable interest test is in substance met because the nature of the transaction is such that the protection buyer must hold a particular underlying obligation for the duration of the transaction and there is no practical alternative to using that obligation as the deliverable or valuation obligation.

We considered but do not recommend an additional carve-out to the safe harbor relating to insurance companies. The direct and indirect participation of insurance companies in the CDS market raises issues about the boundaries between insurance and non-insurance transactions. One possible prophylactic rule would be to exclude from the scope of the rule above any transaction in which an insurance company participates. A rule of that kind, however, would exclude transactions in which an insurance company acts simply as an investor, such as a RSAT, which is a form of synthetic CLN – that is, from an economic perspective, the purchase of a security.

A more narrowly tailored rule would exclude a CDS that is regulated as an insurance contract, or that is part of a transaction in which CDS risk is laid off directly or indirectly on a transaction-specific basis by an instrument that is regulated as an insurance contract by the regulator with jurisdiction over the contract. A rule of this kind, however, would make the operation of the U.S. federal income tax laws depend on local regulatory law, which differs from country to country and could differ state to state. Moreover, we believe that U.S. tax policy considerations are adequately protected by the insurable interest condition described above, because that condition should serve to eliminate from the safe harbor transactions that may in substance be insurance contracts for U.S. federal income tax purposes.

In view of the many different and ever-expanding types of CDS, we recommend that either presumptions or factors be provided for assessing whether CDS other than qualifying CDS should be excluded from insurance, guarantee or similar treatment and therefore should be

treated as derivative financial instruments.¹³³ Such presumptions or factors should include, as determinative or highly probative indications (a) the lack of an insurable interest and (b) the lack of risk distribution.¹³⁴ Presumptions or factors of this kind should give taxpayers confidence, for example, that a CDS on a managed portfolio of reference obligations, or a pay-as-you-go swap where the financial institution that is the protection buyer does not expect to hold the ABS reference obligation during the life of the swap (even if it holds the obligation from time to time in the course of making a market in ABS securities), can be expected to be treated as derivative financial instruments.

The first recommendation above addresses the principal types of conventional CDS presently traded. As described above, new CDS structures continue to be developed. We believe that additional guidance should be provided of a more general nature for all CDS appropriately treated as derivative financial instruments, whether under the rules described above or otherwise.

We have discussed above the reasons why we believe that it is appropriate to look to the rules applicable to notional principal contracts in order to determine whether a foreign entity that transacts in CDS is engaged in the conduct of a U.S. trade or business and in order to determine the source of payments on a CDS. Accordingly, we recommend that in determining whether a taxpayer that engages in transactions in CDS treated as derivative financial instruments is engaged in the conduct of a trade or business within the United States, the regulations (and proposed regulations) under section 864 applicable to securities and derivatives transactions should apply. This recommendation is intended to apply to CDO issuers that sell protection through CDS as part or all of their investment portfolio (that is, both “cash” CDO transactions with a “bucket” for CDS transactions and also synthetic CDOs). We suggest that several examples of such transactions be provided, for example (a) a CDS entered into by an SPV whose sole function is to issue a CLN; (b) a CDO with a static portfolio that includes CDS,

¹³³ A transaction may qualify as a guarantee even if no risk distribution takes place. In fact, that is the rule than the exception, when the guarantee is provided by a related party. For transactions with unrelated parties, however, we urge that a rule or presumption against guarantee treatment be adopted, in view of the fact that in practice guarantees ordinarily are provided in the form of financial guarantee insurance and that there is no coherent body of taxation for guarantees or any Congressionally-mandated set of tax rules governing them.

