Securities Industry Association

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July 30, 2003

SUBMISSION IN RESPONSE TO ADVANCE NOTICE
REGARDING PROPOSED SAFE HARBOR UNDER SECTION 475

This Submission is being made by the Securities Industry Association's (the "SIA's") Committee on the Federal Taxation of the Securities Industry.[1] We write in response to the request for comments made by the Internal Revenue Service (the "IRS") in its Advance Notice of Proposed Rulemaking: Safe Harbor for Satisfying Statutory Requirements for Valuation under Section 475 for Certain Securities and Commodities (the "Notice").[2] The Notice proposes a framework for developing an elective safe harbor to determine the fair market values of securities held by dealers therein for purposes of section 475 of the Internal Revenue Code (the "Code").[3]

This Submission was drafted by a working group comprised of the following firms: Bank of America, NA, Citigroup Inc., Goldman, Sachs & Co., J.P.Morgan Chase & Co., Merrill Lynch & Co. and Morgan Stanley. The Submission has been reviewed by all the firms whose representatives sit on the SIA's Committee on the Federal Taxation of the Securities Industry.[4] We have endeavored to identify those points where member firms have divergent

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1 The SIA, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals. Industry personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift and pension plans. In 2002, the industry generated $222 billion in domestic revenue and $356 billion in global revenues. (More information about the SIA is available on its home page: www.sia.com)

2 68 Federal Register 23,632 (May 5, 2003).

3 Unless indicated otherwise, all section references herein are to the Code or Treasury regulations promulgated thereunder.

4 The members of the SIA's Committee on the Federal Taxation of the Securities Industry are: ABN AMRO Holding N.V., Alliance Capital Management LP, Banc One Capital Markets, Inc., Bank of America, NA, Bear, Stearns & Co. Inc., Brown Brothers Harriman & Co., Charles Schwab & Co., Inc., CIBC World Markets Corp., Citigroup Inc., Credit Suisse First Boston LLC, Daiwa Securities America Inc., Deutsche

practices or viewpoints; where none is indicated, we believe that the Submission reflects a consensus practice or understanding among our member firms.

At the outset, we would like to commend the IRS for issuing the Notice; it could not have come at a better time. On the same day that the Notice was issued, the Tax Court issued its opinion in *Bank One Corporation*,[5] the first case to address the valuation of over-the-counter ("OTC") derivatives positions of OTC derivatives dealers for purposes of section 475. It is not the purpose of this comment letter to discuss the merits of that decision, which addresses the accounting practices of one taxpayer more than a decade ago. Rather, we believe that *Bank One* sounds a call to all interested parties to work together to develop fair, accurate and administrable rules in respect of the valuation of securities held by dealers therein for purposes of section 475. The IRS's Notice answers that call, and we appreciate the opportunity to respond to the Notice.

The timing of the Notice is also propitious in light of the recent proposal by the IRS of an "Accelerated Issue Resolution" program (the "AIR program") for the resolution of section 475 valuation issues related to positions held by OTC derivatives dealers, and the IRS's request for volunteer participants for that program. Several member firms of the SIA's Committee on the Federal Taxation of the Securities Industry have volunteered to participate in the program, and while we cannot speak for any of the individual volunteer participants, we believe that the AIR program is all the more important to our industry as a whole in light of the *Bank One* decision. Moreover, we expect that the IRS's experience with volunteer participants in the AIR program will provide practical insights into precisely the types of questions raised in the Notice, and will complement our comments herein.

For the reasons developed in the remainder of this Submission, we believe that a safe harbor based on book-tax conformity and the principles outlined in the Notice is the best

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Bank AG New York**,** E*TRADE Group, Inc., Edward D. Jones & Co., L.P.**,** Goldman, Sachs & Co., ING Financial Services**,** J.P. Morgan Chase & Co., Lazard Freres & Co, LLC, Legg Mason Wood Walker, Inc., Lehman Brothers Inc., Merrill Lynch & Co., Inc., Morgan Stanley, Prudential Securities Incorporated, Quick & Reilly/Fleet Securities, Inc., Robert W. Baird & Co. Incorporated, Stephens, Inc., Twenty-First Securities Corp., UBS Financial Services Inc., and Wachovia Securities, LLC.

[5] 120 T.C. No. 11 (May 2, 2003).

means of establishing a streamlined, effective, and accurate process for auditing compliance with section 475. In fact, we see no other workable alternative to the approach outlined in the Notice — either for future taxable years or for past years that have not yet been closed to audit. Therefore, once the terms of the safe-harbor are finalized, we urge the IRS to consider making the safe-harbor available to taxpayers on a retroactive basis.

I. GENERAL COMMENTS ON SECTION 475.

Since 1973, "generally accepted accounting principles" ("GAAP")[6] have required securities firms to prepare their financial statements by employing mark-to-market accounting for their dealer operations.[7] For decades before that date, dealers relied on mark-to-market accounting to understand and manage many of their business segments, and filed their U.S. federal income tax returns generally by reference to lower-of-cost-or-market accounting, which is a type of mark-to-market accounting. Today, of course, securities firms routinely employ mark-to-market accounting in the service of a wide range of financial and commercial controls, and both GAAP and the Code require the use of mark-to-market accounting in their respective spheres.

It is true that mark-to-market accounting is an exercise in valuation, but that fact does not mean that it lacks a theoretical foundation. In our experience, one cannot apply mark-to-market accounting in a coherent manner without first articulating the purposes to be served by the mark-to-market exercise, and then identifying the market most relevant to those purposes. As a result of its long experience in utilizing mark-to-market accounting in different contexts, the securities industry has developed a widely-shared understanding of the theoretical underpinnings of mark-to-market accounting.

The remainder of this Part I begins with some brief observations about the nature of, and legal standards applicable to, mark-to-market accounting in general. Part II then

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6 Unless indicated otherwise, references to GAAP in this Submission are to the generally accepted accounting principles of the United States.

7 Department of the Treasury, *Summary of the Administration's Revenue Proposals* (Fiscal Year 1994), at 46 (February 1993) (the "1993 Green Book").

describes the securities industry's collective understanding of the purposes served by a mark-to-market tax regime, and draws from that description some observations on how a mark-to-market accounting system *for securities dealers* could be designed that best furthers those objectives. Part III provides some background on financial accounting standards and the relevant standard-setting entities, and discusses recent developments in fair value accounting principles. Finally, Part IV applies the principles discussed in Parts I, II and III to the specific questions raised by the Notice.

A. Marking to Market Constitutes an Accounting Method.

Marking to market under section 475 constitutes an accounting method for tax purposes.[8] As with all accounting methods, the overarching objective of mark-to-market accounting under section 475 is the "clear reflection of income" within the meaning of section 446(b).[9] The determination of the fair market value of securities for purposes of section 475 serves as a *means* of clearly reflecting the income of a securities dealer, not as an end in itself. This point is critical and, we believe, easily overlooked: section 475 is a tool employed to clearly reflect a securities dealer's taxable income, not a securities pricing service.[10]

An accounting method must provide a reasonable degree of certainty and consistency — that is, the value of an item of income or expense that is recognized for tax purposes should be objective and verifiable.[11] To this end, our tax system generally applies the

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8 *See*, *e.g.*, *Bank One Corporation*, 120 T.C. No. 11, slip opinion at 164 (May 2, 2003).

9 Joint Committee on Taxation, *Tax Reform Proposals: Accounting Issues*, JCS-39-85, at 6 (September 13, 1985) (the "Joint Committee Report").

10 *See E.W. Bliss Co. v. United States*, 224 F. Supp. 374 (N.D. Ohio 1963), *aff'd.* 351 F.2nd 449 (6th Cir. 1965) (holding that a "substantially accurate" inventory valuation method was sufficient for purposes of clearly reflecting income, and stating that "[t]he tax law and generally accepted principles of accounting recognize that substantial accuracy is the objective to be achieved and that in many situations exact determinations are neither practicable nor necessary"); *Huntington Securities Corp.v. Busey*, 112 F.2nd 368, 370-371 (6th Cir. 1940) ("'Clearly,'as used in the [clear-reflection-of-income standard] means plainly, honestly, straightforwardly and frankly, but does not mean 'accurately' which, in its ordinary use, means precisely, exactly, correctly, without error or defect. The method used by appellant in valuing its inventories in our opinion clearly, but not accurately, reflected income, which is all that is required."). *See also S.Weisbart & Co.*, T.C. Memo 1964-130 (holding that a "reasonably accurate" method of valuing cattle held in inventory was sufficient for purposes of clearly reflecting income, and stating that it "is not necessary that [the taxpayer's] inventories be absolutely accurate or correct").

11 Joint Committee Report, at 6.

"realization" principle. In the case of mark-to-market accounting under section 475, the realization principle is not applied, but a substantial amount of certainty is nevertheless achieved, because the fair market value of dealers' securities can be determined in a reasonably reliable and consistent manner without a realization event.

Any method of accounting also must attempt to match the recognition of items of income and related expenses contributing to such income in the same taxable year; this objective is commonly referred to as the "matching principle."[12] A great many provisions of the Code are devoted to implementing the matching principle by requiring the deferral of losses or expenses until the period in which the taxpayer's corresponding income is realized.[13] In the case of traditional physical inventories, the matching principle is implemented through "full absorption" accounting for inventory costs; this method effectively capitalizes the direct and indirect costs of producing inventory into the carrying value of that inventory. Mark-to-market accounting produces economically similar results (provided that the methodology is applied comprehensively), by effectively accruing estimated future income and expenses into the current period; the result is economically similar to comprehensive expense capitalization.[14] Mark-to-market accounting, however, can be used in contexts where it would otherwise be

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12 Joint Committee Report, at 6.

13 *See, e.g.,* section 1092 (deferral of losses on straddles until offsetting gain recognized), section 263(g) (capitalization of carrying costs in respect of straddles), section 163(d) (limitations on deductions of interest for individuals to the amount of "net investment income" for the taxable year in question), and Treasury regulation section 1.446-4 (matching items of income, deduction, gain or loss in respect of hedged transactions with the offsetting items in respect of the hedging transaction); *cf.* section 265 (disallowance of deduction for interest attributable to tax-exempt income).

14 Section 263A's capitalization rules effectively replicate the economics of a mark-to-market result by allocating debt under section 263A(f)(2)(A)(ii) to activities that result in the production of inventory, with the result that interest expense attributable to that allocated debt is capitalized in accordance with Treasury regulation section 1.263A-9. The capitalization of interest expense that would otherwise be deductible is similar economically to imposing a tax on a deemed rate of return in respect of the inventory equal to the interest rate. Of course, to the extent the interest rate on debt is different than the rate of return produced by the inventory, the capitalization methods of section 263A are only an imperfect approximation of a mark-to-market regime. *See* Evans, "The Evolution of Federal Income Tax Accounting — A Growing Trend Towards Mark-to-Market?" 67 TAXES 824, 826, n. 24 (December 1989) (quoting Treasury officials who were involved in formulating these rules and who confirmed that a simulated mark-to-market result was intended); Kleinbard and Evans, *The Role of Mark-to-Market Accounting in a Realization-Based Tax System*, 75 TAXES 788, 793 (December 1995).

administratively infeasible to defer expenses until the later realization of the relevant corresponding income items.

An accounting method should not be susceptible to distortive results. As discussed below, the cost and lower-of-cost-or-market methods of inventory accounting previously available to securities dealers ran afoul of this principle, because dealers could elect to minimize their income at low or no transaction costs. Mark-to-market accounting methods eliminate this election.

Finally, an accounting method should be relatively easy to use, not be unduly burdensome, and should be applied consistently from period to period.[15] As the Joint Committee on Taxation aptly observed: "Extremely complex methods of accounting, while perhaps providing a more precise measurement of income, may be so difficult to use that their very complexity causes erroneous results, and may be so expensive to implement, that the taxpayer may seek to avoid compliance."[16] These objectives reflect the pragmatic concerns that we believe are particularly relevant at this stage in the effort to develop guidelines for the safe harbor contemplated by the Notice, and the utility of avoiding additional complexity is clear when one considers the complexity already inherent in valuing OTC derivatives.

B. Mark-to-Market Accounting is an Inventory or Quasi-Inventory Method.

Depending on the context, the section 475 mark-to-market accounting method used by securities dealers is an *inventory* method or a *quasi-inventory* method. Technically, mark-to-market accounting under section 475 is an inventory method for a dealer's positions in physical securities, and may be viewed as a *quasi-inventory* method when applied to a dealer's derivatives positions. Assets or positions that are subject to mark-to-market accounting often generate current cash returns (*e.g.,* interest income on a bond, or periodic payments on swaps). Securities dealers include those returns in income on a current basis. As a practical matter, therefore, a dealer's annual net income from its dealer operations comprises (i) its

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15 Joint Committee Report, at 7.

16 Joint Committee Report, at 7.

mark-to-market gains or losses, *plus* (ii) net cash returns on its mark-to-market assets, *less* (iii) related costs and expenses.[17]

The traditional touchstone for determining if a taxpayer is a dealer in securities, and thus whether its physical securities constitute inventory, is whether that taxpayer holds such securities "primarily for sale to customers in the ordinary course of [its] trade or business."[18] More generally, a dealer in securities is a "merchant" — a taxpayer that performs merchandising and liquidity services for customers, and is compensated therefor through commissions or bid-ask spreads.[19]

For reasons explained in Section II.B, below, dealers in interest rate swaps and similar OTC derivatives do not hold their derivatives positions primarily for resale, as they do for their inventories of physical securities. As such, a dealer's swaps books are not inventories in the traditional sense. Nonetheless, the inclusion of a dealer's OTC derivatives positions within the scope of section 475 is consistent with the inclusion of a dealer's physical securities inventory, because OTC derivatives dealers perform the same economic functions of merchandising and providing liquidity as do traditional dealers, by standing ready to enter into either side of a new derivatives contract with customers.[20] (In addition, OTC derivatives dealers provide credit intermediation services.) For this reason, the Code and Treasury regulations have regularly treated dealers in OTC derivatives as directly analogous in their economic activities to dealers in physical securities.[21]

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17 By convention, cash returns include accrued interest coupons, but not, for example, original issue discount. Dealers typically do not track accrued original issue discount and the like in respect of their mark-to-market assets, because the mark-to-market valuation renders that exercise unnecessary: the annual income attributable to a zero-coupon bond that is subject to mark-to-market accounting will in the end equal the change for the year in that bond's fair market value, regardless of whether one first accrues original issue discount and then marks the accrued value to actual market value.

18 *George R. Kemon et al.*, 16 T.C. 1026, 1032 (1951) (citing section 117(a)(1) of the 1939 Code — the predecessor to current section 1221(a)(1), which retains the quoted language).

19 *Cf.* Treasury regulation section 1.471-5.

