Securities Industry Association
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October 23, 2006

Courier's Desk
Room 105, First Floor
Internal Revenue Service
Attn: CC:PA:LPD:PR (REG-158080-04)
1901 S. Bell Street
Arlington, Virginia 22202-4511

Re: Comments to Proposed Regulations Issued Pursuant to Section 409A

Dear Sir or Madam,

The Securities Industry Association (SIA)[1] appreciates this opportunity to comment on certain discrete portions of the Proposed Regulations under Section 409A of the Internal Revenue Code ("Section 409A") as they relate to payments on account of conflicts of interest, application to participation in non-US deferred compensation plans, and settlement of compensatory stock options. More specifically, for the reasons indicated below, we recommend that Treasury:

- broaden permissible accelerations of deferred compensation due to a *conflict of interest* to include other positions besides Executive Branch positions,
- clarify the rules applicable to *non-US arrangements* such that Section 409A is sensitive to the legitimate public policy goals furthered by broad-based plans outside of the US, and
- permit employers to cancel *compensatory options* for payment at their fair value.

1. Conflict of Interest. While Section 1.409A-3(h)(2)(ii)[2] permits acceleration of payment if necessary to comply with a "certificate of divestiture" under Code

[1] The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (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, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2005, the industry generated an estimated $322.4 billion in domestic revenue and an estimated $474 billion in global revenues. (More information about SIA is available at: www.sia.com.)

[2] Unless otherwise indicated, references to "Section" are to sections of the Proposed Regulations issued on September 29, 2005.

Section 1043(b)(2), even after Notice 2006-64, the exception is limited solely to certain individuals who hold equity or other deferred compensation and leave their employment to work for the Executive Branch of the Federal government. We note that individuals who become employed by other branches, a state or local government or any other government office, including the judiciary, may have similar constraints in their ability to hold securities issued in connection with plans subject to Section 409A. Similarly, codes of ethics and other anti-conflict rules adopted by private employers (which in some cases may be mandated by federal or state regulatory agencies, as in the accounting profession) may impose similar limitations on continued participation in deferred compensation arrangements. *We recommend that this exception be expanded to include any circumstances where the organization imposing the restriction provides a certificate to the service provider and service recipient stating that continued participation in a specified deferred compensation arrangement represents an unwaiveable conflict of interest under its policies.*

2. Exceptions for certain foreign plans. We believe that the existing exceptions for foreign plans are limited in scope and expose US taxpayers who participate in such plans to significant penalties in circumstances beyond their control. Because the penalty structure of Section 409A has an impact far greater than simple income inclusion, and US taxpayers do not have control over the structure of plans customarily offered outside of the US (which may accomplish legitimate public policy goals but are nonetheless different from US qualified plans), we believe that broader relief in connection with such participation in non-US arrangements is warranted.

   Specifically:

   a. Plan or Provision Required by Foreign Law. A foreign plan that complies with local law may violate Section 409A. There are countries (*e.g.*, Korea and France) where a distribution from certain plans is mandated upon a transfer of employment between affiliated entities. This is not permitted under the Proposed Regulations, because such a transfer is not a separation from service. Similarly, some jurisdictions may not permit a delay of payment of six months as may be required under Section 409A for "specified employees." Lastly, some jurisdictions mandate that plans cover all employees and do not permit a waiver of coverage or benefits (see point b, below). *Accordingly, we recommend an exception for distributions under foreign plans or other plan provisions that are mandated by applicable non-US law*. The burden would be on the taxpayer to establish the mandate.

   b. Broad-Based Foreign Retirement Plan Exemptions. Sections 1.409A-1(a)(3)(ii) & (iii) provide exemptions related to participation in "a broad-based foreign retirement plan." It appears that the exemptions will not apply to many broad-based plans that satisfy foreign tax laws. For example, we believe a defined contribution plan in accordance with Article 83 of the French tax code will fail to meet the

requirements of the broad-based retirement plan exemption because it permits employee contributions. *We recommend that a foreign plan qualify for the broad-based retirement plan exemption provided the first two requirements of Section 1.409A-1(a)(3)(v) (that the plan be in writing and that it cover a wide range of employees substantially all of whom are nonresident aliens[3]) are satisfied and the plan also satisfies the applicable non-US law requirements for special tax treatment*.

i. The Proposed Regulation superimposes on foreign retirement plans additional US tax law concepts such as: (x) limiting a participant's access to plan benefits except due to hardship, (y) "discouraging" participants from using benefits for purposes other than retirement, and (z) mandating that a minimum amount of distributions commence at a certain time "to ensure that any death benefits provided to the participants' survivors are merely incidental. . . ."

ii. While the three concepts listed above may be worthwhile social goals in the US – and have been in part enforced by way of the US tax-qualification requirements imposed on broad-based retirement programs – many non-US jurisdictions do not impose similar rules and may have, in fact, contrary or different social policies or goals. In particular, we have found that many jurisdictions (*e.g.*, Hong Kong, France, Germany, Japan, Switzerland) are not as stringent in respect of pre-retirement access to funds, nor do they mandate a minimum level of distributions.