¹³⁴ For example, in the CDO context, some or all of the following criteria often are required to be satisfied with respect to any CDS entered into by the CDO issuer:

- (i) The CDS is documented under standard ISDA documentation.
- (ii) The CDS is entered into for investment purposes, with the expectation of profiting from holding the CDS, and pursuant to a decision process similar to that used when investing in physical securities.
- (iii) The CDS does not require any person to hold the reference obligation or similar obligations.
- (iv) The CDS permits cash settlement based on the value of an obligation (and not loss).
- (v) Alternatively, or in addition, the CDS permits physical settlement by delivering any of a group of obligations that may include the reference obligation but is not required to be the reference obligation.
- (vi) At least one of the potential deliverable obligations is one as to which price quotations can be obtained from at least two dealers.
- (vii) The issuer has no direct claim against the reference entity prior to delivery of an obligation, if any.
- (viii) The reference entity is not affiliated with the issuer or portfolio manager.
- (ix) The CDS is entered into with a dealer therein.
- (x) The issuer and portfolio manager will not hold themselves out as an insurer or as a dealer in CDS, and no party to the transaction will treat the CDS as insurance or a guarantee (or the issuer and portfolio manager have no reason to expect that the other party will do so), and
- (xi) The CDS is not treated as insurance for non-tax purposes.

and (c) a synthetic CDO with a managed portfolio (that is, a CDO issuer that is managed by a portfolio manager that sells protection via CDS and that from time to time closes out and replaces a CDS).

Also as stated earlier, we recommend that the source of income and expense from CDS treated as derivative financial instruments be determined under the sourcing rules applicable to notional principal contracts. Under those rules, a payment made under a CDS by a U.S. person to a foreign person generally would not be subject to U.S. withholding tax.

C. *Notional Principal Contract or Option?*

This Section V.C addresses the question of how those CDS that are treated as derivative financial instruments should be taxed. For the reasons discussed earlier in the report, this section assumes that the choice is limited to taxing CDS as notional principal contracts or as options. The discussion below does not address the question of how CDS not treated as derivative financial instruments should be taxed.

As the summary in Section V.A above demonstrates, the principal differences between the tax rules applicable to notional principal contracts and to options have to do with timing and character. The timing rules applicable to notional principal contracts differ radically from those applicable to options. Character rules may differ as well, although that is less certain as a result of uncertainty as to how the character rules applicable to notional principal contracts would apply to CDS. While timing and character issues are less pressing than those relating to the possible imposition of withholding tax, guidance on timing and character issues also is important.

As an economic matter, CDS can be characterized in more than one way. Some economic models of credit risk treat default risk as an option, and base valuations of CDS off that model.¹³⁵ Treating a CDS as an option is consistent with the fact that a change-of-value payment is made only if a credit event (a negative event) takes place, so that a CDS can be viewed as protection against the downside risk of the underlying obligations without participation in their upside. The value of a CDS also is affected by the remaining time to its maturity.

Alternatively, a CDS can be viewed as a “slice” of a debt obligation consisting of the credit spread and the credit risk, without funding cost and interest rate risk. This characterization can readily be understood by comparing the different forms of actual and synthetic CLN described in Section II.B.3(e), above. A tax regime that minimizes the potential for both taxpayer arbitrage and inadvertent whipsaws would seek to minimize the differences in the way that those structures are taxed by harmonizing the results for synthetic investments with those resulting from an actual investment in the underlying obligation.

Yet another approach would be to treat a CDS as a “slice” of a total return swap to maturity or default, if earlier, on a debt obligation. That is, if the interest equivalent amounts payable on a total return swap were paid at the same time and on the same basis as the coupons on the debt obligation, they would net out to a payment equal to the credit spread, which should

¹³⁵ See Anson & Fabozzi et al. 2004 book, chs. 8 and 10.

broadly correspond to the periodic payments made on a CDS. A tax regime that minimizes the potential for both taxpayer arbitrage and inadvertent whipsaws would seek to minimize the differences between the taxation of total return swaps on debt instruments and CDS. Each of these paradigms thus points in a somewhat different direction.

1. Timing Rules.

(a) Possible Models for CDS Timing Rules. There are two principal regimes that could serve as models for timing rules for CDS treated as derivative financial instruments. One is a regime under which no payments are taken into account until the contract terminates, which is to say the rules applicable to options. The other is a regime under which periodic payments for credit protection are taken into account on a current basis, and amounts received in the event of a credit event are taken into account no earlier than the occurrence of the credit event. Rules of this kind apply to insurance and guarantees, although the rules applicable to the receipt by an insured/beneficiary of payment in the event of credit loss are more complicated than this summary suggests. Treating a CDS as a series of annual options that either are exercised or expire annually also would give rise to similar timing results.

