By Electronic Delivery

February 11, 2019

Krishna Vallabhaneni
Acting Tax Legislative Counsel
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

William Paul
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

RE: Single Security Initiative and Diversification under Section 817(h)

Dear Mr. Vallabhaneni and Mr. Paul:

The Investment Company Institute (ICI) and the Securities Industry and Financial Markets Association (SIFMA)[1] request clarification of the guidance recently provided in Rev. Proc. 2018-54. The guidance addresses the diversification requirements of section 817(h) as applied to Uniform Mortgage-Backed Securities (UMBS) that Fannie Mae and Freddie Mac plan to issue as part of their Single Security Initiative. The guidance allows taxpayers to elect to treat UMBS purchased in the To-Be-Announced (TBA) market as having certain deemed issuers for purposes of section 817(h).

Our members manage and advise investment funds and managed accounts that serve as investment vehicles for life insurance company segregated asset accounts supporting variable insurance and variable annuity contracts. As such, they are responsible for compliance with the asset diversification requirements of section 817(h) and thus greatly appreciate the guidance provided by the Internal Revenue Service (IRS) and Treasury Department in Rev. Proc. 2018-54. We remain concerned, however, that the guidance does not address the more pressing diversification issue for these transactions regarding which entity is treated as the "issuer" of a TBA contract for purposes of section 817(h) if that contract is held over a quarter-end. We also are concerned about the operational feasibility of applying the deemed issuance ratio in Rev. Proc. 2018-54 to UMBS that are physically delivered pursuant to a TBA transaction. We thus ask the IRS and Treasury Department to provide that:

(1) Taxpayers may elect to apply the deemed issuance ratio from Rev. Proc. 2018-54 to UMBS TBA contracts before the underlying UMBS have been physically delivered; and

[1] Descriptions of ICI and SIFMA and their respective memberships are attached.

(2) The deemed issuance ratio election applies separately to a TBA contract and the UMBS that are delivered pursuant to that contract, so that the deemed issuer election could apply to an open TBA contract prior to the UMBS being delivered without the election also applying to the UMBS once they are physically delivered.

Background

Single Security Initiative

Pursuant to the Single Security Initiative and under the direction of the Federal Housing Finance Agency (FHFA), the Federal Home Loan Mortgage Corporation (Freddie Mac) will align key features of its securities with those of the Federal National Mortgage Association (Fannie Mae, and together with Freddie Mac, the GSEs) to create the new UMBS. The UMBS then will be issued by both GSEs with substantially similar terms and will trade primarily in the TBA market. The FHFA and the GSEs hope these changes will increase liquidity and reduce costs in the mortgage-backed security (MBS) market.

The FHFA and GSEs plan to implement the Single Security Initiative in June 2019, which means that UMBS TBAs likely will begin trading by March. Once trading begins, investors that acquire UMBS in unstipulated TBA transactions will not know whether Fannie Mae, Freddie Mac, or some combination thereof will be the issuer(s) of the securities to be delivered until 48 hours prior to settlement.

Investment in the TBA Market for MBS

The TBA market is by far the most liquid and important secondary market for MBS and one of the most liquid fixed income markets globally. The TBA market is responsible for significant capital flow from a wide range of investors, including life insurance company separate accounts and related investment funds. We estimate the portion of the market subject to section 817(h) and potentially impacted by the treatment of TBAs to be approximately $200 billion or higher.

TBA trades can be stipulated or unstipulated. Today, in an unstipulated TBA trade, the price, issuer, coupon, settlement month, size of trade, and maturity are known at the time of trade.[2] With the advent of UMBS, the issuer will no longer be specified or known; the trade will simply be for UMBS.

In a stipulated TBA trade, certain additional parameters are specified when the parties enter into the TBA contract. For example, a buyer may stipulate that only new pools be delivered, or the buyer may wish to avoid MBS pools from certain seller-servicers. These stipulated TBA trades place additional burdens and risks on trade counterparties, and accordingly market makers often will demand additional compensation (through trade pricing) for such trades. These costs are borne by end-investors in mutual and other funds. Stipulated trading also

[2] For example, A buyer may place an order for $5 million of FNMA 5% 30-year MBS to settle in April at a price of 104. The specific CUSIPs will not be know until two days before the settlement date.

reduces TBA market volume and liquidity. Accordingly, with regard to UMBS, the industry has consistently expressed a desire to minimize any additional stipulated trading driven by the construction of UMBS or the regulatory regime around it so as to maximize TBA market liquidity and help ensure a smooth transition to the new market.