20 *Cf.* section 475(a)(2) (application of mark-to-market accounting to securities, even if not held in inventory) and sections 475(c)(2)(D), (E) (inclusion of financial derivatives in definition of "security").

21 *Cf.* Treasury regulation section 1.954-2(a)(4)(iv)(B) (treating OTC derivatives dealers as analogous to dealers in physical property for foreign personal holding company income purposes).

Treasury regulations governing inventory accounting methods generally adopt a flexible and pragmatic approach that reflects the business realities of different industries. Section 471(a), which describes the general principles for inventory accounting, provides that "inventories shall be taken by such taxpayer on such basis as [Treasury] may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."[22] That pragmatic approach is further reflected in the guiding principles adopted by Treasury regulation section 1.471-2(b), which provides that:

> "[I]nventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is in accord with §§ 1.471-1 through 1.471-11."

Treasury regulation section 1.471-2(d) then goes on to provide that:

> "Where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of the goods used, transferred, or sold, calculated upon the basis of the actual cost of the goods acquired during the taxable year (including inventory at the beginning of the year), the net value as shown by such inventory accounts will be deemed to be the cost of goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith."

Inventory methods thus do not attempt to achieve absolute economic precision, but rather adopt pragmatic solutions that strike a balance between accommodating the complexities of the business operations of various industries and the tax policy objective of certainty or economic accuracy. In this regard, as indicated in the quoted Treasury regulations,

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[22] *See also* Treasury regulation section 1.471-2(a) (restating these standards of section 471).

above, tax inventory methods largely follow best practice accounting methods, so long as such methods meet the clear-reflection-of-income test.[23]

The clear-reflection-of-income standard is not defined by the Code or Treasury regulations. It is nonetheless clear that the standard embodies a pragmatic approach and does not require strict economic precision in measuring income.[24] As the Court in *Bank One* held, citing numerous authorities, an accounting method may meet the clear-reflection-of-income standard even where there is another method that "more clearly reflects income."[25] Similarly, Treasury regulation section 1.446-4(e) describes methods of accounting for hedging transactions that meet the clear-reflection-of-income test, and provides examples of "simpler, less precise," but nonetheless acceptable, methods of accounting for transactions that hedge inventories.[26]

The Code itself explicitly sacrifices economic precision to reflect the practical realities of business operations. For example, section 471(b) permits a taxpayer to use estimates of inventory shrinkage for a taxable year that are confirmed only after the close of that taxable year, so long as the taxpayer regularly and consistently performs a physical count of inventory and makes proper adjustments to reflect actual shrinkage. Furthermore, inventory accounting methods sometimes even countenance a systemic bias in its valuation method — the most

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23 *See Prudential Overall Supply*, T.C. Memo 2002-103 ("A method of accounting will ordinarily be regarded as clearly reflecting income when the method reflects the consistent application of generally accepted accounting principles in a particular trade or business, is in accordance with accepted conditions or practices in that trade or business, and provides that all items of gross income and expenses are treated consistently from year to year."); *Rockwell International Corp.*, 77 T.C. 780, 809 (1981) ("It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business."); *Lucker v. United States*, 53 F.2nd 418, at 423 (Ct. Cl. 1931) ("Taxation is eminently practical and we think this is particularly true as to inventories, which need only conform to the 'best accounting practice in the trade or business and as most clearly reflect [sic] the income.'") However, as the Supreme Court held in *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), while a tax accounting system that conforms to GAAP and is consistently applied "in most cases . . . will pass muster for tax purposes," conformity with GAAP does not by itself create a presumption in favor of the taxpayer, and an accounting method that violates an express accounting requirement in an applicable Treasury regulation by definition does not meet the clear-reflection-of-income requirement.

24 *See* authorities cited in note 10, above.

25 *Bank One Corporation*, 120 T.C. No. 11, slip opinion at 174-179 (May 2, 2003).

26 *See generally* Treasury regulation section 1.446-4(b) (clear reflection of income for hedging transactions must "reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged").

notable example being section 472's sanctioned use of the LIFO method, which has the effect of deferring recognition of income for a company with constant or rising inventories in an inflationary environment.

We believe that our industry's implementations of section 475 aspire generally to a *higher* standard of economic accuracy than that found in the inventory practices of many other industries. Our industry also has refined its mark-to-market methodologies over time, and continues to refine them, as the applied mathematics of financial instrument valuation and computer technologies continually improve. As we and others have commented in the past,[27] and as we discuss below in Section II.E, the securities industry relies on mark-to-market accounting for critical non-tax commercial and financial purposes that place a high premium on precision and accuracy. We therefore are completely confident that current industry practices, as reflected both in our tax returns and our financial accounts, clearly satisfy the federal income tax standards of inventory valuation and clear reflection of income.

C. Book-Tax Conformity Prior to Section 475.

For eight decades, it has been the explicit or implicit understanding that mark-to-market valuations employed for tax purposes are consistent with those employed both for financial accounting and for other important commercial and financial purposes. The safe harbor contemplated by the Notice is thus a continuation of a long-standing tradition of what often is labeled book-tax conformity — although, as we have pointed out in the past, it might be more accurate to describe the conformity as one between best business practices, on the one hand, and financial accounting and tax valuations on the other.[28]

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[27] *See, e.g.,* Letter from Marc E. Lackritz of the SIA to Mark A. Weinberger, Assistant Treasury Secretary (Tax Policy), dated April 25, 2001, *reprinted in* 2001 *Tax Notes Today* 96-27 (May 17, 2001); Letter from Saul Rosen of the SIA to Jonathan Talisman, Assistant Treasury Secretary for Tax Policy, and Eric Solomon, Deputy Assistant Secretary, dated April 13, 2000, *reprinted in* 2000 *Tax Notes Today* 92-39 (May 11, 2000); Letter from Mark Perwien of the International Swaps and Derivatives Association, Inc. ("ISDA") to Jonathan Talisman, Deputy Assistant Treasury Secretary (Tax Policy), and Charles O. Rossotti, Commissioner of the IRS, dated Sept 21, 1999, *reprinted in* 1999 *Tax Notes Today* 199-26 (October 15, 1999).

[28] *See, e.g.,* letters cited in note 27, above.

Since at least 1919, taxpayers have been permitted to value inventories at the lower of cost or market.[29] From 1958 until the passage of section 475, Treasury regulation section 1.471-5 specifically authorized dealers in securities to value securities inventories at (i) cost, (ii) market, or (iii) the lower of cost or market, so long as the method employed by the dealer for tax purposes was also "the basis on which his accounts are kept."[30] In practice, Treasury regulation section 1.471-5 had the result that, to the extent that market values of inventories were used in computing taxable income, taxpayers consistently used the same values for both tax and financial accounting purposes. With the exception of the current debate over the valuation of OTC derivatives that has led to the *Bank One* decision and the Notice, this long-standing practice of book-tax conformity has, to the best of our knowledge, met with consistent approval from the IRS.

In consequence, although many cases involve disputes over the relevant "market" for purposes of applying, for example, lower-of-cost-or-market accounting, we have found no decided case — other than *Bank One* itself— in which a taxpayer's good faith calculations of the actual fair market values of inventories, employed consistently for tax and financial accounting purposes, have been challenged by the IRS.[31] It is also our collective experience that financial-statement/tax-accounting conformity in calculating fair market values of securities inventories has for decades been both necessary and sufficient for purposes of IRS examinations. For example, Revenue Ruling 74-223[32] (involving futures contracts that commodities dealers entered into as hedges) relied on the *non-tax* purposes for which the taxpayers employed mark-to-market accounting to conclude that the method clearly reflects income:

> "This system of bookkeeping is the only accurate and correct system that has been devised that truly reflects the net profit or loss

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29 T.B.R. 48, 1 C.B. 47 (1919). *See also* O.D. 8, 1 C.B. 56 (1919) (confirming that securities dealers, like other taxpayers, could value their inventories at lower of cost or market).

30 Treas. Reg. § 1.471-5 (adopted under T.D. 6336, 1958-2 C.B. 176).

31 *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1975), for example, essentially involved the question of what was the appropriate "market" for applying lower-of-cost-or-market accounting: the replacement cost to the taxpayer for the "excess" inventories it held, or the resale value of those inventories if sold to an unidentified buyer whose highest and best use of the inventories would be as scrap?

32 1974-1 C.B. 23.

> of any given year's business, either fiscal or calendar. *It is the system in use, approved by auditors who certify to the correctness of his financial statements which are the basis of his credit, and is the system accepted by his bankers for all his financial transactions and the only system which would not be false and misleading*." (Emphasis supplied.)

Essentially identical language had appeared in Appeals and Review Memorandum 135, which was issued in 1921 and permitted commodities dealers to adopt a comprehensive mark-to-market accounting system for open hedge contracts.[33] It appears, then, that in both Revenue Ruling 74-223 and Appeals and Review Memorandum 135, the taxpayer employed the same valuations for tax and non-tax purposes, and that this fact was important to the analysis of the Committee on Appeals and Revenue (and later the National Office of the IRS) in accepting that valuation methodology as an appropriate accounting method for tax purposes. Similarly, Treasury has made book-tax conformity a prerequisite to the use by taxpayers of the LIFO method of inventory accounting.[34]

Before the enactment of section 475, the IRS and Treasury responded to a dealer-driven request to clarify the scope of mark-to-market accounting by proposing Treasury regulation section 1.446-4 in 1991, which would have explicitly permitted OTC derivatives dealers to place their OTC derivatives businesses onto mark-to-market systems.[35] In the end, Treasury did not promulgate the proposed regulation in final form, because the enactment of section 475 rendered it moot. The proposed Treasury regulation would have *conditioned* the availability of mark-to-market accounting for a swaps dealer on that dealer *employing the same valuations for tax purposes as it employed in its financial statements*:

> "A dealer or trader in derivative financial instruments may elect to account for a derivative financial instrument at market value only if: …[t]he dealer or trader values all of the derivative financial instruments that it holds in its capacity as a dealer or trader (or as hedges of such instruments) at market for purposes of computing net income or loss on its applicable financial statement (as defined

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33 5 C.B. 67 (1921).

34 Treasury regulation section 1.472-2(e).

35 Notice of Proposed Rulemaking FI-16-89, 1991-2 C.B. 951. For a discussion of dealer efforts to promote mark-to-market tax accounting, *see* note 38, below.

> in § 1.56-1(c)), and the dealer or trader *uses the same method of valuing* those instruments on its income tax return…" (Emphasis supplied.)[36]

We believe that this condition of book-tax conformity was proposed because it was clear in 1991, as it is today, that the methods used for financial accounting and other substantive non-tax commercial purposes have been developed on an objective basis, without systematic bias, and clearly reflect the taxpayer's income. Although we recognize that the *Bank One* Court discounts the notion of book-tax conformity by distinguishing the tax concept of "fair market value" from the GAAP concept of "fair value," we believe that conclusion was based on overly formalistic, impractical reasoning, and is contrary to the long-held, if informal, understanding on the part of the IRS and taxpayers that the two terms are, for all practical purposes, synonymous. (*See* discussion below in Section IV. I, Response 1)

Case law on inventory accounting methods also provides substantial support for adopting a safe-harbor approach based on the financial accounting standards of the securities dealer industry. For example, in *Wal-Mart Stores, Inc. v. Commissioner*,[37] the Court of Appeals upheld the taxpayer's method of using inventory shrinkage estimates, because the method was not prohibited by the Code or Treasury regulations, complied with GAAP, was applied consistently for both tax and financial accounting purposes and produced accurate results.

D. Section 475: Legislative History and Regulatory Authority.

The enactment of section 475 in 1993 was the result of two independent but congruent concerns. First, dealers in OTC derivatives had lobbied for a mark-to-market accounting system for their derivatives businesses to prevent timing whipsaws that might otherwise result from differences in the timing of income or loss from customer positions, on the one hand, and hedges of those customer positions, on the other.[38] Second, in light of the

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36 *Id.* at 962.

37 153 F.3rd 650, 657 (8th Cir. 1998), *aff'd* 73 T.C.M. 1625 (1997).

38 An early initiative to use mark-to-market accounting came from cotton and wheat dealers, who hedged all their "long" positions with "short" futures and forward contracts, not only as a risk control matter but also to obtain bank financing for their highly leveraged businesses, and used mark-to-market accounting for non-tax purposes. A.R.M. 100, 3 C.B. 66 (1920); A.R.M. 135, 5 C.B. 67 (1921). The commodities dealers

liquidity of many securities dealers' inventories of traditional "physical" securities, Congress saw the inventory accounting methods then permitted to securities dealers, particularly the lower-of-cost-or-market method, as systematically understating a dealer's income, and as being inconsistent with the best accounting practices in the industry. Mark-to-market accounting addressed both sets of concerns.

The immediate antecedent of section 475 was first proposed by President George H.W. Bush's Treasury Department in its January 1992 Budget Proposals. That proposal was titled, "Conform Book and Tax Accounting for Securities Inventories." Treasury observed that securities dealers use mark-to-market accounting "to report their income to shareholders and creditors. The market method represents the best accounting practice in the trade or business of dealing in securities and is the method that most clearly reflects the income of a securities dealer." Accordingly, Treasury proposed that securities dealers be required to use mark-to-market accounting for their inventories, "as they already do when preparing financial statements."

The Administration's 1992 Proposal was contained in President Bush's 1992 tax bill,[39] which emerged in essentially the same form as section 3001 of the Revenue Bill of 1992.[40] The Conference Report on the Revenue Bill of 1992 noted that the then-prevailing law allowing lower-of-cost-or-market accounting for inventory securities resulted in an asymmetric recognition of unrealized losses on such securities, whereas both unrealized losses and gains would be recognized under pure mark-to-market accounting.[41] The Conference Report also

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emphasized that the use of mark-to-market accounting for open contractual positions would act as a cure for the timing mismatches that otherwise would result from reporting the income of a hedged trading business on a nonrealization basis for inventory and a realization basis for the related hedges.

Much later, and prior to enactment of section 475, derivatives dealers sought to apply mark-to-market accounting to their swaps books, for essentially the same reasons that the cotton and wheat dealers gave. *See, e.g.,* Letter from Cynthia Beerbower on behalf of nine interest rate cap dealers to D. Kevin Dolan, Associate Chief Counsel (Technical and International) at the IRS (March 4, 1988), *reprinted in* 88 *Tax Notes Today* 69-29 (March 28, 1988); letter from Salomon Brothers Inc to K. Walli, IRS (December 6, 1991), *reprinted in* 91 *Tax Notes Today* 225-37 (December 17, 1991).

39 Section 372 of the Long-Term Growth Act of 1992, H.R. 4150, 102nd Cong., 1st Sess. (1992).

40 H.R. 11, 102nd Cong., 2nd Sess. (1992).

41 H.R. Rep. No. 102-1034, 102nd Cong., 2nd Sess., 770 (October 5, 1992).

observed that inventory securities are valued at market for financial accounting purposes. The Revenue Bill of 1992 was passed by Congress, but ultimately vetoed by President Bush.