As summarized above, under the timing rules for options, option premium payments are not treated as income or expense until the option expires, is exercised or is otherwise disposed of. It does not matter for this purpose whether the premium payment is made in a lump sum at the outset of the contract, or over time. In the case of an option with a term of more than one year, these rules can be criticized as ignoring the time value of money element involved in making premium payments prior to the potential exercise of the option, and do not appear to be a paradigm for the future.¹³⁶ The option timing rules are similar to the “full allocation” method considered and rejected by the Service last year as a model for taxing contingent nonperiodic payments under notional principal contracts.¹³⁷

By contrast, an insured generally is permitted to deduct periodic insurance premiums on a current basis. A lump-sum insurance premium may be deducted over the period to which it relates. In effect, these rules treat an insured as purchasing insurance on an annual basis. A current deduction for an insurance premium is justified because the insurance it purchases either expires, if no loss is incurred during the relevant taxable year, or is drawn on, if a loss does occur. (This description is admittedly oversimplified in various ways. It does not explain, for example, why insurance premiums are deductible on a current basis when compensation for a loss that occurs in the relevant year will not be paid until a future year – that is, why matching of income and expense is not required in such a case.)

The differences between these regimes can be explained in several possible different ways. One might be that in the case of an option, there is some expectation at the time

¹³⁶ Cf. Treasury regulation section 1.1275-4 (rules for contingent payment debt instruments effectively provide for accrual of income on embedded option premium).

¹³⁷ See Notice 2001-44, 2001-2 C.B. 77 (requesting comments on the appropriate method for inclusion and deduction of contingent nonperiodic payments on notional principal contracts, and describing several models under consideration, including the full allocation method); Preamble, Notice of Proposed Rulemaking: Notional Principal Contracts; Contingent Nonperiodic Payments, 2004-1 C.B. 655-57 (REG-166012-02) (proposing to adopt variation on “noncontingent swap” method described in Notice 2001-44).

the option is entered into that the option will be exercised, while with insurance, it is expected at the time of issuance of the policy that the insurance will not be drawn on. Indeed, an option with too low a likelihood of exercise may not qualify as an option for U.S. federal income tax purposes, while an insurance policy with too high a likelihood of being drawn on may not qualify as insurance for those purposes.¹³⁸

Another difference might be that the insurance (or annual option) approach takes into account that the value of the protection purchased diminishes over time. The increment of cost or income attributable to a taxable year's purchase of unused protection therefore should be taken into account in that taxable year. An approach of this kind raises issues about how to determine the amount allocable to each year during which the contract is outstanding. Possible alternatives include level payments, payments that increase or decrease over time based on a schedule set at the outset (such as the rules applicable under Treasury regulation section 1.446-3(f)(2)(iv) to caps and floors that do not hedge debt instruments), or mark-to-market.

We believe that the insurance model is the appropriate starting place for crafting timing rules for CDS treated as derivative financial instruments. As a result of the fact that CDS to date have primarily referenced investment grade assets and have had a medium – generally five-year – maturity, the likelihood that a credit event will take place during the term of a CDS is very low.¹³⁹ Moreover, the occurrence of a credit event ordinarily has the consequence that the CDS terminates, so that no further premium payments are made. As with insurance, therefore, each periodic premium payment effectively is purchasing protection only for a limited period, and should be deductible during that period.