iii. Lastly, it may not be practical or legal to impose these US-type requirements while maintaining qualification under applicable non-US law, and, as in the US under ERISA, participants may not be permitted to waive application of required provisions.

c. Totalization Agreements and Similar Plans. Section 1.409A-1(a)(3)(iv) exempts plans covered by a totalization agreement and foreign social security systems. Because it is difficult to determine whether a foreign plan is part of a foreign social security system, we recommend that the IRS clearly identify the foreign social security systems that are eligible for this exclusion. The Social Security Administration currently publishes and posts on its website "Social Security Programs Throughout the World" and therefore, *we recommend that a safe harbor be provided for plans listed in this publication* (see http://www.ssa.gov/policy/docs/progdesc/ssptw/index.html).

[3] In analyzing the "substantially all of whom are nonresident aliens" test, we are assuming that the standard set forth in Section 4(b)(4) of ERISA applies. We recommend a clarification if this is not correct.

3. Foreign Earned Income Exclusion Under Code Section 911. Under Section 1.409A-1(b)(8)(ii)(B), the exemption for foreign earned income under Code Section 911 does not apply if an individual's income exceeds the maximum exclusion under Code Section 911. *We recommend that this exemption be expanded so that an individual could elect for the Code Section 911 exclusion to apply first to deferred compensation and then to other taxable income* so that, for example, if an individual has $82,400 (for 2006) of foreign earned income and $10,000 of deferred compensation, he or she could elect for the Code Section 911 exclusion to apply to $10,000 of deferred compensation and to $72,400 of other income.

4. Stock Option Issues. We recommend that the Proposed Regulations be clarified in two respects.

    a. Hedging/Derivative Transactions. Some have expressed concern that entering into a hedging/derivative transaction with respect to a stock option that satisfies all of the requirements for exemption from Section 409A may result in a "modification" of the option or otherwise undermine its exemption from Section 409A. Hedging/derivative transactions related to stock options include entering into a collar or purchasing a put on the underlying stock. The optionee may enter into these hedges with the employer that granted the option or an outside dealer in securities, and if entered into with an outside dealer the optionee may need the ability to pledge the option. We do not believe that such transactions entered into at arm's length should have any impact on the underlying option's status under Section 409A. These types of transactions are not post-grant modifications because they do not result in a "direct or indirect reduction in the exercise price of the stock right, or an additional deferral feature, or an extension or renewal of the stock right" and we interpret the Proposed Regulations as also permitting transfers of stock options (see Section 1.409A-1(b)(5)(v)(B)). *We request, for clarity, that the final regulation address this question, perhaps in an example.*

    b. Cancellation of Options at Black-Scholes or Other Fair Valuation Formula. Section 1.409A-1(b)(5)(i)(C) provides that an option may result in deferred compensation subject to Section 409A if the amount payable under the option exceeds the spread value. As noted above, however, the Proposed Regulation also permits the transfer of options (see Section 1.409A-1(b)(5)(v)(B)), and the regulations under Section 83 of the Code expressly provide for the taxation of options transferred in an arm's length transaction (see Reg. § 1.83-7(a)). *We recommend that the final regulations permit options to be cashed out at a value that recognizes the remaining option value.* That value could be established either by reference to the arm's length standard set forth in the regulation under Section 83 of the Code or, perhaps more readily, by reference to the Black-Scholes value (or other value used by the service recipient for financial reporting purposes). The Black-Scholes or other fair value used for audited financial statements (together,

referred to herein as "fair value") represents an objective and equitable basis on which to settle an option because:

- Options could be transferred at any time at an amount approximating that value and such a transfer is recognized under the Proposed Regulations,
- Black-Scholes value is recognized by the IRS as an appropriate valuation methodology, *e.g.,* under Code Section 280G,
- Fair value is used for financial reporting purposes and now mandated for purposes of compensation reporting under the proxy-statement rules, and
- As a compensation matter, many companies use an option valuation formula for determining the amount of options to grant to employees.

We believe that a cancellation of an option at the discretion of the employer and at fair value will not provide the optionee with greater value than what was intended at the time of grant and is consistent with the purpose of Section 409A. If the IRS and Treasury disagree or believe that there may still be potential for abuse that Section 409A was intended to eliminate, then we suggest considering limiting the circumstances under which such a cancellation and payment might be allowed to the permissible payment events listed in Section 1.409A-3.[4]

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We would welcome the opportunity to discuss these issues or other related issues with you or your staff at your convenience. Please do not hesitate to call me at (202) 216-2032 or contact me by email at evarley@sia.com if SIA can be of assistance in any way as you develop regulations on these provisions.

Sincerely,

Elizabeth Varley
Vice President and Director, Retirement Policy
Securities Industry Association

cc: Dan Hogans

[4] A further refinement of this standard (which we do not believe to be any more necessary than the limitation suggested above to fulfill the intent of Section 409A) would be to permit the payment in connection with those events that are beyond the control of the optionee, e.g., involuntary termination, conflict of interest, death, change of control, etc.