Congress took up section 475 again the following year, and this time enacted the provision as part of the Revenue Reconciliation Act of 1993.[42] The legislative history of the 1993 Act essentially mirrored the points made in 1992. The House Report, for example, stated that inventories of securities generally are easily valued at year end, and noted again that dealers valued their securities on a mark-to-market basis for financial accounting purposes.[43] On the subject of valuation, the House-Senate Conference Report provided that:

> "The conference agreement does not provide any explicit rules mandating valuation methods that are required to be used for purposes of applying the mark-to-market rules. However, the conferees expect that the Treasury Department will authorize the use of valuation methods that will alleviate unnecessary compliance burdens for taxpayers and clearly reflect income for tax purposes."[44]

Congress also granted Treasury specific regulatory authority under section 475(g) to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section," in addition to Treasury's general authority under section 7805(a).

We believe that the legislative history set out above, as well as the long-standing tradition of book-tax conformity discussed in the preceding Section of this Submission, confirms that it would be appropriate for Treasury to use the Congressional grant of regulatory authority to implement a safe harbor valuation method along the lines contemplated by the Notice. As discussed above, all of the legislative history of section 475 acknowledges the use of mark-to-market accounting for financial accounting purposes. Given the potential substantive complexity of the task, Congress did not attempt to provide any substantive guidelines for determining fair market values under section 475. Congress *did* contemplate, however, that Treasury would allow taxpayers to utilize valuation methods that would minimize taxpayer compliance burdens

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42 P.L. No. 103-66, 103rd Cong., 1st Sess. (August 10, 1993).

43 H.R. Rep. No. 103-111, 103rd Cong., 1st Sess., 660 (May 25, 1993).

44 H.R. Rep. No. 103-213, 103rd Cong., 1st Sess., 616 (August 4, 1993).

while clearly reflecting income. Finally, we think that a fair reading of the legislative history, while falling short of *requiring* book-tax conformity under section 475, is consistent with the view that Congress and Treasury anticipated that financial accounting valuations would serve at least as the starting point for mark-to-market valuations for purposes of section 475.[45]

E. GAAP Valuations Are Subject to Rigorous Checks and Balances.

Every securities dealer of which we are aware that is required to prepare its financial statements in accordance with GAAP uses the valuations of its securities reported on such statements for other significant business purposes. We believe that the book-tax conformity principle set forth in the Notice will lead to reliable valuations, because those valuations are used for a wide variety of day-to-day core business functions, and thus are subject to rigorous checks and balances by different influential stakeholders. Those functions include internal business management, compensation, risk measurement and regulatory supervision.

An OTC derivatives dealer, for example, will use the identical adjusted mid-market valuations of its OTC derivatives portfolio to determine which derivatives are profitable and which are unprofitable as a commercial and financial matter.[46] Therefore, if an OTC derivatives dealer's implementation of mark-to-market accounting were systematically to understate the value of positions (in order, for example, to achieve some putative tax benefit by creating a conservative bias in the marks), traders would have incentives consistently to forego profitable trades. Similarly, systematic overvaluation would cause traders consistently to enter into unprofitable trades. In addition, if a position in a trader's book were undervalued by the firm's valuation system, the trader could improve his or her apparent profitability by unwinding the position for cash, thereby booking an illusory profit to the detriment of the firm.

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[45] "The [mark-to-]market method represents the required GAAP method in the trade or business of dealing in securities and is the method that provides the most accurate measure of the income of a securities dealer." The 1993 Green Book, at 47.

[46] As discussed in Section IV.B, below, adjusted mid-market values are used to determine profitability, but do not directly determine the prices charged to a customer. Those prices will be influenced by such other factors as how motivated the parties are to enter into a transaction, which in turn may be a function of such things as a desire to develop a business relationship or a particularly urgent need to hedge against a certain risk.

Senior managers at securities dealer firms employ the profit and loss figures generated by the same valuation model that is used to calculate tax "marks" to supervise the performance of swaps traders, to help set those traders' bonuses (which form the bulk of their compensation),[47] and to determine how much of the firm's capital to dedicate to the swaps business. Again, systematic undervaluation would lead to undercompensation of those traders (and, eventually, senior management) and to a misallocation of the firm's capital.

Securities dealers generally employ the same valuation models that they use to calculate their "marks" for financial statement reporting in order to quantify the market risks inherent in a given position for purposes of hedging that risk.[48] A biased valuation model would cause a securities dealer to draw incorrect inferences about the amount of risk associated with the dealer's book of positions, with the result that positions would be either underhedged or overhedged.[49]

In sum, there has been a consistent practice among securities dealers for decades in the context of both lower-of-cost-or-market and mark-to-market inventory accounting methods of using the same valuations for tax, financial accounting and important business purposes, and the accuracy of valuations is too important for business reasons for dealers to tolerate a systematic bias in their valuations, and certainly those whose compensation depends upon the values of the portfolio would not tolerate a conservative bias.

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47 In this regard, *see* the discussion in Section IV.B., below.

48 Dealers typically monitor and adjust their risk hedges many times during the course of a day. Obviously, adjustments for creditworthiness, liquidity costs, administrative expenses and the like vary far more slowly. It therefore is the case that in hour-to-hour hedge decisions an OTC derivatives dealer may choose to ignore such adjustments, because from the perspective of a hedge time horizon, those adjustments effectively are constants. This implementation is simply a practical and simplifying application of a consistent OTC derivatives valuation model.

49 *See* Group of Thirty, *Derivatives: Practices and Principles — Appendix I: Working Papers*, at 3 (July 1993) ("Incorrect valuation leads not only to inaccurate income recognition, but also to inaccurate hedging. For instance, incorrect valuation of an option can lead to an incorrect measure of its price sensitivity (*i.e.*, delta) and consequently an inadequate hedge.").

II. APPLICATION OF MARK-TO-MARKET PRINCIPLES TO DEALERS IN SECURITIES.

Part I has argued that marking to market constitutes a method of accounting and must therefore reflect the business model of the taxpayers to which the accounting method is applied. As applied to dealers in securities, mark-to-market accounting is an inventory or quasi-inventory method of accounting. That method clearly reflects income because:

1. Mark-to-market accounting eliminates the income distortions that otherwise would follow from the random application of traditional realization principles to a dealer's long and short positions that hedge one another, but which may be sold or terminated in different periods.

2. Mark-to-market accounting eliminates the taxpayer electivity that follows from cost or lower-of-cost-or-market accounting for securities inventories.

3. Mark-to-market accounting appropriately captures on a current basis the value of the economic services that a dealer provides to customers, namely merchandising and liquidity services (and, in the case of OTC derivatives dealers, credit intermediation services).

4. Mark-to-market accounting appropriately matches revenues with the expenses incurred to generate those revenues.

The remainder of this Part II considers these points in more detail. The discussion emphasizes points 3 and 4, because they are less obvious than the first two points, and because they have a direct impact on precisely how the securities industry has implemented mark-to-market accounting.

One additional theme that has been central to the development of the securities industry's collective theory of mark-to-market accounting is that an accounting system should not directly affect trader behavior: that is, accounting control executives at every securities firm have labored for the last several decades to ensure that their mark-to-market accounting systems do not contain any systematic biases that will encourage or discourage particular patterns of

trading at their firms. This theme is particularly relevant to the different "markets" to which physical and derivative securities are marked, as explained below.

A. Inventories of Physical Securities.

The first issue raised by any mark-to-market valuation method is to determine the relevant "market" in which the property trades and should be valued. Most securities firms believe that this question, insofar as physical securities inventory is concerned, is answered by Treasury regulation section 1.471-4(a): for tax purposes the "market" value of inventory is the prevailing "bid" price for that asset. (Because "short" positions are the mirror image of "longs," the "market" value of shorts is the "ask" side of the bid-ask spread.)

By defining the "market" value of inventories by reference to the bid side of the market, the inventory valuation rules equate market value with prevailing *replacement* costs: bid prices are the prices at which members of the relevant *dealer* community are offering to acquire the property in question, and therefore the prices that the taxpayer would be expected to pay to replenish its inventory.[50] As applied to physical securities inventories, existing Treasury regulations thus define the "market" to which positions are marked as the *interdealer* market — not the "market" of end users, such as investors in securities. Nothing in the statutory language or legislative history of section 475 suggests that the adoption of that provision changed the consistent meaning of the word "market" when applied to physical inventories.

Several economic and tax accounting consequences flow from this principle of inventory market valuation. First, this principle means that "market" valuations of the same property can vary, depending on the economic role of a particular taxpayer. A diamond, to take an easy example, has different market values to the company that mines it, to a wholesaler, to a retail jeweler and to a retail customer. Each of these values has its own utility in its proper context, but all cannot simultaneously be appropriate to any one particular purpose (*e.g.,* valuing

[50] *D. Loveman & Son Export Corp.*, 34 T.C. 776, 796 (1960), aff'd per curiam, 296 F.2d 732 (6th Cir. 1962), cert. denied, 369 U.S. 860 (1962). ("[T]he term 'market' in the phrase 'lower of cost or market,' means the price which petitioners would have had to pay to replace items in their inventories on the applicable inventory dates. Conversely, it does not mean the price at which such merchandise is resold or offered for resale.")

the mining company's inventory of raw diamonds, or insuring a retail customer's replacement value of her diamond ring), and any one value cannot simultaneously be appropriate to every application. Phrased differently, the same diamond will have different market values when carried in the inventories of a major wholesaler and a local retailer, where both use a market-based inventory accounting method.[51]

A similar point applies to "physical" securities: a dealer's "market" valuation (replacement cost) is not identical to the value of the same security in the hands of a customer. Imagine that Dealer A, a dealer in bonds (and interest rate swaps), employs mark-to-market accounting and the calendar year as its taxable year. On December 31st, Dealer A, in the ordinary course of making a two-way market in Xco bonds, offers to buy Xco bonds with a principal amount of $1000 from customers for $999, and to sell these bonds to customers for $1000. A customer sells one bond to Dealer A for $999. Markets do not move during the day, and Dealer A still holds the Xco bond at the end of the day.

What is Dealer A's year-end mark-to-market gain on that bond it just purchased for $999? Under Treasury regulation section 1.471-4(a), the answer can only be z*ero*. Dealer A records the bond at its market value — the bid side of the market — or $999, even though Dealer A hopes (all other factors being constant) that it will sell the Xco bond for $1000 in the very near future, which is the value in the "end user" market. (Of course, if interest rates or credit spreads did move during the course of the day, there would be mark-to-market gain or loss.)

In economic terms, Dealer A performs two valuable services by making a two-way market in Xco bonds. Dealer A provides merchandising services and liquidity to the

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[51] The particular market in which a taxpayer routinely purchases his or her goods is the relevant market for determining the market value for inventory. *D. Loveman & Son Export Corp*, *supra* note 50 (taxpayer that began purchasing steel from premium mills instead of major mills could no longer value its steel inventories based on published prices of major mills); *E.T. Bamert*, 8 BTA 1099 (1927) ("The locality [in which the taxpayer bought and sold his sheep] was his market, and it is by the prices of that market, and not some distant one, that the value of his goods should be fixed."). *Cf. St. James Sugar Cooperative v. United States*, 643 F.2nd 1219 (5th Cir. 1981) (holding that, where taxpayer was under contract to deliver inventory for less than the current bid price, the relevant market price for that taxpayer for purposes of valuing the inventory was the contract price, because generally available bid prices were not applicable to the inventory in question); *Space Controls, Inc. v. Commissioner*, 322 F.2nd 144 (5th Cir. 1963) (same).

marketplace: customers know where to turn to buy or sell Xco bonds whenever they wish. In economic terminology, Dealer A's bid-ask spread is its compensation for the merchandising and liquidity services it provides. In tax terms, however, Dealer A (like any dealer in any sort of property) is simply purchasing and selling inventory property. Dealer A does *not* record income when it purchases inventory (even though conceptually that purchase is a liquidity service provided to customers); instead, Dealer A realizes both halves of its liquidity-service income when it sells its inventory. The simple explanation for this fundamental principle of tax accounting for dealer income (whatever the nature of the dealer's inventory) is that the tax accounting (and business) model assumes that inventory assets will turn over rapidly, and therefore that one can take into account the gain or loss as it happens.

One can construct an argument that physical inventories of securities whose prices are quoted in terms of bid-offer spreads (*e.g.,* most debt securities) should be marked to mid-market (the mean of bid and ask prices), on the theory that by doing so one could capture the income from the economic services provided by dealers to customers (merchandising and liquidity services) in the period those services are rendered. Indeed, some major dealers do so, because those dealers believe that marking physical securities to adjusted mid-market values most appropriately reflects the increased integration of their OTC derivatives businesses and physical securities businesses. A substantial majority of major dealers, however, have rejected this approach, whether for tax or for any other purpose (including financial accounting), because marking "longs" and "shorts" in physical securities to mid-market can have the unintended effect of rewarding traders who bulk up their positions at year-end simply to capture credit for the resulting mark-to-market income. This is precisely the sort of distortive trading behavior that financial control executives find troubling, and securities dealers adopting a mid-market valuation methodology with respect to physical securities are therefore required to implement procedures to ensure that such behavior does not occur. In addition, some dealers believe that such a result arguably would be inconsistent with Treasury regulation section 1.471-4(a).

As a result, it continues to remain standard market practice to mark long positions in physical securities to bid, and shorts to ask. As a practical matter, no significant deferral of income results from this standard market practice (particularly, of course, where inventory levels remain relatively stable from year to year), because of the very rapid turnover of securities inventories.[52]

The consensus result is a tax and financial accounting model that conforms to best business practices and that is consistent with the definition of "market" as applied in Treasury regulations governing inventory valuations. The method is based on a factual premise — that physical securities inventories turn over very rapidly — but that premise is, if anything, more correct now than when the rule first was developed. The *purpose* of mark-to-market accounting in this context — to measure accurately a securities dealer's income from its dealings in physical securities without distorting trading behavior — thus is served.

B. The OTC Derivatives Business Model.

An OTC derivatives dealer earns its income in a manner different from the manner in which a physical securities dealer earns its bid-ask spread. Instead of acting as "a merchant of securities, regularly engaged in the purchase of securities and their resale to customers,"[53] a derivatives dealer stands ready to enter into either side of a derivatives contract with customers, with the expectation of *retaining* the resulting cash flows for the duration of the contract.[54] The business model thus is one of developing and holding a portfolio of net cash flows — a synthetic annuity, in the case of a perfectly hedged derivatives book — not of

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[52] We acknowledge that the *Bank One* Court held that the relevant market for valuing OTC derivatives is the retail market. Although we disagree with this holding for the reasons described above, we also wish to point out that, unlike the plain vanilla interest rate swaps discussed in the *Bank One* decision, many more recent OTC derivatives are not available in retail markets, and are not easily broken down into components that are. For example, there are many exotic derivatives that are used to transfer very specific types of risks for purposes of dynamic hedging, and although they are reasonably common in the OTC derivatives interdealer market, they are not normally issued to so-called "end users."