As it happens, the timing rules for notional principal contracts, as historically understood by most practitioners, would give rise to such a regime for CDS. That is, as discussed in our report on the Treasury regulations proposed last year to address the timing of income and expense arising from contingent nonperiodic payments under notional principal contracts, prior to the issuance of those proposed regulations most practitioners believed that both periodic payments on notional principal contracts were currently deductible or includible (which remains the law) and also that no accrual was required in respect of future contingent payments such as a CDS settlement payment.¹⁴⁰

We note that while market practice is not uniform, in many situations taxpayers have treated CDS as swaps qualifying as notional principal contracts or otherwise as giving rise to annual deduction/inclusion for CDS periodic payments. There are a number of reasons for that practice. As described above, protection sellers view themselves as making synthetic investments in debt of the reference entity, and expect to be taxed on periodic payments in a manner similar to how they would be taxed if they held the underlying. Protection buyers that

¹³⁸ See *Old Harbor Native Corp.*, 104 T.C. 191 (1995) (contracts were not options but instead inchoate contracts that could possibly have ripened into options if several highly contingent events outside taxpayer's control had occurred); Rev. Rul. 94-42, 1994-2 C.B. 16 ("An insurance contract or similar agreement is treated as [such] only if, at the time it is purchased, the amount paid is reasonable, customary, and consistent with the reasonable expectation that the issuer of the bonds, rather than the insurer, will pay debt service on the bonds.").

¹³⁹ For example, according to studies done by Moody's, during the 1970 through 2003 period, the likelihood that a bond rated Baa (the lowest investment grade rating) would be in default 5 years later was less than 2 percent.

¹⁴⁰ See NYSBA 2004 NPC report, commenting on proposed Treasury regulation section 1.446-3(g)(6).

use CDS to hedge their positions similarly expect to be able to deduct the periodic payments they make against the coupon income they receive. As a technical matter, even if a protection buyer makes a hedging election, that matching may be attainable only if the rules applicable outside the hedging context provide for current deductions for those payments.¹⁴¹ The historic notional principal contract regime also has the benefit, as discussed above under Section V.B.1(d), of limiting taxpayers' ability to achieve different timing results by (i) selling protection under a CDS, or (ii) buying a bond on a leveraged basis and then using interest rate swaps and other derivatives to hedge away all of the risks other than credit risk.

For these reasons, the notional principal contract timing rules for swaps are better suited to provide a model for the timing of income and expense on CDS. As described in more detail in the next section of this report, under current law neither option characterization nor notional principal characterization is certain. Relatively minor variations in the structure of a CDS should not give rise to radical differences in the timing of income or expense. We urge that all CDS that are treated as derivative financial instruments be subject to the same rules. Accordingly, we recommend that guidance clarify that CDS treated as derivative financial instruments should be treated as swaps qualifying as notional principal contracts rather than as options, and that the definition of notional principal contract be modified to the extent necessary. Subject to the discussion below, therefore, we believe that the timing rules for taxing credit default swaps should provide that (a) periodic payments are taken into account on a current basis, under the rules of Treasury regulation section 1.446-3(e) for periodic payments, (b) an initial lump-sum payment made in lieu of such periodic payments should be taken into account over the term of the CDS, under the rules of Treasury regulation section 1.446-3(f) for nonperiodic payments, and (c) no current accrual should be required for potential settlement payments.¹⁴² This method is hereinafter referred to as the "current inclusion/deduction" method.

The following sections of the report discuss the definition of the term "notional principal contract" as applied to CDS and anti-abuse considerations, and recommend that the

¹⁴¹ Treasury regulation section 1.446-4 provides a general rule that requires the matching of the timing of income or deduction from the hedge to the timing of the corresponding amounts on the hedged item. Views differ as to whether the regulation contemplates the acceleration of deductions on the hedge or permits the deferral of income from the hedged item.