Diversification under Section 817(h)

Section 817(h) prescribes a diversification requirement for segregated asset accounts supporting variable insurance contracts. In general, section 817(h)(1) provides that a variable contract that is based on a segregated asset account shall not be treated as an annuity, endowment or life insurance contract for any period for which the investments made by the account are not adequately diversified. A failure to satisfy section 817(h) will result in significantly adverse tax consequences for any policyholders who own the affected variable contracts.[3] Because of this, our members typically maintain a high degree of conservatism regarding compliance with these requirements.

The regulations set forth detailed rules for the diversification requirement. In general terms, the values of a segregated asset account's investments must satisfy certain concentration limits as of the last day of each calendar quarter or within the ensuing 30 days.[4] For these purposes, all securities of the same "issuer" are treated as a single investment, thus requiring the segregated asset account to identify the "issuer" of the securities the account holds.[5] Various special rules apply for purposes of the diversification test. For example, each US government agency or instrumentality (such as Fannie Mae or Freddie Mac) is treated as a separate issuer,[6] and look-through treatment applies to certain types of insurance-dedicated investment entities in which the segregated asset account invests (hereinafter, IDFs).[7]

Revenue Procedure 2018-54

As indicated above, investors that acquire UMBS in unstipulated TBA transactions will not know whether Fannie Mae, Freddie Mac, or some combination thereof will be the issuer(s)

---

[3] Specifically, the "income on the contract" generally is treated as ordinary income received or accrued by the policyholder for the year, resulting in a loss of tax deferral for gains credited to the policy. Treas. Reg. § 1.817-5(a)(1). In some cases, a life insurance company may be able to correct inadvertent non-compliance, but doing so can be very costly. *See* Treas. Reg. § 1.817-5(a)(2); Rev. Proc. 2008-41, 2008-29 I.R.B. 155. In addition, non-compliance can adversely affect the federal income tax returns of the issuing life insurance companies.

[4] *See generally* Treas. Reg. § 1.817-5(b) and (c).

[5] Treas. Reg. § 1.817-5(b)(1)(ii)(A).

[6] Sec. 817(h)(6); Treas. Reg. § 1.817-5(b)(1)(ii).

[7] Sec. 817(h)(4); Treas. Reg. § 1.817-5(f). The types of look-through entities are limited to regulated investment companies (RICs), real estate investment trusts, partnerships, and grantor trusts. Such an entity is insurance-dedicated if beneficial interests in the entity and public access to the entity are limited to life insurance company segregated asset accounts or certain other limited classes of investors listed in the regulations.

of the securities to be delivered until 48 hours prior to settlement. This has caused concern regarding how segregated asset accounts and IDFs will manage compliance with section 817(h).

Rev. Proc. 2018-54 provides an option that investment managers may use to address this uncertainty. It allows a "taxpayer"[8] to make an election pursuant to which "generic GSE securities"[9] acquired through settlement of a TBA trade will be deemed to be issued in part by Freddie Mac and in part by Fannie Mae, regardless of the actual issuer of the delivered securities. The portions deemed issued by each GSE are determined by the "deemed issuance ratio" for the year the TBA contract was entered into, which the FHFA will announce annually. The deemed issuance ratio applies for as long as the electing taxpayer holds the generic GSE security. The ratio also remains constant with respect to the delivered securities, even as they pay down and even if the taxpayer disposes of some of the securities.

Industry Concerns

Lack of Guidance on Open TBA Contracts for UMBS

Rev. Proc. 2018-54 applies to UMBS that are acquired through the TBA market, but it does not directly address the treatment of the TBA contracts themselves. TBA contracts are forward contracts that generally are settled mid-month, so it is not uncommon for a segregated asset account's portfolio to include unsettled TBA contracts when the diversification test applies on the last day of a calendar quarter. Furthermore, segregated asset accounts often "roll" open TBA contracts rather than settling them,[10] which increases the likelihood that the portfolio will include unsettled TBA contracts on the testing date. Certain segregated accounts may hold TBAs as a hedge or analytic exposure and will never take delivery of pools, and thus always will have unsettled TBA contracts when the diversification tests take place.

The issue raised by the open TBA contracts is that the segregated asset account will not know whether Fannie Mae, Freddie Mac, or some combination thereof will be the issuer of the securities that will be delivered until 48 hours prior to settlement. If the taxpayer holds the TBA contracts over a quarter-end, it is unclear how the contracts should be treated for diversification

[8] For this purpose, a "taxpayer" is defined as "(1) An insurance company that issues variable contracts within the meaning of § 817(d); and (2) An investment company, partnership, or trust … that qualifies for 'look-through' treatment under § 1.817-5(f)."