[53] Treasury regulation section 1.471-5.

[54] The fact that some contracts are liquidated prior to maturity through assignment or close-out should not obscure the fundamental fact that a derivatives dealer captures the bulk of its economic compensation for the merchandising, liquidity and credit intermediation services it provides to the market in the form (in the simplest case) of a multi-year net annuity, not current commissions.

immediately capturing bid-ask spreads through purchases and resales of physical inventories. The economic services provided by dealers in physical securities and OTC derivatives, however, are largely the same: merchandising and liquidity services, plus, in the case of derivatives alone, credit intermediation services.

Assume, for example, that Dealer A on December 31st offers to customers to enter into five-year swaps in which it will pay 3 percent, or receive 4 percent, in each case vs. LIBOR. (This hypothetical spread is off by a factor of roughly one hundred-fold, but it makes the example simpler.) One customer enters into a 5-year swap with a $1000 notional principal amount in which Dealer A is the fixed-rate payor at 3 percent, and another customer enters into a 5-year swap (with the same notional amount) in which Dealer A is the fixed-rate recipient at 4 percent. Rates do not move for the remainder of the day, and Dealer A still has the swaps on its books at the end of the day.

What does Dealer A record as its year-end mark-to-market gain from the two swaps it just entered into at market prices? In one sense, the two swaps could be said to have a value of zero, because they were just executed that day at market rates (*i.e.*, they are on-market swaps). The mark-to-market accounting answer, however, is not zero, but rather the net present value of the annuity that the dealer just created for itself through its activities as a financial intermediary — $10/year projected gross future income for 5 years,[55] less projected costs and expenses of earning that projected future gross income, discounted at the mid-market rate (3.5 percent in this simplified example).[56] This is the "adjusted mid-market" valuation methodology universally followed by dealers in OTC derivatives.

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55 This amount is determined by multiplying the difference between the bid and ask prices by the $1000 principal amount — 4 percent *minus* 3 percent equals 1 percent, and 1 percent *multiplied by* $1000 equals $10.

56 For the appropriateness of deducting anticipated future expenses, *see Bank One Corporation*, 120 T.C. No. 11, slip opinion at 227 (May 2, 2003).

It should be noted that adjustments to mid-market valuations of OTC derivatives do not double count expenses. Current expenses are, of course, claimed under standard accrual accounting principles; estimates of future administrative or other expenses reflected in the valuation of the dealer's future net income stream are amortized into income each year, thereby leaving the taxpayer (in a steady-state scenario) with current expense deductions simply of its current year expenses. Of course, expenses will cease to be reflected in the mark-to-market calculation once they are deducted currently, just as current-year cash flows receivable

Thus, when a dealer enters into an on-market customer swap, unlike when that dealer buys a security into inventory, the dealer recognizes income immediately, because in the swap case, but not the physical securities case, the dealer values the *anticipated future net income* it expects to derive from the new asset. The business model drives the difference: traditional inventory accounting methods assume that inventories will turn over rapidly, and therefore that one can take the future as it happens. The OTC derivatives business model, by contrast, assumes that the dealer will be compensated for what an economist would term the dealer's merchandising, liquidity and intermediation services through the creation of a long-term synthetic asset — the bid-ask spread that is captured in the dealer's hedged portfolio.

In light of the differences in the business models between a physical securities dealer and an OTC derivatives dealer, it becomes apparent as to why it is appropriate to accelerate income (when compared to normal tax accrual principles) in developing mark-to-market rules for OTC derivatives. If the rule were that one marked "long" swaps to bid, and "shorts" to ask (as securities firms do with physical securities inventories), then the first year a dealer entered into the swaps business (and ignoring subsequent market movements), it would show net operating losses, because it would have current compensation and administrative expenses, against only the prospect of long-term future income that plainly was not currently includible in income.

The adjusted mid-market method also does not distort trader behavior. If a firm were to mark "long" swaps to bid, and "shorts" to ask, then a trader effectively would book no current revenues to his or her desk from the merchandising, liquidity and credit intermediation services provided to the swap customer. This issue is immaterial in the context of physical inventories that turn over every few days (and in fact would be made worse, albeit from the opposite direction, if the alternative were adopted), but would systematically and inappropriately understate a trading desk's contribution to firm income when applied to a portfolio of cash flows

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in respect of an OTC derivative are taken currently into income when received and thereafter are no longer included when calculating the remaining value of that derivative.

(*i.e.*, an OTC derivatives book) with multi-year terms. Different business models thus appropriately lead to different constructs of the market to which securities should be marked.

C. The Matching Principle

We observed earlier that mark-to-market accounting effectively implemented the matching principle — *i.e.*, the principle that, in calculating net income, revenues should be matched against the expenses necessary to earn those revenues. The mechanisms by which mark-to-market methodologies do so, however, vary from one business model to another.

In the case of physical securities inventories, the matching principle applies in the sense that *future* costs and expenses of holding a physical security are reflected unconsciously and automatically through classic price discovery: investors may be expected to pay less, for example, for a foreign security that has extra costs associated with holding it than an otherwise identical domestic security.

The implementation of the matching principle for a dealer's book of future cash flows represented by its OTC derivatives portfolio follows a different path. Current production costs generally are deducted, even where the revenues generated by these costs (*e.g.*, a perfect synthetic annuity created by two offsetting swaps) will be received over a period of years. Marking to market, on the other hand, accelerates these future revenues into the current period, thereby achieving matching of revenues and the costs incurred to produce them. The result is economically equivalent to capitalizing production costs and offsetting them against revenues as the revenues are realized over time under a traditional accrual method.

As we noted at the outset, the purpose of marking to market is to measure a taxpayer's *net* income. It is necessary to ensure that the future revenue streams represented by swap contracts be adjusted to reflect the predictable future expenses associated with earning these revenues. As noted above, this step is not necessary when dealing with physical securities, because it happens automatically when the securities are later sold: for example, if Issuer X's credit rating is downgraded, the prices of X's bonds decline. One could describe the price

decline as a "credit adjustment," but it is not necessary to do so: marking the bond to the new market price effectively captures the "credit adjustment."

In the case of the stream of future cash flows represented by a dealer's portfolio of OTC derivatives, the adjustments for future expenses must be made directly, because the swaps portfolio by itself reflects only contractual future *gross* cash flows.[57] Section III.C, below, and Appendix A to this Submission discuss in detail the adjustments that OTC derivatives dealers make to their contractual gross cash flows to arrive at a market value for the incremental *net* income generated by the OTC derivatives business in a year.

D. Unit of Measure for Marking Derivatives Positions to Market.

To summarize to this point, dealers in physical securities capture the value of the economic services they provide by purchasing and *selling* these securities from inventory. Dealers in OTC derivatives, by contrast, capture the value of the comparable services that they provide through the *retention* of potential future positive net cash flows on their books. This distinction also drives the difference in the "unit of measure" employed by dealers in determining what property it is that should be marked to market.

In the case of inventories of physical securities, the relevant "units of measure" of course are each security: prices are quoted on a security-by-security basis, and any one security can be purchased or sold without affecting the dealer's inventories of other physical securities.[58] In the case of OTC derivatives, by contrast, a derivative-by-derivative approach to valuation would be completely inconsistent with the business model, which is to develop a portfolio of synthetic annuities. Therefore, although OTC derivatives dealers do track *unadjusted* mid-market values on a contract-by-contract basis, contracts are broken into their constituent cash flows for purposes of determining *adjusted* mid-market values, and it is the aggregate of all

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[57] *Bank One Corporation*, *supra* note 25 at 240 ("Midmarket is the value of the payments but not the value of the swap contract in that [the taxpayer] must incur Administrative costs and bear the risk that payment may never be received.").

[58] There are technical issues relating to when (or whether) inventories of physical securities should reflect liquidity discounts for unusually large quantities. These issues as they apply to OTC derivatives positions are discussed in Section III.C, below and in Appendix A to this Submission.

adjusted future cash flows that the dealer values using its mark-to-market methodology. A derivative-by-derivative approach to arriving at an adjusted mid-market value typically would overstate a dealer's exposures to counterparty credit risk (by ignoring netting of multiple contracts), thereby understating the dealer's net income. Other adjustments, such as for future administrative expenses, make sense only when calculated across the dealer's entire portfolio.[59]

As a result, the mark-to-market valuation of an OTC derivatives dealer's books of derivatives positions is universally calculated for all purposes (including tax) on a portfolio-wide basis. In this respect, the mark-to-market valuations of a dealer's OTC derivatives positions are more analogous to the valuation of an *ongoing business* (other than goodwill) than to the valuation of "physical" securities held in inventory.[60] The appraiser of the market value of a dealer's inventories of "physical" securities is indifferent about the dealer's future prospects for deriving a profit from those inventories; all that concerns the appraiser is what the marginal dealer in the relevant dealer community would bid to acquire those inventories. While it is true that a dealer's projected holding period, hedging costs, and financing costs all factor into its bid-ask spread, the key point is that mark-to-market valuation methodologies for inventories do not look past dealers' bid prices to those dealers' internal estimates of the future profits they will derive from their dealer operations.

Mark-to-market accounting for a dealer's portfolio of OTC derivatives also is an exercise in market valuation, but in the derivatives case, the focus shifts entirely to the future. Since the business model presumes that newly-acquired derivatives will be held indefinitely, the valuation exercise becomes an inquiry into the present value of the *future net income* that the

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[59] This point is separate from the question of whether administrative costs properly are calculated on an average or marginal basis: one can agree that these costs should be calculated on a marginal basis, but apply that principle to the marginal costs of administering the portfolio as a whole, rather than on a contract-by-contract basis. In fact, a position's effect on the value of the entire portfolio is arguably the most accurate measure of the position's incremental cost.

[60] Due to technological limitations, derivatives were valued on a contract-by-contract basis in the early days of the OTC derivatives business. However, this approach was generally abandoned as soon as it was technologically feasible to do so, because, among other reasons, a portfolio-based approach leads to a greater recognition of income and lower overall downward adjustments to mid-market values by taking greater account of factors (such as netting) that increase the value of the portfolio.

dealer can expect to earn from holding these long-term positions. The "adjustments" made by dealers to mid-market values are conceptually no different than projecting the future expenses (as well as future gross income) of any operating business as a step in valuing that business through discounting to present value its projected future net income.

In valuing a dealer's portfolio of OTC derivatives, the dealer thus focuses *not* on the derivatives themselves, as if they were inventory from which the dealer will profit through their prompt resale, but rather on the future net income streams expected to be generated through retaining and tending to those derivatives. In section 475 terms, the property that hypothetically is sold each year is the dealer's existing derivatives *portfolio*, and the valuation issue is what a hypothetical second dealer would bid to buy that portfolio (*i.e.*, the future net income stream) — or, alternatively (and with the different consequences noted in the next paragraph), how much it would cost this particular dealer to replicate the portfolio's future net income stream. In other words, an OTC derivatives dealer says that it marks its OTC derivatives to market, but that really is a shorthand for discounting to present value the expected future net income of its *swaps business* if it were to write no new contracts.

The above discussion also sheds light on the ongoing controversy within the dealer community as to whether a mark-to-market method of accounting for OTC derivatives should reflect the taxpayer's own credit. Fluctuations in a single dealer's own credit rating generally are irrelevant to the mark-to-market values of its physical inventories, because, while a deterioration in that dealer's credit might affect its borrowing costs, and therefore the price it is willing to pay to hold physical inventories, that single dealer presumptively does not drive the market price in liquid markets. (In addition, many important physical securities markets, such as the market for U.S. Treasurys, are funded primarily through collateralized funding arrangements, such as sale-repurchase contracts, which further reduce the relevance of an individual dealer's credit.)

The analysis becomes more complex, however, when one turns to OTC derivatives, and in fact OTC derivatives dealers today disagree as to precisely what the relevant

market is from which to calculate the value of a dealer's portfolio of derivatives. If the relevant market is defined as the replacement cost to that dealer of replicating its existing portfolio, then a dealer's own credit rating must be considered, because that credit rating will affect the prices at which the dealer could enter into new contracts that replicate its existing portfolio. Because a dealer would pay more to replicate the same portfolio following a downgrade of the dealer's credit, the dealer's existing portfolio can be said to have become that much more valuable to the dealer following its downgrade. (The same conclusion can also be reached by phrasing the relevant market as the aggregate exit price that a dealer would realize in a three-way negotiation among that dealer, its counterparty, and a hypothetical replacement dealer with a better credit rating: in that negotiation, the counterparty would logically pay the new dealer, with its superior credit rating, to replace the existing dealer.) Conversely, if one defines the relevant market as the price at which the dealer's counterparty could enter into a new contract with the dealer community on terms identical to the existing contract, then the particular dealer's credit rating is generally irrelevant, because (as in the case of liquid markets in physical securities) the individual dealer would not drive market prices. Either approach today is considered appropriate under GAAP.

III. FINANCIAL ACCOUNTING.

This Part III discusses the GAAP mark-to-market regime applicable to securities dealers. Section III.A provides a general overview of the relevant standard-setting bodies and describes the processes by which they issue guidance. Section III.B describes the general principles of fair value accounting as they apply under GAAP to securities and derivatives. Section III.C discusses in more detail the adjusted mid-market method employed by OTC derivatives dealers in valuing derivatives. Section III.D describes current developments in GAAP fair value accounting.

A. Overview of Financial Accounting Standards and Rulemaking.

1. FASB. The Financial Accounting Standards Board ("FASB"), which has seven board members, was created in 1973. The Securities and Exchange Commission ("SEC"),

which has the authority to establish standards for GAAP, has relied on FASB to set standards for GAAP throughout FASB's existence.[61]

All companies whose securities are publicly traded in the United States, including non-U.S. companies, are required to file financial statements with the SEC that are prepared in accordance with U.S. GAAP.[62] The importance of GAAP in the United States extends beyond financial accounting by publicly traded companies; as the most widely recognized set of accounting standards, GAAP is employed by many nonpublicly traded companies that are not required by the SEC to file financial statements. Each country has its own FASB-equivalent that sets the accounting standards for companies within its jurisdiction, and consequently, GAAP varies from country to country. As discussed in Section III.A.3, below, however, there is a growing effort to achieve international convergence in standards across national GAAPs.

FASB works in the public interest. In promulgating standards, it is expected to be objective, while considering the views of its constituents, and to weigh the benefits and costs inherent in implementation of such standards. FASB is required to implement new standards as needed in a prompt manner, while minimizing the disruption of reporting practices.