¹⁴² We understand that some taxpayers are concerned that there is a risk under current law that a CDS entered into by a protection buyer that applies current inclusion/deduction timing rules like those described in the text to the CDS could be treated as "substantially similar" to the transactions described in Notice 2002-35, 2002-1 C.B. 992, and that such taxpayers are making protective disclosure under Treasury regulation section 1.6011-4 for all of their CDS (as well as equity swap transactions). Notice 2002-35 was issued together with Revenue Ruling 2002-30, 2002-1 C.B. 971. Revenue Ruling 2002-30 addressed a notional principal contract that, in effect, consisted of an interest rate swap with a backloaded fixed payment coupled with an equity swap maturing on the same day. The Ruling provides that the fixed component must be accrued over the life of the contract, under the rules generally applicable to nonperiodic payments on notional principal contracts. Notice 2002-35 addressed a similar transaction entered into as part of a larger transaction including circular flows of cash, hedging of the economic risks of the contract, and/or nominally related trading activities intended to give rise to a trade or business, and identifies such transactions as "listed transactions" for purposes of Treasury regulation section 1.6011-4's disclosure rules. *See also* Coordinated Issue Paper, All Industries, Notional Principal Contracts (Jan. 6, 2005) (describing Notice 2002-35 transactions in more detail). We do not believe that the Notice addresses conventional CDS (or equity swap) transactions absent the additional potentially abusive features identified in the Notice. In view of some taxpayers' concerns on this issue, however, clarification on this point would be welcome.

2004 proposed regulations on notional principal contracts with contingent nonperiodic payments be revised to state explicitly that they do not apply to CDS.

(b) Definition of notional principal contract. The definition of the term “notional principal contract” for timing purposes is very expansive. It provides that 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 amounts. The regulations then carve back the scope of this definition by excluding specified categories of financial instruments, including options. The term “option” is not defined.

Some CDS fit better into the definition of notional principal contract than others. Relevant considerations include (i) whether the premium is paid in the form of periodic payments or as a single lump sum, (ii) whether the CDS provides for cash settlement or physical settlement, and (iii) whether the CDS provides for a single credit event-related settlement or for multiple settlements. A CDS that provides for a single lump sum premium payment and a single physical settlement has payment flows like those of an option, and may be viewed as failing to satisfy the definition of a notional principal contract both because of the lack of “amounts” paid by one party to the other and because the settlement is on an actual rather than notional basis. There is case law suggesting, however, that an option the exercise of which is contingent on a specified event is not an option for federal income tax purposes.¹⁴³ A CDS that provides for periodic premium payments and potentially multiple cash-settled settlement events meets the notional principal contract definition and may be viewed as roughly comparable to a cap or floor. Views among practitioners differ as to the persuasiveness of one characterization versus another even of conventional CDS. Accordingly, we recommend that the definition of the term notional principal contract be revised to make clear that all of these variations fit within the definition.

(c) Anti-abuse rules. As with other notional principal contracts, timing rules for CDS that provide for current inclusion/deduction could give rise to abuse. The Treasury regulations addressing notional principal contracts provide two anti-abuse rules, and the Service has not hesitated to assert that the more general substance over form doctrine applies to notional principal contract transactions.¹⁴⁴

In view of the fact that, if our recommendation above is adopted, the notional principal contract rules would be expanded to include financial instruments with characteristics that may be somewhat different from those of other notional principal contracts, we recommend that the anti-abuse rule of Treasury regulation section 1.446-3(g)(2) be expanded or clarified. The revised anti-abuse rule should take into account explicitly the possibility that taxpayers will utilize non-controlled pass-through entities in order to achieve inappropriate timing results, and that entering into a CDS or transaction without taking on the corresponding economic risk of that transaction is a hallmark of tax avoidance transactions. Bona fide hedging transactions, of

¹⁴³ For a discussion of this issue, *see* Stevens 2004 Options article.

¹⁴⁴ *See* Treasury regulation section 1.446-3(g)(2); Treasury regulation section 1.446-3(i); Notice 2002-35, 2002-1 C.B. 992 (stating that transactions described in Notice may be challenged under these regulations, under trade or business authorities, under case law dealing with circular cash flows, or by applying other variations of the substance over form doctrine).

course, should not be within the scope of the anti-abuse rule. We suggest the regulation be revised as follows (new language is in boldface):

If a taxpayer, either directly or through a related person (as defined in paragraph (c)(4)(i) of this section) reduces risk with respect to a notional principal contract by purchasing, selling, or otherwise entering into other notional principal contracts, futures, forwards, options, or other financial contracts (other than debt instruments), the taxpayer may not use the alternative methods provided in paragraphs (f)(2)(iii) and (v) of this section. Moreover, where such positions are entered into, directly or through any related party (as defined above) or pass-through entity, to avoid the appropriate timing or character of income from the contracts taken together, the Commissioner may require that amounts paid to or received by the taxpayer under the notional principal contract be treated in a manner that is consistent with the economic substance of the transaction as a whole. Whether a position or positions are entered into to avoid the appropriate timing or character of income from the contracts taken together shall be determined under all of the facts and circumstances, including the correspondence or lack thereof between the economic risks nominally and actually taken on by the taxpayer.

