



Securities Industry Association

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Internal Revenue Service
CC:ITA:RU (OGI-130836-01)
Room 5226
POB 7604
Ben Franklin Station
Washington, DC 20044

Dear Sir or Madam:

The Securities Industry Association ("SIA")¹ is writing in response to Notice 2001-59, which requests comments on whether the interest expense allocation and apportionment rules of sections 1.861-9T, 1.861-10T and 1.882-5 of the Income Tax Regulations should be modified to provide integrated treatment of certain financial transactions. We understand that you are considering whether such treatment might be appropriate in situations in which a taxpayer holds financial instruments that, although formally separate, are economically related, such as in the case of "matched books" of securities repo and reverse repo transactions or similar "matched books" of notional principal contracts.

As you point out in Notice 2001-59, the basic approach of the interest allocation rules is that because money is fungible, most borrowing is effectively deemed to contribute to the financing of all of an affiliated group's activities and properties. Current regulations under Treas. Reg. Sec. 1.861-10T(c) do provide for the direct allocation of interest expense to associated financial income in certain cases. These integration rules do not apply, however, to ordinary course income and expense of a "financial services entity". Moreover, they are available for only a limited range of perfectly

¹ The Securities Industry Association brings together the shared interests of nearly 700 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. The U.S. securities industry manages the accounts of nearly 80 million investors directly and indirectly through corporate, thrift, and pension plans, and generates \$358 billion of revenue. Securities firms employ approximately 760,000 individuals in the United States. (More information about SIA is available on its home page:<http://www.sia.com>.)

matched transactions. You have requested comments on (1) whether this limited integration rule should be made applicable to financial services entities, (2) whether its limited definition of an integrated financial transaction should be expanded, (3) if so, what criteria should apply in determining whether financial transactions are sufficiently related to make integrated treatment appropriate, and (4) what administrative and record keeping requirements might be appropriate.

As you know, various members of the securities industry have discussed the feasibility of integrated treatment of so-called “matched books” of financial transactions with members of the staffs of the IRS and Treasury at various times over the past 15 years. Despite considerable effort, these discussions have not borne fruit, primarily on account of the difficulties associated with the issues that you have outlined above. Broadly speaking, after several such discussions, both the relevant staffs and the members of the industry concluded that it would be very difficult to devise a workable substitute for the current formal approach, under which each transaction stands on its own for purposes of interest allocation. Set out below are two of the issues that we recall having been of concern to staff members in the course of previous discussions. We would of course be glad to revisit these issues and work with relevant staff members to develop a more satisfactory approach.

The first difficulty we encountered was how to define, clearly and objectively, the circumstances in which integrated treatment would apply. The relevant staff members were concerned that without a clear and objective definition, taxpayers might seek to integrate positions in circumstances that did not reflect the underlying policy of Section 864(e) of the Code and the associated “fungibility” of interest expense. The relevant members of the securities industry were likewise concerned that without a clear and objective definition, integrated treatment might be denied to some taxpayers but granted to others in substantially equivalent circumstances, or that integration might be required of taxpayers in unanticipated cases. Any effort to generate rules providing for integrated treatment would therefore need to focus on defining the circumstances in which integrated treatment applies.

One fact that must be considered, in this regard, is that risk managers do not perfectly match the risks within *any* books of financial positions - - even those that are commonly described as “matched books”. Neither is there a class of books that are intended to be matched and a class of books that are not. Rather, all books have some amount of net “directional risk” - - *i.e.*, the relevant firm will make or lose some amount of money if interest rates, or currency values, or yield curves, etc., move in a particular direction. Books move along a continuum from relatively matched to relatively unmatched, although even the most “naked” investment positions are normally hedged to a significant extent. Moreover, the limit of acceptable net directional risk for a given book may change over time, or even on a daily basis, depending on the views and needs of relevant managers.

The second difficulty we encountered concerned the rules for determining what happens when integration does occur. The general rule for integrated financial

transactions is that (a) the relevant interest expense is allocated and apportioned directly against the relevant interest or other income, and (b) the value of the relevant assets is reduced, for purposes of allocating and apportioning other interest expense, by the principal amount of the indebtedness to which the directly allocated interest expense relates. Where integration occurs in connection with a book of financial transactions that is primarily hedged but partly directional, it will be necessary to determine which interest expense is directly apportioned to which income, and which assets are correspondingly reduced. The drafters should bear in mind, however, that it would be difficult, if not impossible, to “separate out” from most books a portion of the book that is perfectly matched and a portion that is nakedly directional. Books of financial positions generally consist of hundreds, or thousands, of transactions, and no one transaction is matched to any other particular transaction. Rather, complex computer programming and methodologies serve to ensure that the aggregate directional risk associated with the book as a whole does not exceed a specified amount over a specified range of acceptable market changes.

In any case, neither of these issues is currently addressed by the limited identification election for “integrated financial transactions” that is currently set out in Treas. Reg. Sec. 1.861-10T(c). That election is not currently available for books of financial transactions maintained by securities dealers, not merely because it is not available for ordinary course of business transactions, but also because it is only available for perfectly matched borrowings and investments that are incurred and mature at the same times. As noted above, most books of financial transactions maintained by securities dealers involve transactions entered into at different times where each transaction partially matches all of the other transactions, rather than any particular transaction. Thus, because of its limited availability, the identification election provided by Treas. Reg. Sec. 1.861-10T(c) does not deal with the issues set out above that are relevant to books of financial positions maintained by the securities industry.

Please do not hesitate to contact me or David P. Hariton (212-558-4248), SIA's outside counsel on this matter, if you would like to discuss these issues further.

Sincerely,

Saul M. Rosen
Chair, SIA Committee on Federal Taxation
of the Securities Industry
Securities Industry Association

cc: Mark Weinberger
Barbara Angus
Robert Hanson