FASB has procedures to ensure that the public is involved in any standard that it promulgates. FASB regularly receives requests for action in promulgating new standards and modifying existing standards and actively keeps itself abreast of any trends in financial reporting or relevant legislative or regulatory changes or changes in business practice. Issues are presented

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[61] FASB's authority has recently been confirmed by the SEC under the higher level of scrutiny required by the Sarbanes-Oxley Act of 2002. The requirements of the Sarbanes-Oxley Act include that any body responsible for setting accounting standards must:

- have a board of trustees, a majority of whom are not, during their service on the board and the two years preceding such service, associated persons of any registered public accounting firm;
- have procedures in place that ensure prompt consideration of revisions to accounting standards that reflect emerging accounting issues and changing business practices; and
- take in consideration when evaluating changes in accounting standards the need to reflect changes in the business environment and international convergence of accounting standards.

[62] Each of the member firms of the SIA signing this Submission (or its parent) is a corporation that is required to file quarterly financial statements with the SEC that are prepared in accordance with GAAP.

at board meetings, which are open to the public (although observers are not allowed to participate). Once a conclusion is reached on an issue, a proposal is drafted by FASB staff and, once approved by FASB, is distributed for public comment — generally, for a period of 60 days. Depending on the comments it receives, FASB incorporates such comments and can either distribute another proposal for public comment or issue a final document that will be adopted upon a vote of approval from four out of seven FASB members. FASB's primary means of issuing guidance is through numbered "Statements of Financial Accounting Standards" ("FASs"), each of which addresses a specific topic in financial accounting.

2. EITF. The Emerging Issues Task Force (EITF) was created in 1984 to improve financial reporting on an expedited basis by identifying and resolving financial accounting issues within the framework of existing GAAP. Although the EITF has no authority itself to change standards in GAAP, the EITF serves FASB by highlighting issues that may require a modification of GAAP before problems related to those issues become widespread. Members of the EITF have backgrounds related to various specialties within financial accounting. The chief accountant of the SEC attends EITF meetings regularly and is allowed to participate in EITF's deliberations, as is the chairman of the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (the "AICPA").

The EITF meets six times a year, and meetings are open to the public. Issues that cannot be resolved by the EITF within the framework of existing GAAP standards may be submitted to FASB for possible action, and in any event, all resolutions approved by the EITF must subsequently be ratified at the next public meeting of FASB. Thus, the EITF serves as the first responder to many new financial reporting developments. Consensus positions reached by the EITF on a particular issue may be relied upon as an authoritative interpretation of GAAP in respect of that issue.[63]

[63] Technically, consensus positions of the EITF rank as a third-tier source of GAAP authority, but because of the specific nature of the issues addressed by the EITF, its consensus positions may represent the sole

3. IASB and International Convergence of Accounting Standards. The International Accounting Standards Committee (the "IASC"), which was the predecessor of the International Accounting Standards Board (the "IASB"), was created in 1973 through an agreement of the accounting bodies of Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom, Ireland and the United States. The IASC was formed with the purpose of formulating a single set of international financial accounting standards that promotes transparency and consistency across international markets. The IASC was restructured in 2001; its successor, the IASB, has continued to work towards the same goal.

The IASB has a commitment to due process in promulgating international accounting standards, in a manner similar to FASB's standard-setting process. The IASB has public meetings, distributes all proposals with a public comment period and incorporates those comments before presenting any new standards, which must then be approved by at least eight out of a total of fourteen board members to be finalized. Members must come from varied backgrounds, including academics, as well as auditors, preparers and users of financial statements. Seven members of the IASB are required to have formal liaison responsibilities with the accounting boards of seven different countries (including FASB in the United States).[64] The SEC and FASB have committed to achieving the goal of convergence of international financial reporting standards.[65]

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source of GAAP authority directly addressing a particular issue. *See* Delaney, Epstein, Nach and Budak, WILEY GAAP 2003, pp. 6-7 (John Wiley & Sons, 2002).

64 The seven other IASB "liaison countries" are Australia, New Zealand, Canada, France, Germany, Japan and the United Kingdom.

65 *See* the memorandum of understanding between FASB and IASB, dated September 18, 2002 (memorializing the commitment of FASB and IASB to achieve and maintain full compatibility between each of their existing financial reporting standards).

In April 1996, the SEC commended IASC for its work in promulgating standards and indicated that it was "committed to working with its securities regulatory colleagues, through IOSCO [(the International Organization of Securities Commissioners)], and with the IASC to provide the necessary input to achieve the goal of establishing a comprehensive set of international accounting standards." <http://www.iasb.org.uk/cmt/0001.asp?s=9273451&sc={268A3714-B6C7-40CA-9A76-63BD869FE98E}&n=3285>.

B. Fair Value Accounting for Securities Generally.

1. In General. Under GAAP, dealers in physical securities or OTC derivatives dealers (referred to in the accounting literature as "broker-dealers") are required to mark to market all securities held in inventory and all derivatives positions entered into as part of their business.[66] The primary sources of guidance in implementing GAAP's mark-to-market regime for broker-dealers include Statement of Financial Accounting Standards 107, *Disclosures About Fair Value of Financial Instruments* ("FAS 107"), and FAS 133, as amended by FAS 149, *Accounting for Derivative Instruments and Hedging Activities* ("FAS 133").

The AICPA has summarized and interpreted the relevant guidance for broker-dealers in the Audit and Accounting Guide, *Brokers and Dealers in Securities* ("the *Broker-Dealer Guide*"), which is an authoritative document issued with FASB's approval. Although the *Broker-Dealer Guide* is intended to provide guidance to broker-dealers that are regulated by the SEC, its principles of fair value accounting are equally applicable to all securities and OTC derivatives that are required to be valued in accordance with GAAP for U.S. financial accounting purposes.[67]

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[66] As a general matter, institutions other than broker-dealers record financial instruments depending on the relevant institution's intent for holding the instrument and the nature of its business activity. If an institution other than a broker-dealer has the positive intent and ability to hold a debt security to maturity, for example, the debt security is classified as "held-to-maturity" and reported at amortized cost. Debt and marketable equity securities that are bought and held principally for the purpose of reselling them in the near future are classified as "trading securities" and reported at fair value under a mark-to-market system. Debt and marketable equity securities not classified as either held-to-maturity or as trading securities are classified as "available-for-sale" and, like trading securities, are marked to market.

Mark-to-market gains and losses in respect of "available-for-sale" securities, and in respect of certain derivatives held for hedging purposes, are recorded as a separate component of shareholder's equity (so-called "Other Comprehensive Income") and are not recorded currently in the profit-and-loss statement. We note, however, that the valuation methodologies used to determine those gains and losses are identical to those used to compute mark-to-market gains and losses that are currently reflected in profit and loss statements. We therefore do not see any significant issues presented by the GAAP treatment of available-for-sale securities, and believe that the GAAP valuations for such securities are fully suitable for purposes of the mark-to-market tax regime of section 475.

[67] Some U.S. financial institutions that are SEC reporting companies conduct a significant amount of OTC derivatives dealer business through foreign subsidiaries (located, for example, in the United Kingdom). Positions entered into by the foreign dealer subsidiary are reflected on the parent's consolidated financial statements in accordance with U.S. GAAP.

As a general matter, securities dealers and derivatives dealers are required to account for financial instruments at "fair value," as of the last business day of each reporting period. "Fair value" is "the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale."[68] Accountants in the securities industry often use the term "exit price" as synonymous with "fair value." We compare the terms "fair value" and "fair market value" below in Section IV.A, Response 1.

Paragraph 7.08 of the *Broker-Dealer Guide* permits any of the following measures to determine the fair value of physical securities, so long as the chosen measure is applied on a consistent basis:

- An average of bid and ask prices;
- Bid prices for long positions and ask prices for short positions;
- Some average of price quotations of a representative selection of market makers quoting on a particular financial instrument; or
- A range of bid and ask prices considered best to represent value in the circumstances.

The *Broker-Dealer Guide* requires only that ask prices not be used for long positions and that bid prices not be used for short positions, because such a method would lead to an inappropriate acceleration of income. Although the *Broker-Dealer Guide* thus provides a certain degree of flexibility in determining fair value, securities dealers have consistently and uniformly implemented the fair value standard by marking long positions in physical inventory to bid prices and short positions to ask prices for the business reasons described above in Section II.A.

Paragraph 7.10 of the *Broker-Dealer Guide* provides that, if there are no readily available price quotations or if readily available price quotations are considered to be unreliable (*e.g.,* because securities held by the dealer are subject to special restrictions or are only thinly traded), it may be necessary to determine fair value based on management's good-faith estimates. To determine fair value in these circumstances, management must satisfy itself that:

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[68] *See Broker-Dealer Guide*, paragraph 7.02 (for general requirement to account using fair value); FAS 133, paragraph 540 (for definition of "fair value").

- All appropriate factors relevant to the value of financial instruments for which price quotations are not readily available have been considered;
- The procedures for arriving at the fair value of each financial instrument are reasonable and consistently applied; and
- The underlying documentation supports the fair value estimates.

For certain financial instruments, listed prices such as those quoted on an exchange do not exist. In such instances, the *Broker-Dealer Guide* notes that management may use a variety of methods to assist in determining the value of a financial instrument. These methods include pricing by analogy to reliable quotations of similar financial instruments, pricing models, matrix pricing, and other formula-based pricing methods. These methodologies incorporate factors for which published market data generally is available. As discussed in Section III.D, below, there are several projects, either underway or recently completed, by various accounting standard-setting bodies to provide more specific guidance as to the types of evidence that should be used in certain situations to establish fair value.

In the specific case of OTC derivatives, paragraph 7.14 of the *Broker-Dealer Guide* states that factors such as volatility, anticipated future interest rates, term to maturity, and the complexity of the derivative should be considered in determining fair value, and goes on to note with approval a much-cited policy recommendation from the "Group of Thirty" (a non-profit organization concerned with financial policy) that derivatives portfolios be valued based on "mid-market levels less specific adjustments."[69] These adjustments are discussed in Section III.C, below.

2. Mitigating Reliability Concerns. Proper controls are fundamental to ensuring that trading contracts are appropriately valued and that the resulting fair value measurements are reliable.

A substantial body of literature exists regarding controls and best practices for valuation. This guidance includes The Group of Thirty Report, *Derivatives: Practices and Principles*, guides published by the Counterparty Risk Management Policy Group and the

[69] *See* Group of Thirty, *Derivatives: Practices and Principles,* Washington, D.C.: Group of Thirty, 1993.

Derivatives Policy Group, and OCC Bulletin 2000-16–*Reliance on Computer-based Financial Models*. Consistent with the conclusions reached in these documents, certain practices are necessary for a well-controlled valuation environment. These practices may include the following:

- Principles should be applied consistently in determining the fair value of trading products with the following characteristics:
  - *Justifiable* – the rationale for a value should be supportable and clearly defined.
  - *Measurable* – the model should be sufficiently clear so that calculations can be consistently reproduced.
  - *Comparable* – the model should be consistent over time. Changes to the model should be justifiable based on market conditions and new developments in the industry, made consistently throughout the organization.
- Models should be independently reviewed for conceptual soundness.
- Risk management functions should establish pricing review procedures that would require frequent back testing (*i.e.,* comparing internal pricing with actual market data for similar transactions). Model inputs should be continuously verified and results should be compared to other models and back tested against transaction prices.
- Groups independent from the trade function should review fair values.
- Risk management measurements such as "value at risk" and stress tests should be performed.
- Market, credit and concentration risk limits should be established and monitored for exposures to individual counterparties and sectors. In addition, credit risk measurements of expected exposure and "worst case" exposure should be performed frequently.
- Risk management and credit risk management departments should be independent from trading personnel and report directly to senior management.
- Independent controls groups, such as the finance and risk management departments, should have technical knowledge of relevant markets and products.
- Clear guidelines on the types of transactions that are permitted should be established. Large and unusual transactions should require the review of various personnel within the company, including, for example, those persons responsible for risk and credit management, finance, accounting, operations, and internal audit.
- As OTC derivatives transactions require significant expertise and the valuation of OTC derivatives often requires material estimates and judgment, senior management should be informed about all significant and unusual transactions and kept abreast of credit and market risk metrics.

- Certain transactions require margining/posting of collateral based on moves in market prices. In determining margin requirements and resolving discrepancies, both counterparties must agree to the valuation upon which the margin is based. While margining is not a perfect valuation process, it is a good mechanism for price discovery, even for illiquid transactions.

Within the control structure, valuations determined through modeling are compared to quoted prices or execution levels to ensure that the model is providing accurate information. As such, when establishing meaningful processes for valuing trading contracts, the methodologies should be applied to model inputs based on observed market information rather than the prices themselves. In addition, back testing of valuations provides further validation of both the actual valuations being used throughout the life of a trade as well as validation of the existing models used and process for determining appropriate model inputs on a going forward basis. Where valuation models utilize historical and statistical analysis to determine fair value, recently executed representative transactions will further validate the models' assumptions; and where the transaction prices deviate significantly from the model-determined fair values, the transaction prices will be used to refine further the models' statistical techniques.

C. The Adjusted Mid-Market Method

This Section III.C discusses the adjusted mid-market method for valuing derivatives, as it is currently employed by all derivatives dealers of which we are aware.

In the absence of observable third-party prices (*see* the discussion of EITF 02-3 in Section III.D.1, below), OTC derivatives are valued using pricing models that determine the present value of estimated future gross cash flows (the unadjusted mid-market valuation), based on inputs such as directly observed prices from exchange-traded derivatives, other OTC trades, or external pricing services. Because new and/or complex derivatives may have immature or limited markets, pricing models used for valuing them may incorporate an element of judgment.

The values produced by these pricing models (or by reference to observable market prices, if available) are intended to reflect the price for a derivative that is at the midpoint between the prevailing bid and ask prices. These "mid-market" valuations effectively value the

anticipated future *gross* income from a position. As discussed in Section II.C, above, it is necessary to make additional adjustments to the mid-market values in order to produce the *net* value of a dealer's portfolio of OTC derivatives (*i.e.,* to arrive at the "adjusted mid-market" value).[70] For derivatives dealers, marking to mid-market without further adjustments would be a departure from the fundamental principle of fair value—that is, fair value should represent the price at which a willing buyer and seller would enter into an exchange, other than in a forced or liquidation sale. Unadjusted mid-market values are ordinarily not exit prices for dealers, because they do not take into account the costs required to realize the value of the positions. Therefore, using a mid-market valuation method without adjustments would overstate the value of a derivatives portfolio.

Attached as Appendix A to this Submission is a discussion of the various adjustments that are made to mid-market valuations by industry participants. As previously described, securities dealers apply these adjustments consistently for GAAP, tax and their internal commercial and financial purposes. Appendix A is based on a letter sent to Treasury on May 9, 2000 by the International Swaps and Derivatives Association, Inc., but has been updated somewhat to take account of general changes in current market practice.