In addition, we recommend that the anti-abuse rule of Treasury regulation section 1.446-3(i) be supplemented with an example addressing CDS. Treasury regulation section 1.446-3(i) applies if a taxpayer enters into a transaction with a principal purpose of applying the rules of Treasury regulation section 1.446-3 to produce a material distortion of income, and permits the Service to depart from the rules of the regulation as necessary to reflect the appropriate timing of income and deduction from the transaction. The timing rules we propose for CDS would not be appropriate, for example, if a taxpayer entered into a transaction with a principal purpose of taking deductions on a current basis for periodic payments and of deferring any income arising from a settlement payment that (a) has a high risk of being made and (b) has a high risk of being made on a deferred basis rather than potentially in any of the years prior to the stated maturity of the CDS. (The example should make clear that it is not intended to apply to a conventional CDS, where there is a real albeit ordinarily small risk of a settlement payment in each year the CDS is outstanding. It also should not apply if a CDS has a real but high risk of a settlement payment in each year the CDS is outstanding or a risk that declines, since in such cases it is appropriate to allow an annual deduction for the payment buying protection for that year's risk. It is the combination of high likelihood of a settlement payment and high likelihood that the payment will be deferred that we think would be troubling.)

A significant minority of the Tax Section Executive Committee believes that it also would be appropriate to limit the current inclusion/deduction method to CDS as to which the likelihood of a settlement payment is low. This approach might be justified on the grounds that the current inclusion/deduction method clearly reflects income only when there is not a significant risk that a settlement payment will be made, or as a way of preventing the form of potential abuse described in the prior paragraph. One possible approach to implementing such a rule would be to permit the current inclusion/deduction method only if the risk of a payment

resulting from a credit event is an investment-grade risk.¹⁴⁵ In those cases where a CDS is part of a CLN that is rated by one or more of the rating agencies, and the other assets of the CLN issuer are AAA-rated, the rating agency effectively is rating the CDS. In other cases, guidance would be necessary in order to determine when a risk was an investment-grade risk.¹⁴⁶ Consideration also would need to be given as to what timing rules should apply to CDS that do not fall into the investment-grade category.

(d) Proposed regulations on swaps with contingent nonperiodic payments.

Our prior report on the proposed regulations on notional principal contracts with contingent nonperiodic payments acknowledged that CDS provide for contingent payments that qualify as nonperiodic payments (assuming they are not termination payments, as discussed in the final section of this report) but recommended that the regulations not apply. Specifically, we recommended that the contingent payment on a CDS

should not be subject to an amortization regime such as the [noncontingent swap method], because the probability-weighted value of any payment from [the protection seller] to [the protection buyer] during the instrument's term is very low. Nor, in our view, should they be subject to an open transaction regime, at least in the case of a protection buyer . . . that is hedging, economically, a debt or other fixed income portfolio. That is because in economic substance, a taxpayer's cost of hedging a debt portfolio is appropriately considered expended in that period, and should be accounted for as such.¹⁴⁷

For the reasons already discussed, we continue to believe that this recommendation is appropriate.