[9] A "generic GSE security" is a TBA-eligible security that a buyer acquires by taking delivery pursuant to a TBA trade in which, at the time the buyer enters into the contract, the buyer cannot know the actual issuer of the securities to be delivered under the contract.

[10] Rather than physically settling the contracts, the parties may choose to close the initial contract and open a new longer-term contract for the same underlying assets at the current fair market value.

testing purposes. Accordingly, we ask the IRS and Treasury Department to clarify that taxpayers may apply the guidance in Rev. Proc. 2018-54 to open TBA contracts.[11]

Absent such clarification, taxpayers could avoid the UMBS TBA market altogether and enter into contracts only in the stipulated TBA market (in which the taxpayer can stipulate whether it wants to receive Freddie Mac or Fannie Mae securities). Entering into stipulated TBAs, however, is not desirable for the reasons discussed above: Increased risk to counterparties, increased costs to investors, and decreased liquidity in the TBA market. More importantly, it could undermine the purpose of the Single Security Initiative, which is to increase the fungibility of the GSE securities and their liquidity in the market, by providing an incentive for market participants to recreate, with stipulations, the bifurcated market we have today that the single security initiative seeks to change.[12]

Separate Elections for TBA Contracts and the Delivered UMBS

It is not uncommon for taxpayers to acquire GSE securities through sources other than the TBA market. Consequently, a taxpayer may simultaneously hold both a GSE security that it acquired by delivery through the TBA market, and an identical GSE security of the same issuer acquired in an open-market purchase. Regardless of how a GSE security is acquired, it is always assigned the same CUSIP number, which is a standardized system for identifying securities.[13] For example, the MBS issued by Fannie Mae have the same CUSIP number whether they are acquired in a TBA trade or otherwise. This will continue to be the case after the Single Security Initiative goes live – Fannie Mae securities and Freddie Mac securities still will have different CUSIP numbers. The procedures and computer systems that taxpayers use to administer the section 817(h) diversification test almost always rely upon the CUSIP numbers assigned to the securities in the portfolio. In contrast, TBA contracts have generic CUSIP numbers that indicate the issuer, settlement month, and product type.[14]

If a taxpayer makes the election permitted by Rev. Proc. 2018-54 as currently written, the taxpayer must treat the GSE securities delivered in a TBA trade as issued by Fannie Mae or Freddie Mac in accordance with the deemed issuance ratio regardless of the actual issuer of the delivered securities. This, in turn, means that in many cases the taxpayer will need to disregard the CUSIP number assigned to a particular GSE security, treat two GSE securities with the same

[11] We ask that the IRS and Treasury state that no negative inference is to be made regarding section 817(h) compliance testing done before such guidance.

[12] Alternatively, in the absence of guidance, taxpayers may conclude that they must test the portfolio twice by treating the TBAs as being issued first by one GSE and then by the other GSE to ensure that neither results in a diversification problem.

[13] "CUSIP" stands for the Committee on Uniform Securities Identification Procedures.

[14] The generic CUSIPs for the UMBS TBAs will all reference Fannie Mae, even if the underlying issuer ultimately is Freddie Mac.

CUSIP number as having different issuers (actual issuer versus deemed issuers),[15] and/or treat two GSE securities with different CUSIP numbers as having the same deemed issuer.[16] Moreover, this treatment will continue to apply for the entire period the taxpayer holds the GSE securities. All of this will require significant changes to taxpayers' procedures and computer systems, including new recordkeeping systems to track the deemed issuers over time for multiple tranches of GSE securities. The costs of implementing such procedural and system changes may well outweigh the utility of the relief that Rev. Proc. 2018-54 provides. Indeed, it is our understanding that many taxpayers likely will not make a deemed issuance election for UMBS for this reason.

On the other hand, making the election with respect to an open TBA contract – as we have requested above – would not entail these types of additional costs and compliance burdens because all UMBS TBA contracts with the same CUSIP would have the same problem of issuer identification, and taxpayers would need to apply the deemed issuance ratio to all such TBA contracts As a result, if the IRS and Treasury provide the additional guidance on open TBA contracts as we have requested, we ask for further clarification that taxpayers may apply the deemed issuance ratio election separately to TBA contracts and the UMBS delivered with respect to those TBA contracts. In fact, if our request is granted, we expect that many of our members would make the deemed issuance election for the TBA contracts but not for the UMBS themselves.[17]