D. Recent Developments in Fair Value Accounting.

In response to several factors, most notably a series of accounting controversies in the United States and an attempt to conform accounting standards on an international basis, there have been three recent initiatives, discussed in detail below, to increase the levels of transparency and objectivity in the process of determining fair value for GAAP purposes. The first project, initiated by the EITF (known as "EITF 02-3," discussed below), produced standards that have been generally effective since November of 2002. The remaining two, initiated by FASB and the IASB respectively, are in their preliminary stages. A common theme among each of these

[70] *See Bank One Corporation, supra* note 25 at 240 ("We agree with [the taxpayer] that the [unadjusted] midmarket method, standing alone, fails to reflect [the taxpayer's] swaps income clearly. Midmarket is the value of the payments but not the value of the swap contract in that [the taxpayer] must incur administrative costs and bear the risk that a payment might never be received.")

projects is a desire on the part of standard-setting bodies to maximize the role of objective, verifiable data in the process of determining fair value for derivatives and securities by establishing clearer standards as to which types of evidence are acceptable in establishing fair value for book purposes, and which types of evidence are to be accorded the most deference. Although it is too early to be able to predict the outcome of the FASB and IASB projects with any accuracy, each of these initiatives demonstrates a clear preference on the part of the standard-setting bodies for types of evidence that are more transparent and easily verifiable over valuation methods that rely on dealer judgment.

Because reliable price quotes and other high-quality data generally are available for physical securities and for most types of derivatives and are already used in valuing those instruments, the importance of the projects (in terms of potential to change reported valuations) is primarily limited to the valuation of the most nonstandard of the "exotic" derivatives, which may be difficult to value based solely by reference to transparent, third-party data and for which values must therefore be determined predominantly through the use of complex models. We anticipate, for example, that these projects will have little or no impact on the valuation for GAAP purposes of conventional interest rate swaps.

1. EITF 02-3. EITF Issue No. 02-3: "*Issues Involved in Accounting for Derivatives Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*'" ("EITF 02-3")[71] is a document that provides guidance (in the form of minutes to meetings of the EITF) as to the types of evidence that must be provided in order for an OTC derivatives dealer to recognize mark-to-market profits (or losses) in respect of a derivatives position. Because EITF 02-3 began as a response to the Enron accounting controversies, in which Enron was said to have inflated profits by accelerating income recognition on energy trading contracts, its scope initially was limited to energy trading contracts. Since late 2002, however, the evidentiary standards of EITF 02-3 have applied to all derivatives (but not to physical securities).

[71] EITF, *EITF Abstracts*, Issue No. 02-3, 1428A.

EITF 02-3 attempts to increase the transparency and objectivity of the process of determining fair value for OTC derivatives positions. EITF 02-3 does *not*, however, change the definition of "fair value," or the ultimate goal under GAAP of producing accurate valuations.

EITF 02-3 essentially requires that, in order for a derivatives dealer to recognize an immediate mark-to-market profit for its liquidity, merchandising and credit services in respect of a recently-initiated derivatives position, the dealer must demonstrate that the fair value of the position is greater than the price contracted by the dealer to enter into the position (*i.e.,* the dealer must demonstrate as a factual matter the existence of a dealer "spread"). In this regard, EITF 02-3 provides that the dealer may establish this greater fair value for the position by reference to: (i) a "quoted market price in an active market," (ii) "observable market prices of other current market transactions," or (iii) a "valuation technique incorporating observable market data."[72] If none of these three types of evidence is available at inception, then the transaction price actually contracted by the dealer is presumed to be the best evidence of the position's value at that time.

There is a clear consensus among the accounting community that EITF 02-3 affects only a very small minority of derivatives positions. For the vast bulk of derivatives, including "plain vanilla" interest rate swaps, conventional currency swaps, equity swaps on publicly-traded stock, etc., it is virtually always possible for a dealer to establish a fair value above the transaction price based on highly-reliable third-party data that meets the requirements of EITF 02-3.[73]

For the reason discussed above, EITF 02-3 is of importance almost exclusively in the case of some "exotic" derivatives, for which values may be determined, at least as an initial matter, only through the use of valuation models that both require subjective inputs and that are more complex than, for example, the programs used to determine mid-market values for interest rate swaps. In the case of such derivatives, EITF 02-3 states that, at the time of the derivative's inception, the transaction price is considered to be better evidence of value than a valuation

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72 EITF 02-3 at 1428B, footnote 2.

73 Specifically, the third-party data would be used to determine an unadjusted mid-market value, which in turn would be subject to further adjustments based on the OTC derivatives dealer's valuation methodologies.

technique that "includes extrapolated price curves with little or no observable market inputs for any significant duration of the instrument."[74] As a result, a dealer that enters into an exotic OTC derivative contract and that cannot satisfy the evidentiary standards of EITF 02-3 cannot book an immediate profit equal to its anticipated dealer spread.

EITF 02-3 does not precisely define when a dealer's initial anticipated spread, as calculated by the dealer's own risk models, may be taken into income. In this regard, the relevance of the original transaction price as an indicator of fair value diminishes with time, because the price becomes stale. Evidence that, at a date subsequent to the initiation date, may be considered superior to the transaction price, and thus that might establish a higher fair value, includes prices indicated by certain hedging activities carried out in respect of the derivative in question, and "proxy" transactions (*i.e.,* prices may be established by analogy to other, observable transactions).

Because EITF 02-3 is concerned with a dealer's own assessment of the amount of its dealer spread at inception of an exotic derivative, the evidentiary standards of EITF 02-3 do not affect the accounting treatment of subsequent fluctuations in the value of a derivatives position. For example, consider a highly complex and illiquid derivative for which little relevant observable data is available at inception. Assume that the derivative is valued at $100 using the dealer's proprietary valuation model (including an internal model-driven determination of a $5 dealer spread), but has a transaction price of only $95 and is thus considered to have a $95 value at inception. If the value of that $95 position (determined through the dealer's valuation model) subsequently increases by $3 by virtue of movements in market prices or rates, that $3 increase will be reflected in the profit and loss accounts under the dealer's mark-to-market GAAP accounting regime, regardless of whether the $5 of profits relating to the dealer's own assessment of its dealer spread at inception has been recognized or not by that point in time. This approach is consistent with the goals of financial accounting in light of the fact that most "exotic" derivatives are hedged with positions in liquid instruments. Where those liquid

[74] EITF 02-3 at 1428B, footnote 2.

positions are marked to market, a failure to take account of offsetting fluctuations in the value of the exotic derivatives would distort the dealer's profit and loss statements in a manner similar to the distortions that led dealers to request mark-to-market treatment initially (*see* discussion in Section I.D, above).

In sum, EITF 02-3 provides evidentiary standards for establishing fair value for derivatives for purposes of allowing a dealer to recognize a profit equal to its anticipated dealer spread at the inception of the contract. For the vast bulk of derivatives, these standards are met, and the profit attributable to the dealer spread is booked. For certain "exotic" derivatives, however, the standards are more difficult to meet at inception, because there is less high-quality, observable data to support a valuation of such derivatives. In such cases, valuations may be established on a later date as the transaction price becomes stale and other types of data become more relevant. EITF 02-3 does *not* change the definition of "fair value," but merely provides guidance as to how fair value may be demonstrated in a more transparent and objective fashion.

2. FASB Project. FASB recently has initiated a much more ambitious project than EITF 02-3 to provide guidance for determining the fair values of "essentially all financial assets and liabilities and certain related assets and liabilities."[75] Although it is too early in the standard-setting process to be able to predict accurately what the guidance will be, FASB has, at least as an initial matter, set forth two basic principles for determining fair value: (i) maximization of market (*i.e.,* objective) inputs and minimization of internal estimates and assumptions, and (ii) permission to change an estimation technique only if "an improvement can be demonstrated or if a change is necessary because of changes in availability of information."[76] As in the case of EITF 02-3, we believe that this project will focus fundamentally on increasing transparency and objectivity in the process of determining fair value, and not on changing the definition of fair value or the ultimate goal of providing accurate valuations.

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[75] FASB, "Project Updates — Disclosures about Fair Value Measurement," Last Updated June 20, 2003. (available at www.fasb.org/project/fairvalue.shtml).

[76] *Id.*

3. IASB Project. The IASB first promulgated fair value standards in International Accounting Standard 39 "Financial Instruments: Recognition and Measurement" ("IAS 39"), and like FASB, has undertaken a project to amend the evidentiary standards for determining fair value. The IASB has issued a set of "Proposed Amendments" to IAS 39.

As is the case with EITF 02-3, the IASB intends to establish clearer standards for valuing financial instruments that maximizes the use of market inputs and minimizes the role of judgment. The IASB proposed standards require the use of contemporaneous quotes, when they exist, as a proxy for fair value where the instrument in question is actively traded,[71] and in the case where an instrument is not actively traded, but where there are *recent* market transactions "between knowledgeable, willing parties in an arm's length transaction," recent price quotations should be used to arrive at fair value.[72] In addition, if "conditions have changed since the most recent market transaction, the corresponding change in fair value of the financial instrument being valued is determined by reference to current prices or rates for similar financial instruments, as appropriate."[73]

According to the Proposed Amendments, if fair value cannot be determined using the techniques described above, a valuation technique should be used that "(a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments " that have the "objective of . . . establish[ing] what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations."[78] The valuation techniques that are acceptable under IAS 39 are those that (i) are accepted by the market, (ii) have proven to be reliable and (iii) are validated by comparison to actual prices. [79]

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71 IASB, *exposure Draft of Proposed Amendments to IAS 32 (Financial Instruments: Disclosure and Presentation) and IAS 39 (Financial Instruments: Recognition and Measurement)*, paragraph 99, ("The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability.")

72 *Id.* at paragraph 100.

73 *Id.* at paragraph 100.

78 *Id.* at paragraph 100A.

79 *Id.* at paragraphs 100A through 100C.

Given the general trend towards uniform international accounting standards, we believe that the FASB project and the IASB project will inform and influence each other, and the ultimate outcome of both projects will be determined by a process that will take account of the input of various industry participants, as well as regulators and accounting professionals. It is therefore too early to predict the precise outcome of these projects. We note, however, that the projects are part of an ongoing process of regulatory development that, like the development of tax rules, is unlikely ever to stop. We therefore do not believe that the existence of these projects should serve as a reason for delaying the implementation of a safe harbor under the Notice.

IV. SPECIFIC COMMENTS.

We fully agree with the overarching principle of the safe harbor described in the Notice — that valuations of securities and derivatives reported for financial statement purposes meet the fair market value requirement of section 475, provided certain requirements are met and safeguards applied. We also agree with the Notice's formulation of the three broad principles that should determine a taxpayer's eligibility for the safe harbor. Below, we discuss those principles and respond to the request for comments made by the Notice in connection with each of them. Our comments should be read in light of our agreement with the Notice's overall approach, and in light of our desire to see that approach implemented.

A. Principle One: Sufficient Consistency between GAAP and Section 475.

The Notice's Principle One is that any mark-to-market methodology used for a financial statement submitted for financial reporting purposes needs to be "sufficiently consistent" with the mark-to-market methodology used under section 475. Specifically, the Notice states that a proper mark-to-market methodology under section 475 must (i) value securities and commodities as of the last business day of each taxable year, (ii) recognize into income the gains and losses arising from changes in value each year, and (iii) compute gain or loss on disposition by reference to the value at the end of the prior year.

A mark-to-market regime implemented for GAAP purposes clearly is consistent with each of the three above-listed requirements, because GAAP (i) requires dealers using a

mark-to-market method to value their positions as of the last day of the fiscal year (GAAP in fact requires valuations on a quarterly basis for financial statement purposes, and as a matter of business necessity and regulatory reporting, positions are valued daily), (ii) measures income by reference to changes in value, and (iii) measures gain or loss on the disposition of a position by reference to the value previously recorded for the position. The Notice therefore discusses the potential use of the "fair value" standard under GAAP as a proxy for "fair market value" within the meaning of section 475. In connection with your consideration of Principle One, you have asked the following questions:

Question 1: "To the extent that mark-to-market methodologies for financial reporting and section 475 differ, the IRS and the Treasury Department request comments identifying the differences and addressing whether and how the differences should affect the safe harbor."

Response 1: Our current mark-to-market methodologies for financial reporting and section 475 do not differ. Our dealer members have consistently used GAAP fair values in the preparation of their U.S. federal income tax returns. For that reason, no firm that is a member of the working group that has prepared this report makes a Schedule M-1 adjustment for any differences in valuation methodologies. We believe that most (and probably all) tax departments of large dealers do not possess the expertise, nor would be able to dedicate the resources, to perform a second valuation to determine a tax "fair market value" that is different from GAAP fair value. In cases where, for example, positions are required to be marked to market for GAAP purposes, but not for tax purposes (or vice versa), all such adjustments would appear in the dealer's Schedule M-1.

As described above, in the case of a dealer marking a financial instrument to market for GAAP purposes, "fair value" is defined as "the amount at which the instrument could be exchanged in a current transaction between willing parties, other than a forced or liquidation sale."[80] The definition of "fair market value," which is used for U.S. federal income tax

[80] FAS 133, paragraph 540.

purposes, on the other hand, is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts."[81] We see no difference between the concepts of "fair value" and "fair market value" in practice, and strongly support the book-tax conformity principles proposed in the Notice. For this reason, we wish to comment on the holdings by the Tax Court in *Bank One* that (i) the two concepts are different and (ii) fair value is not an adequate substitute for fair market value for purposes of a mark-to-market taxation regime.[82]

As an initial matter, we believe that the Tax Court's holding was based on an extremely narrow reading of the two definitions that did not take proper account of the purposes for which the two definitions are used. As a result, we believe that the differences the Tax Court found between "fair value" and "fair market value," which we discuss in more detail below, have no bearing on the question of whether the *use* of fair value for purposes of a safe harbor is a desirable means of implementing a workable and efficient system for auditing securities dealers and derivatives dealers. As explicitly discussed in Principle Two of the Notice (discussed below), the safe harbor will rely on financial statements only to the extent that book values are used for significant non-tax purposes, such as regulatory reporting, risk management and employee compensation. If this condition is met, so that valuations are subject to checks and balances from different stakeholders in a dealer's business and so that the IRS can be confident that the valuation process does not contain a systematic upward or downward bias, then we believe the issue of whether the terms "fair value" and "fair market value" are conceptually equivalent becomes a largely academic inquiry. Again, Principle One requires "sufficient

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81 Treasury regulation section 1.170A-1(c)(2) (defining "fair market value" for the purposes of the charitable contribution regulations); Treasury regulation section 20.2031-1(b) (defining "fair market value" for estate tax purposes); Treasury regulation section 25.2512-1 (defining "fair market value" for gift tax purposes); *United States v. Cartwright*, 411 U.S. 546, 591 (1973) (quoting Treasury regulation section 20.2031-1(b) with approval); *Easter Service Corp. v. Commissioner*, 650 F.2d 379, 384 (2nd Cir. 1981) (quoting *United States v. Cartwright*).