We understand that the concern animating the timing rules of the proposed regulations was that taxpayers otherwise could transform what would otherwise be ordinary income on the final change-of-value payment on an asset swap into capital gain, by terminating the contract early. CDS do not provide for a final change-of-value payment, or any payment, reflecting an increase in the value of an underlying obligation. Accordingly, the opportunity for the type of conversion transaction that the proposed regulation appear to be intended to forestall should not be of concern here. Any potential timing abuses that might arise from the current

¹⁴⁵ It is important in this regard to distinguish between the risk associated with the possibility of a settlement payment on the CDS, and the risks associated with the underlying reference obligations. In the case of a conventional single-name CDS, those risks ordinarily would be the same. In the case of a more complex CDS, they may not be. Consider, for example, a single-tranche CDS on a portfolio of investment-grade reference entities that exposes the protection buyer to the tranche of loss on the portfolio between 3% and 5% over a ten-year period. The risk of a settlement payment on the CDS, which is effectively a highly leveraged risk position in the portfolio, might well be less than investment grade. Conversely, the risk of a settlement payment on a single-tranche CDS on a portfolio of high-yield reference entities that exposes the protection buyer to the tranche of loss on the portfolio between 20% and 22% over a five-year period might be investment grade, because this CDS economically has 20% equity supporting the risk position in the portfolio.

¹⁴⁶ One possibility might be to compare the periodic payments on the CDS to the credit spread on investment grade bonds. It would be necessary, however, in view of the complexity of the investment grade market, to specify in more detail how such a comparison should be made.

¹⁴⁷ NYSBA 2004 NPC report, commenting on proposed Treasury regulation section 1.446-3(g)(6).

inclusion/deduction method should be dealt with as described in the prior section.¹⁴⁸ We recommend, therefore, that the proposed regulations be modified to provide that conventional CDS are outside their scope.¹⁴⁹

2. Character Rules. The appropriate rules for determining the character of a payment made in respect of a credit event are less clear, because the “right” answer depends in part on the particular circumstances and in part on the rules applicable to similar instruments.¹⁵⁰

If we were writing on a clean slate, settlement payments would be treated as capital. Capital gain/loss treatment would give rise to the same treatment regardless of whether a taxpayer purchased or sold short an underlying obligation physically or synthetically. It would eliminate the possibility that cash settlement and physical settlement could give rise to different character for gain or loss on a CDS. It would eliminate the potential for a taxpayer to transform what might otherwise be ordinary loss on a cash settlement payment into capital loss. It would provide matching character for taxpayers hedging capital assets, and would not affect taxpayers hedging ordinary assets because such taxpayers could make a hedging election. There is a compelling case, therefore, for treating CDS settlement payments as capital gain or loss.

That result would follow naturally from characterization of a CDS as an option, in view of the fact that cash settlement of an option on property is treated as the sale of the option.¹⁵¹ For the reasons described above, however, we think the timing rules for options are not appropriate for a CDS. It is possible in principle to reach the conclusion that CDS settlement

¹⁴⁸ Perhaps the best reason for applying the proposed regulations to CDS would be to deal with the issue mentioned above, that it is possible to structure CDS as to which the likelihood of a settlement payment is not low. In principle, the proposed regulations could provide rules requiring the accrual of income to a protection buyer in respect of such a potential settlement payment. The regulations would have to be modified to deal with payments contingent both as to amount and timing – a task of sufficient difficulty that no attempt has yet been made to do so in the only moderately comprehensive set of timing rules that currently exist for financial instruments with contingent payments. See Treasury regulation section 1.1275-4(b)(9)(iii)(B) (general rules for timing contingencies reserved). Assuming this task were accomplished, the result would be to recreate, albeit in far more complicated form, a version of the rules that now apply to options, because a requirement to accrue income (expense) in respect of a future contingent settlement payment is effectively the denial of a deduction (inclusion) for that payment. We do not believe that the proposed regulations were intended to, or should, recreate the rules for options. See the text at note 137, *infra*.

¹⁴⁹ While outside the scope of this report, consideration should also be given to excluding conventional interest rate swaps, which also do not provide the opportunity for the type of conversion transaction that the proposed regulation appear to be intended to forestall, and conventional currency swaps, which are governed primarily by Treasury regulation section 1.988-2(e).