Other Issues

In addition to the primary concerns outlined above, our members have raised other issues regarding Revenue Procedure 2018-54:

(1) Changes to the deemed issuance ratio introduce operational and other complexities for fund managers and taxpayers. The most significant of these is that securities acquired through a TBA trade in December could have a different deemed issuance ratio from securities with the same CUSIP acquired in January of the next year. This difference in ratio for two identical securities would complicate compliance and analysis. Small changes in the deemed issuance ration would cause outsized burdens

[15] For example, a taxpayer could have two securities with the same CUSIP: One acquired by delivery of a TBA with a deemed issuance ratio of 60% Fannie Mae and 40% Freddie Mac; and the other acquired by purchase in the open market with an actual issuer of Fannie Mae (100%).

[16] For example, a taxpayer could have two securities with different CUSIPs, the same deemed issuer, and different actual issuers: One security acquired by delivery of an April 2019 TBA with a deemed issuance ratio of 60% Fannie Mae and 40% Freddie Mac and an actual issuer of Freddie Mac (100%); and the other acquired by delivery of an October 2019 TBA with the same deemed issuer (60% Fannie Mae and 40% Freddie Mac) and a different actual issuer of Fannie Mae (100%).

[17] Any new guidance should clarify that it does not create any inferences for other situations, and provide relief for taxpayers who, in the past, have applied section 817(h) by treating the counterparty as the issuer of an open TBA.

on market participants and taxpayers, with no consummate benefit, and should be avoided.

(2) The definition of "taxpayer" presents some ambiguity because both the insurance company and the IDF are treated as "taxpayers" that could potentially take conflicting actions with respect to the permitted election. Clarification on which entity makes the election is needed to prevent confusion and conflicting or duplicate elections with respect to the same assets. Further, the guidance suggests that an insurance company's election applies to all its separate accounts/sub-accounts. Insurance companies should be permitted more flexibility in managing these elections.[18]

(3) To revoke a deemed issuance election, a taxpayer must seek the consent of the Commissioner of the IRS by filing a request for a private letter ruling. This seems excessive and quite burdensome for taxpayers. A less onerous requirement, such as revocation through a notice or statement filed with a tax return, would provide adequate notification to the IRS without creating additional burdens or costs to the taxpayer.

Request for Guidance

For the reasons discussed above, we respectfully request the IRS and Treasury Department provide that:

(1) Taxpayers may elect to apply the deemed issuance ratio from Rev. Proc. 2018-54 to UMBS TBA contracts before the underlying UMBS have been physically delivered; and

(2) The deemed issuance ratio election applies separately to a TBA contract and the UMBS that are delivered pursuant to that contract, so that the deemed issuer election could apply to an open TBA contract prior to the UMBS being delivered without that election also applying to the UMBS once they are physically delivered.

To address our additional concerns, we also ask the IRS and Treasury to provide that:

(a) The deemed issuance ratio will be adjusted annually only if the change in the ratio is material. We suggest a reasonable threshold would be 5 percent.

(b) The "taxpayer" that makes the deemed issuance ratio election with respect to any GSE securities or TBA contracts is the entity that acquires those securities or contracts (either

[18] The diversification requirements of section 817(h) apply separately to each segregated asset account; it thus follows that the deemed issuance ratio should apply separately to each segregated asset account.

the insurance company segregated asset account or the IDF). If the taxpayer is the insurance company, the election is made separately for each segregated asset account.

(c) A taxpayer may revoke the deemed issuance ratio election by stating that it is doing so in a statement or form filed with its tax return for the year in which the taxpayer wishes to no longer apply the deemed issuance ratio.

* * *

ICI and SIFMA believe addressing the important issues outlined in this letter will help to ensure that the significant proportion of market participants bound by section 817(h) are able to participate actively and without restriction in the TBA market. This will serve not only those taxpayers, but also the millions of mortgage borrowers served by the TBA market each year. We appreciate your attention to our requests and look forward to meeting with you soon to discuss our concerns. In the meantime, please do not hesitate to contact us if you have any questions.

Sincerely,

Karen Lau Gibian
Associate General Counsel, Tax Law
Investment Company Institute

Chris Killian
Managing Director
Securitization and Credit Markets
SIFMA

Attachment

cc: Craig Phillips
US Department of Treasury

Michael Novey
US Department of Treasury

Helen Hubbard
Internal Revenue Service

Katherine A. Hossofsky
Internal Revenue Service

Bob Ryan
Federal Housing Finance Agency

Attachment

The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$20.7 trillion in the United States, serving more than 100 million US shareholders, and US$7.0 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.