82 *Bank One Corporation*, 120 T.C. No. 11, slip opinion at 206-211 (May 2, 2003).

consistency" for purposes of measuring income on a year-to-year basis, not that the two concepts be absolutely identical.

Addressing the *Bank One* decision on its own terms, we believe that the distinctions drawn between "fair value" and "fair market value" are overly formalistic, and that in drawing those distinctions, the Tax Court failed to consider the nature of the property being valued — OTC derivatives, which, like other financial instruments, are merely rights to future cash flows. In order to reach its holding, the Tax Court first quoted the same definitions of "fair value" and "fair market value" as those set out above and then drew three distinctions between the two terms: (i) fair market value requires that the buyer and seller be reasonably aware of all facts relevant to the property being valued, whereas fair value has no such knowledge requirement; (ii) fair market value requires that neither buyer nor seller be under any compulsion to buy or sell, whereas fair value requires that the property not be the subject of a forced sale or liquidation; and (iii) fair market value, according to case law, views the buyer and seller as hypothetical persons rather than actual persons, and requires that the property be valued in accordance with its highest and best use, whereas neither of these requirements is found in the definition of "fair value." Therefore, the Court concluded, fair value is a less precise concept than fair market value and is thus not suitable for purposes of a mark-to-market taxation regime.[83]

The three distinctions discussed by the Tax Court are irrelevant when considering the valuation of OTC derivatives. First, the Court's assertion that "fair value" does not require a knowledgeable buyer and seller is simply incorrect. The Tax Court itself in a footnote to the *Bank One* case, cites a definition of "fair value" as value "determined by bona fide bargain between *well-informed* buyers and sellers." (emphasis added).[84] On a practical level, it cannot be the case that the accounting term "fair value" was ever meant to refer to transactions between

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83 *Id.* at 209-210.

84 *Id.* at footnote 66 (quoting *Kohler's Dictionary for Accountants*, p. 211 (6th ed. 1983)).

uninformed parties, since such a term would be of no practical use to regulators, equity holders and the numerous other constituencies that rely on financial statements for practical purposes.

Second, the Tax Court's distinction between the "no compulsion" requirement in the definition of "fair market value" and the "no forced or liquidation sale" in the definition of "fair value" is irrelevant in the context of OTC derivatives — whatever the relevance of the distinction may be in other contexts. In the case of tract of land with the potential for commercial development, for example, one could imagine that a seller with the resources to develop the land fully would be unwilling to sell the land for a price that might be quite attractive to a different seller that had little ability to develop the land and a desperate need for cash. OTC derivatives, however, are not comparable assets — because derivatives (and all financial instruments) are merely rights to future certain defined cash flows, all holders of those rights have an equal ability to realize those cash flows.[85] Although a dealer's financial condition (*e.g.,* its cost of funding and administrative costs) may affect the net income it realizes in respect of a derivatives position, the Tax Court was incorrect to believe that the differing levels of autonomy between a buyer and seller referred to in the two valuation standards has any meaning when applied to financial instruments.

Third, the Tax Court's claim that the fair market value of property is based on its "highest and best use" again fails to take account of the property actually being valued in the case. Unlike a tract of land that may be used either as a vacant lot or a shopping-mall site, an OTC derivative (or other financial instrument) has *only one use* — the generation of certain defined future cash flows. There is no "higher" or "better" use. Similarly, the Court's discussion of the fact that the tax concept of "fair market value" refers to hypothetical buyers and sellers is similarly unhelpful in the context of a dealer's positions in derivatives. Because there is no actual secondary market in OTC derivatives (or, again, in portfolios of derivatives

[85] Of course, a participant in an interest rate swap could be unable to fulfill its obligation to make payments under the swap (thereby leading to a default), but we do not believe that such an extreme case is contemplated as a benchmark for determining value under either the tax or accounting concepts.

assembled by dealers), neither standard could refer to any buyers and sellers other than hypothetical ones or to the taxpayer itself replicating its portfolio.

Presumably for all of the forgoing reasons, on cross-examination by the taxpayer's counsel, the expert witness upon whom the Tax Court relied in reaching its conclusion, conceded that "the elements of 'fair market value' and 'fair value,' when the definitions of the terms are construed literally, were inconsequential when applied to [taxpayer's] swaps."[86]

Question 2: "The IRS and the Treasury Department seek comments on whether GAAP permits (i) valuation of securities at the bid price, (ii) downward adjustments from mid-market values for future administrative, hedging, or financing expenses, or (iii) one or more redundant downward adjustments from mid-market values for credit risk. (In other words, if future cash flows are discounted to present value using a rate, such as LIBOR, that corresponds to the credit quality of the counterparty, is there a need for any additional credit adjustment?)"

Response 2: GAAP permits the valuation of long positions in physical securities at the bid price, and permits downward adjustments from mid-market valued for future administrative, hedging, or financing expenses. For a general discussion of how securities and derivatives are marked to market under GAAP and of many of the adjustments to mid-market valuations that are currently used, we refer you to Part III and to Appendix A to this Submission.

Regarding the specific question of whether GAAP allows for "redundant downward adjustments from mid-market values for credit risk," GAAP does not allow for redundant credit adjustments. We also note that there is generally no incentive for an OTC derivatives dealer to make unnecessary downward adjustments to position values for financial accounting purposes.

We also note that a yield curve based on a hypothetical borrower with a specified credit rating will account for credit risk imperfectly, and that there are often significant

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[86] *Bank One Corporation*, 120 T.C. No.11, slip opinion at 210.

differences in terms of credit quality among borrowers with identical credit ratings. It is *not* current market practice for our members to look merely to a counterparty's rating from a major credit rating agency in order to evaluate the counterparty's creditworthiness. Instead, dealers develop their own assessments based upon such factors as the price for hedging against the counterparty's credit risk in the credit derivatives market and the trading price of the counterparty's debt relative to Treasury obligations. Particularly in light of the recent growth of the credit derivatives market, these counterparty-specific factors may provide a much more nuanced and accurate assessment of a counterparty's credit quality than would be revealed by a credit rating alone. In other cases, a dealer may simply disagree with a rating agency's assessment of a counterparty's credit quality. For these reasons, even though a counterparty may have a rating of "AA" from Standard & Poors, it nonetheless may be appropriate (and not redundant) to make a downward credit adjustment in respect of that counterparty, even where the relevant yield curve assumes a hypothetical "AA" credit. The converse of course also is true: some "AA" counterparties are viewed as better quality credits than the average contemplated by the "AA" swap curve.

Similarly, although various types of credit enhancements (such as the posting of collateral or netting arrangements) may reduce, or even eliminate, the need for a downward credit adjustment, there are certainly circumstances in which a credit adjustment is appropriate, even though a credit enhancement feature has caused the counterparty risk to rise to the level of the credit rating used to determine the yield curve. Again, such a result would be justified where the particular counterparty's enhanced credit quality (although technically at an "AA" level, for example) was less than that of the hypothetical "AA" borrower used to construct the yield curve.

Question 3: "The IRS and the Treasury Department are interested in receiving information on the types of adjustments that are currently used for financial statement purposes and an explanation of these adjustments."

Response 3: We have described current practices under GAAP in Part III, above, and in Appendix A to this Submission. Again, we note that the specifics of implementing these adjustments will vary somewhat from firm to firm.

Question 4: "Comments are requested on the Financial Accounting Standards Board's consideration of fair value reporting of derivatives and the valuation of projected cash flows and any impact that has on how taxpayers are reporting any valuation adjustments for fair value purposes."

Response 4: A discussion of the FASB fair value project is included, along with a discussion of EITF 02-3 and the IASB Proposed Amendments to IAS 39, in Section III.D, above. As discussed in Section III.D, we believe that these projects are fundamentally concerned with establishing more transparent and objective evidentiary standards, but they do not change the definition of "fair value" or the ultimate goal of GAAP fair value accounting.

B. Principle Two: Financial Statements and Business Use.

Principle Two of the Notice is that a taxpayer must have a strong incentive to report fair values accurately. The Notice contemplates that a taxpayer has such an incentive when the taxpayer makes significant use of its GAAP valuations in the conduct of its business. Potentially significant uses include pricing, risk management decisions and employee compensation.

Principle Two is the principle that we and other industry associations advocated in an *amicus* brief presented to the Tax Court in the *Bank One* case, and that we have advocated in this Submission, and we applaud the IRS's adoption of Principle Two in the Notice. For the reasons summarized in Section I.E, above, we believe that the IRS will be able to satisfy itself that the requirements of Principle Two are met in the case of the vast bulk of securities dealers and OTC derivatives dealers.

As a general matter, every securities dealer of which we are aware makes significant business use of GAAP fair values, for example in risk management, hedging and

employee compensation. It is actually more accurate to turn this thought around: GAAP valuations follow management's best practice in valuing a firm's positions for business purposes.

In informal conversations with IRS officials, some confusion has been expressed with respect to our assertion that employee compensation (*e.g.,* the compensation of traders) relies on the same valuations as are reflected in a dealer's GAAP mark-to-market income statements. We do not mean to suggest that every trader is compensated solely on the basis of a specified percentage of his or her desk's profitability: no major dealer firm routinely employs such a simplistic metric. Rather, our point is that almost every firm, in setting compensation, looks to the profitability of a trading desk as one of the important factors in setting the compensation of the personnel who work on that desk, and for this purpose, that profitability is measured by reference to the same valuations as are employed for GAAP purposes.

Mark-to-market valuation models are used to determine a firm's profitability, but it is important to remember that they do not directly determine the prices charged to a customer. Other factors will enter into the pricing decision, including, for example, one party's eagerness to do business with the other. If a trader believes that a counterparty is highly motivated to enter into a transaction for whatever reason, the trader may be able to get an advantageous price for a trade. Conversely, if a dealer firm wishes to expand its business relationship with a customer, the dealer may offer particularly competitive terms.

Question 5: "Comments are requested on the extent to which each of [certain listed] classes of financial statements is appropriate for the safe harbor and whether other classes of financial statements may be as well."

Response 5: We note that most of our members are SEC reporting companies employing U.S. GAAP accounting, and believe that for public companies with U.S. GAAP financial statements it would be preferable to look to SEC filings (at least in the first instance) when verifying book-tax conformity. However, all reports supplied by our members to federal government agencies, as well as to public investors, are prepared in accordance with GAAP and therefore all employ the same mark-to-market valuation process. In the interest of

administrability, it may be useful for the IRS to provide a hierarchy of different types of reports that are considered acceptable for purposes of the safe harbor, so that dealers will have a clear understanding of what documentation will be required of them in an audit process. In this regard, Treasury regulation section 1.56-1, issued under prior law, might serve as a useful point of reference. The regulation sets forth detailed procedures for reconciling financial statement income with taxable income for purposes of a later-repealed provision of the alternative minimum tax regime. Treasury regulation section 1.56-1(c) sets forth requirements that must be met by a financial statement for purposes of the reconciliation rules and establishes a hierarchy among different types of statements.

Question 6: "Special considerations might arise in respect of securities (or commodities) issued by, and derivatives transactions with, related parties. For example, financial consolidation might cause such securities or derivatives to be eliminated on a financial statement, or related party transactions might not receive the same level of regulatory scrutiny as transactions with unrelated parties. It thus is unclear whether the safe harbor would be appropriate for securities issued by a related party or derivatives transactions with related parties."

Response 6: Insofar as Question 6 relates to the elimination of transactions between related parties and a concern that values for eliminated transactions may not be available for tax purposes, we refer to Response 8, below.

Insofar as Question 6 relates to potential abuses between related parties who deal with each other on a non-arm's-length basis, we believe that it would be advisable to adopt rules addressing situations where a taxpayer's methodology for valuing transactions with related parties is different from that used for transactions with unrelated parties. Such transactions are the proper concern of section 482.

Similarly, valuation methods will not change merely because the transaction valued is eliminated under GAAP consolidation rules, even if the eliminated values could lead to less scrutiny by accounting auditors and non-tax regulators. In this regard, we believe that a rule

requiring consistent valuation methodologies for eliminated and non-eliminated positions would be appropriate and completely consistent with current practice. We note, however, that often transactions that are eliminated under consolidation rules for U.S. purposes are nonetheless used for various reporting purposes by one or both parties to the eliminated transaction — for example, for foreign or state reporting purposes, or for employee compensation purposes. Again, we believe the advisability of a rule requiring arm's-length valuations in all situations is clear, and the primary issue, which we hope will be addressed through the AIR program, is one of developing effective audit procedures.

C. Principle Three: Recordkeeping and Record Production.

Principle Three is that a taxpayer must be able to provide the IRS in a timely manner with the information and documents necessary to verify the relationship between the values reported on the relevant financial statement and the values used for section 475 purposes. Specifically, the Notice states that "the taxpayer's records would have to show clearly that (i) the same value used on the financial statement was used on the tax return; (ii) no security subject to section 475 and reported under the required methodology on the relevant financial statement was excluded from the safe harbor; and (iii) only securities or commodities subject to section 475 have been carried over to the tax return under the safe harbor."

We agree that the IRS's ability to verify the three points enumerated above are essential to the basic functioning of the safe-harbor by the Notice, and we have no doubt that it will be possible to implement reconciliation procedures sufficient to meet this goal. In this regard, we expect that the AIR Program will be of considerable use in developing appropriate procedures and identifying potential sources of difficulty.

Question 7: "Comments are requested on how securities and commodities are pooled for purposes of financial reporting, how they are pooled for tax reporting, and how the Commissioner can verify the basis determination of a single position contained in the pool if that position is sold or settled in the year following the mark and other positions in that pool are not sold."

Response 7: The unadjusted mid-market value generally is calculated first for each individual security and derivatives position. These values are typically posted directly to a security sub-ledger and are verifiable. If an individual derivatives position is disposed of in the following year, it would no longer appear in the sub-ledger, and again, this disposition would be verifiable. The adjustments to the initial mid-market values for credit, liquidity, *etc.* (*see* Part III, above and Appendix A to this Submission, for a more detailed discussion of these adjustments) typically are performed on a portfolio basis, although some adjustments may relate to a specific transaction (*e.g.*, a specific liquidity adjustment). These adjustments are typically posted in the securities sub-ledger in the aggregate — either by type of adjustment or as an overall adjustment — and are supported by detailed calculations and workpapers. The securities sub-ledger will then calculate the adjusted profit and loss and trial balances for all derivatives positions, which will be posted to the firm's general ledger. These numbers are then used for all purposes including financial reporting, risk management and compensation, as well as tax reporting.