¹⁵⁰ The discussion in the text below is framed in terms of treating settlement payments as entirely capital or entirely ordinary. One could conceive of another approach. If one accepts the arguments in the text below that capital treatment is the right answer, then an apparent anomaly arises. Periodic payments would give rise to ordinary expense (or income), while a settlement payment would give rise to capital gain (or loss). One could view a financial instrument that on a stand-alone basis provides for ordinary expense today and capital gain tomorrow as a financial instrument that invites abuse, and an instrument that provides for ordinary income today and capital loss tomorrow as a financial instrument that may give rise to whipsaws. A theoretical alternative to this treatment would be to treat a settlement payment as ordinary to the extent of any previous ordinary periodic payments. Since taxpayers often can elect capital gain treatment by disposing of a financial instrument, it would be necessary to provide as well that gain on disposition would be ordinary to the extent of previous periodic payments. We do not recommend a hybrid system of this kind, at least absent a more fundamental rewriting of the tax rules applicable to financial instruments.

¹⁵¹ Section 1234(c)(2)(B); Rev. Rul. 88-31, 1988-1 C.B. 302.

payments should be treated as capital under the rules applicable to notional principal contracts, but as discussed below the Service's position on that issue is hard to ascertain.

If CDS are characterized as, or taxed under the rules applicable to, notional principal contracts, then the character of gain or loss on the disposition of a CDS other than through a transaction treated as a sale or exchange would be capital if the transaction is within the scope of section 1234A, and ordinary otherwise. The Service has issued a number of private rulings addressing the application of section 1234A to notional principal contracts, and more recently has proposed regulations under section 1234A.¹⁵² The proposed regulations provide that gain or loss arising from a "termination payment" on a notional principal contract is capital, but that a periodic payment (including the last of a series of periodic payments) and a nonperiodic payment gives rise to ordinary income or expense. The definition of termination payment for this purpose is a payment made or received to extinguish or assign all of the remaining rights and obligations of a party under a notional principal contract.¹⁵³

The Service's position appears to be that the term termination payment applies to an unscheduled early termination of a notional principal contract, and that a scheduled final payment constitutes either a final periodic payment or a nonperiodic payment. A settlement payment under a CDS is not a scheduled payment, but it is a payment pursuant to the terms of the contract. It is thus possible that the proposed regulations would be interpreted to treat a CDS settlement payment as ordinary income or expense. That interpretation is more likely for CDS that provide for multiple settlement payments, as the Service has previously ruled that multiple change-of-value payments on a commodity swap should be treated as ordinary income or expense.

As we have urged throughout this report, we consider it important that CDS be taxed in like manner regardless of the particular manner in which they are structured. It also is important for different types of notional principal contracts to be subject to the same rules. We reiterate the position in our prior report that the appropriate solution is for the Service to abandon its narrow reading of the term "termination payment," and to treat any payment made by reference to the value of a capital asset as attributable to the termination (or cancellation or expiration) of a right with respect to that capital asset. We note in this regard that the 1997 amendment that expanded the scope of section 1234A to apply to contracts with respect to any property that is a capital asset was intended "to remove the effective ability of a taxpayer to elect the character of gains and losses," and that the Service's current interpretation of section 1234A frustrates that Congressional intent.¹⁵⁴ Absent such a reconsideration, however, we reluctantly conclude that it is preferable for CDS to be subject to the same rules as other notional principal contracts rather than to a special regime of their own. In any event, guidance should clarify how the character of CDS settlement payments is to be determined.

¹⁵² See Proposed Treasury regulation section 1.1234A-1; Private Letter Ruling 9730007 (periodic payments on commodity swap give rise to ordinary income and expense); see also Field Service Advice 1992-0806-3, dated August 6, 1992 (payment to terminate interest rate swap gives rise to capital gain or loss, whether or not section 1234A applies); Field Service Advice 001634, dated July 6, 1995 (final change-of-value payment on equity swap held to maturity would give rise to ordinary expense if swap treated as notional principal contract).

¹⁵³ Treasury regulation section 1.446-3(h)(1).

¹⁵⁴ See H.R. Rep. No. 148, 105th Cong. 1st Sess. 204 (June 18, 1997).

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