The IRS should be able to verify that the procedures and processes used to calculate both the unadjusted profit and loss (as well as the adjustments to mid-market values used to arrive at fair market value) take into account positions that are disposed of during the year. The IRS should also be able to verify that the adjustments are posted to the general ledger and that no Schedule M-1 adjustments are made to these values in arriving at taxable income. Because each taxpayer's operations and accounting systems are unique, we suggest that the IRS seek an agreement with each dealer regarding the relevant records that need to be maintained and the scope of the verification process. Again, we believe that the AIR program will be useful in providing both the IRS and the industry with insights as to how records may best be maintained and audited.

Question 8: "Comments are requested on the impact of the consolidation and de-consolidation [of businesses] on determining whether the same securities and commodities will be reflected on both the financial statement and the tax return."

Response 8: We understand the concern expressed in Question 8 to be whether the elimination of mark-to-market transactions between consolidated businesses for accounting purposes could result in transactions that are effectively ignored (and thus not valued) under GAAP and yet still must be valued for purposes of section 475. However, the fact that a transaction between consolidated businesses is eliminated for GAAP purposes does not mean that there is no fair value determined for the transaction. Specifically, under FAS 133, fair value is determined for each mark-to-market position held by a dealer and entered into a sub-ledger regardless of whether one or more of those positions will later be eliminated under the consolidation rules. The fair values of eliminated transactions are subsequently entered into a special elimination account. Therefore, it will be possible through inspection of the relevant sub-ledgers to determine a GAAP fair value that may then serve as "fair market value" for tax purposes.

Question 9: "The IRS is considering rules that would require electing taxpayers to maintain and, if requested, provide to the IRS in a timely manner the following records: (i) books and records clearly establishing that the values used in determining gain or loss under section 475 for eligible securities or commodities were the values used in the financial statement; (ii) for taxpayers filing a Form 1120, a reconciliation of the amount of net income reported on the financial statement to the amount reported on line 1 of the Schedule M-1 on the Form 1120; and (iii) for other taxpayers, a similar reconciliation schedule. The documents for reconciliation purposes would include supporting schedules, exhibits, computer programs used in producing the values and schedules, and documentation of rules and procedures governing determination of the values. Books and records would include all those that are required to be maintained for financial or regulatory reporting purposes, even if those books and records are not specifically covered by section 6001. Comments are requested on whether less burdensome recordkeeping requirements could be developed that would still allow for effective verification of conformity."

Response 9: Each taxpayer has developed its own internal systems to facilitate its particular operations and business model, and we strongly recommend the IRS to enter into

separate specific information retention agreements with individual dealers that will take account of differences among the operational and accounting systems of different dealers. Again, we expect that the AIR program will be useful in this regard.

D. Other Comments Requested.

Question 10: "Comments are requested on what securities should be included in the safe harbor."

Response 10: We believe that the safe harbor should be available for all securities that are subject to the section 475 mark-to-market regime. Although we recognize that derivatives and complex notional principal contracts certainly raise a different set of valuation issues than are raised by, for example, a position in Treasury bonds, we do not see the value in adopting a book-tax conformity standard for one group of securities and a different standard for another.

In this context, we believe that, in cases where the valuation of a position involves a non-trivial level of complexity or judgment, the discipline of book-tax conformity serves both the IRS and taxpayers well in ensuring that the valuations are accurate. Alternatively, in cases where the value of a position is clear, we can see no justification for using one valuation for tax purposes and another for book purposes.

Finally, the adoption of a single book-tax conformity rule for all positions subject to the section 475 mark-to-market regime would be consistent with Congress' expectation, expressed in the legislative history to section 475, that Treasury would allow valuation methods that "will alleviate unnecessary compliance burdens for taxpayers and clearly reflect income for tax purposes."[87]

To the extent Question 10 reflects concern over situations where a position is required to be marked to market for tax purposes, but not for GAAP purposes, we believe that

[87] H.R. Rep. No. 103-213, 103rd Cong., 1st Sess., 616 (August 4, 1993).

such situations are rare.[88] One simple approach for addressing such situations would be to require such positions to be valued under the same methods that are used for GAAP valuations.

Question 11: "Comments are requested addressing application of a safe harbor for commodities."

Response 11: For purposes of implementing the mark-to-market taxation regime, we see no difference between the issues regarding the valuation of securities (and securities derivatives) and the valuation of commodities (and commodities derivatives). As with securities derivatives, commodities derivatives are valued in accordance with GAAP for financial accounting purposes, and those valuations are used similarly used for multiple crucial non-tax business purposes. Therefore, we do not see why the same principles set out in the Notice regarding the valuation of securities could not be implemented equally well in the case of commodities.[89]

Question 12. "Comments are requested on whether there are other methodologies for determining fair market values under section 475. Comments are also requested on whether other safe harbors could act as proxies for fair market value under section 475."

Response 12: We believe that there is no practical or comparable alternative to the valuations of securities and OTC derivatives currently employed by dealers for their financial reporting and other non-tax business purposes. Because the vast majority of dealers use their own, proprietary, systems for valuing derivatives, which may vary from one another in non-trivial respects, the book-tax conformity standard does not sanction one specific methodology, but rather recognizes the importance of using values that are incorporated into a dealer's business.

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88 Other than in the case of certain commodities derivatives (*see* note 89, below), we have not identified any such differences.

89 There is a difference between the GAAP and tax definition of commodities derivatives that applies in certain very limited circumstances, and generally may prevent certain forward-settled positions in energy derivatives from being marked to market for GAAP purposes.

If dealers are not permitted to value their derivatives positions in a consistent manner for tax and non-tax purposes, we believe that confusion and disputes over valuation for tax purposes will continue. A rule requiring different tax and non-tax methodologies would create a significant record-keeping burden and consume considerable resources. The synergies of using a single valuation method for tax and non-tax purposes are substantial and inure to everyone's benefit.

Appendix A:

Overview of Commonly Accepted Adjustments to Mid-Market Values

The following discussion of the various adjustments that are made to mid-market valuations by industry participants is taken largely from a letter sent to Treasury on May 9, 2000 by the International Swaps and Derivatives Association, Inc. Although we believe that the discussion below provides an accurate description of industry-wide practice in the implementation of the adjusted mid-market method, it is important to keep in mind that the "state of art" for specific implementation of the adjusted mid-market method is in a continual state of refinement and evolution. In addition, although the principles behind mid-market adjustments are shared by all OTC derivatives dealers of which we are aware, there is variation among dealers as to the specific manner in which adjustments are calculated, and among the terminologies used by different dealers to describe adjustments. Therefore, although we believe the following list gives an accurate overview as to the types of adjustments that are considered market standard, it will not describe perfectly the valuation methodology of any specific given dealer.

(a) Model Adjustments**.** Before making the specific portfolio adjustments described below, a dealer makes adjustments to ensure that the values produced by the model are as accurate as possible. These adjustments may be positive or negative. They may be necessary until a dealer's model can be revised to take into account a particular factor or economic condition. These adjustments may be based on internal research, on comparison of results produced by two different models or on observed prices of trades in the market. Where the estimate produced by one model is adjusted because a comparison to another model yields a different valuation, the adjustment may be referred to as a "model adjustment" or a "model fair value adjustment."

A particular dealer may use a variety of model adjustments to account for a variety of different imperfections in its model. For example, a dealer may make an adjustment called a "quanto adjustment" for certain commodity derivatives in which the two legs are

payable in different currencies. The value of such a transaction depends in part on the correlation between the floating index and the relevant exchange rate. There are at least two schools of thought as to the most accurate way to reflect this correlation. A dealer using a standard model that takes the correlation into account in one way may believe that an alternate approach is more accurate and thus make a quanto adjustment to reflect the difference. Another dealer starting with the same standard model may make the same adjustment, but use a different name for it.

(b) Portfolio Adjustments. Adjustments grouped together as "portfolio adjustments" fall into three general categories. The first includes adjustments for the effects of market factors; they are discussed below under "Market Risk Adjustments." The second includes adjustments for potential losses from counterparty default; they are discussed below under "Credit Adjustments." The remaining category includes adjustments for the effect on value of expected costs of maintaining a position in derivatives, including but not limited to servicing.

(c) Market Risk Adjustments. Market risk adjustments are often broken down by dealers into subcategories based on the kind of market risk that each adjustment reflects. Market risks include both risks that are potentially hedgeable (bid-offer adjustments), risks that may be hedgeable only with difficulty because the dealer has a particularly large position in the risk (concentration adjustments) and risks for which no direct hedge exists (unhedgeable risk adjustments).

(i) Bid/Offer Adjustments. Bid/offer adjustments reflect a portion of the bid/ask spread for positions creating risks that are potentially hedgeable, but that have not yet been hedged.[90] Thus, some dealers describe these adjustments as "hedging fair value adjustments." These adjustment reflect uncertainty that the dealer will be able to

[90] For purposes of this discussion, the term "hedge" is used colloquially to refer to an offsetting position, but is not intended to suggest that GAAP "hedge accounting" principles are relevant to mid-market adjustments.

close out an unhedged position at the mid-market price, and instead would have to accept another dealer's offer price.

Bid/offer adjustments effectively adjust value by some or all of the difference between the mid-market value and the bid or offer price, and effectively reduce the reported value by up to one half the bid/ask spread, but only to the extent that the position has not been hedged. Once a position — or a particular risk created by a position — has been neutralized by an offsetting position, this adjustment is reversed and the value of the position is increased accordingly. Thus, as soon as the hedge is in place, a portion of the bid/ask spread is brought into income.

Bid/offer adjustments are sometimes broken out into a number of different components, each reflecting a different kind of risk that might be hedged separately. It is very important to note that these components never, in the aggregate, exceed the bid/ask spread, because a dealer could always enter into an offsetting position, rather than hedging separately each individual kind of risk.

(ii) Liquidity Adjustments. Adjustments for liquidity reflect the costs that would be incurred in closing out a particular contract because there is no direct hedge against the risk that the contract creates, leaving the dealer at least partly exposed. These adjustments are particularly likely to be necessary for "exotic" contracts that entail unusual risks. Accordingly, these adjustments are particularly important for larger dealers with a wide range of sophisticated products. Unhedgeable risk adjustments are quite distinct from, and do not duplicate, the bid/offer adjustments referred to above.

Some institutions refer to liquidity adjustments as "unhedgable risk adjustments" or "liquidity fair value adjustments." Others use those terms more broadly to refer to all market risk adjustments.

(iii) Concentration Adjustments. Concentration adjustments reflect additional costs that would be incurred in closing out a particular contract because the

dealer holds an especially large position in the risk or risks it creates. Conceptually, concentration adjustments can be viewed as similar to, but distinguishable from, both bid/offer adjustments and liquidity adjustments. Like bid/offer adjustments, concentration adjustments relate to a risk that is hedgeable, but only with difficulty because of the size of the dealer's position in the risk.

We recognize that legislative history indicates that blockage discounts are not to be considered in applying section 475.[91] Concentration adjustments are, however, different from blockage discounts. Blockage discounts reflect the depressing effect on price of simultaneous availability of a large number of similar items. Concentration adjustments relate to the total amount of a particular kind of risk a dealer is subject to, without regard to the number of different items it holds that create that risk.

(d) Credit Adjustments. Adjustments for default risk generally take into account two potential types of losses: *anticipated* and *unanticipated* credit losses. Although below we describe a separate adjustment made in respect of each type of potential loss, the increasing ability of OTC derivatives dealers in recent years to evaluate credit risk by reference to the credit default market (*see* discussion in Section IV.A, Response 2 of this Submission) has caused many of our members to make a single adjustment that takes both of these types of losses into account. Credit adjustments are made "dynamically" — that is, they are regularly revised to reflect the evolving creditworthiness of a dealer's counterparties.

(i) Adjustments for Anticipated Defaults. These adjustments (sometimes called "unearned credit spread adjustments") are made to reflect the risk that the dealer will not receive payments because of anticipated defaults by the counterparty and are generally computed by considering the credit quality of the counterparty. These adjustments generally take into account netting arrangements and collateral. Thus, adjustments that dealers actually make for credit risk tend to be lower than adjustments

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91 H.R. Rep. No. 213, 103rd Cong. 1st Sess. 613 (1993).

that would be made if netting arrangements and collateral were ignored (again, reflecting the fact that the unit of measure is the entire portfolio of derivatives).

(ii) Capital Charge for Unanticipated Credit Losses**.** In addition to the cost of anticipated credit losses, some dealers may make adjustments for a capital charge for bearing the risk of unanticipated losses. Such a charge would be reflected in the prices at which market participants are willing to enter into derivatives transactions. These adjustments reflect the cost of the return that must be paid to capital held to absorb the risk that credit losses will exceed the highest anticipated level. Adjustments for the cost of unanticipated losses are appropriate since the risk of such losses is inherent in a portfolio as of any valuation date.

As noted, the future cash flows of an OTC derivatives contract may be discounted to a present value using a rate such as LIBOR; however, this rate will not necessarily correspond to the credit quality of all counterparties. In such cases, a counterparty-specific adjustment may be required to adjust appropriately for the specific credit quality of the counterparty. As discussed below in Section IV.A, Response 2, the determination of a counterparty's credit quality is more detailed than a simple inquiry into how the counterparty has been rated by major credit rating agencies. If the LIBOR rate were in fact to correspond to the credit quality of the counterparty, however, no additional credit adjustment would be made (and under GAAP would not be permitted).

(e) Administrative and Other Portfolio Adjustments. Other portfolio adjustments include, but are not limited to, the following.[92]

(i) Servicing Adjustments. These adjustments are also known as "maintenance adjustments" or "administration adjustments" or "administrative fair value adjustments" or "future operational costs adjustments." They reflect the anticipated costs of servicing (*e.g.*, monitoring compliance and processing payments) particular contracts,

[92] We note that the permitted adjustments are based on a dealer's own marginal cost at the portfolio level, and in this regard the current standards under GAAP are consistent with the holding of the Tax Court in *Bank One*. *See Bank One Corporation*, 120 T.C. No. 11, slip opinion at 237-239 (May 2, 2003).

and include systems costs and operational costs. They also may include documentation costs (*i.e.*, legal and other costs of preparing and revising documentation for particular contracts).

It is important to note that a different — and more expensive — kind of servicing is required for derivatives than for debt and equity securities. Derivatives generally are bilateral executory contracts in which potential two-way payment flows must be administered and monitored over the life of the contracts.

(ii) Investing and Funding Cost Adjustments. Another cost of maintaining a position in a derivative is the cost of borrowing funds (net of cash generated by the position) required because of cash flow mismatches over its life. Adjustments for these costs are sometimes called "cash management" adjustments. Dealers do not estimate expected funding costs on a position-by-position basis to compute these adjustments. Instead, they net expected cash flows to compute borrowing or investment needs, resulting in smaller adjustments. It might be argued that each position should be valued based only on expected funding costs for that position, but we believe that such an approach would understate value by failing to capture the synergies that are created through holding a diversified portfolio of positions. In this case, as in the case of expected credit losses, a portfolio approach produces lower adjustments, and thus *higher* taxable income, assuming book methods are used for tax purposes.