



Securities Industry Association

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Alex Shojay
Internal Revenue Service
Office of Pre-filing and Technical Services
Large and Mid-Size Business Division
LM:PFTG
Mint Building, 3rd Floor M-3-330
1111 Constitution Avenue N.W.
Washington, D.C. 20224

Re: Inclusion of Section 475 Mark-to-Market Project in Industry Issue
Resolution Program

Dear Mr. Shojay:

In News Release 2002-47, the Internal Revenue Service (the "IRS") announced the adoption of a permanent Industry Issue Resolution ("IIR") Program to develop procedures for addressing in a fair and productive manner important industrywide examination issues. In the absence of the IIR Program, these issues conceivably could (i) consume a disproportionate amount of IRS and taxpayer resources, (ii) lead to an unacceptable number of formal controversies between taxpayers and the IRS, and (iii) possibly result in materially different resolutions for similarly situated taxpayers, to the financial or commercial advantage of some at the expense of others.

The Securities Industry Association ("SIA")¹ applauds the IRS for its adoption of the permanent IIR Program. We believe that the IIR Program will prove to be an effective and creative mechanism for addressing many important tax examination issues, both in our industry and others.

We propose that an ideal candidate for inclusion in the IIR Program is the examination methodology to be applied in auditing the mark-to-market accounting systems of dealers in U.S. dollar interest rate swaps and other U.S. dollar over-the-

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 93 million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2001, the industry generated \$198 billion in U.S. revenue and \$358 billion in global revenues. Securities firms employ approximately 750,000 individuals in the United States.

counter derivative contracts (for convenience, “OTC Dollar Derivatives”).² We make this suggestion for four reasons: first, the issue affects hundreds of derivatives dealers in the United States, and involves very large sums of money; second, the issue is remarkably uniform across those hundreds of taxpayers; third, the issue poses enormous factual complexities if approached on a case-by-case basis, with all the attendant potential negative consequences outlined in the first paragraph of this letter; and fourth, the creative application of the principles underlying the IIR Program can lead to an alternative examination methodology that would be fair to both the fisc and to taxpayers, as well as consistent with the words and purposes of the statute. We take up each of these four propositions in the remainder of this letter.

As noted in Footnote 1, the SIA today has approximately 700 members. Almost all of these members that have trading desks trade in OTC Dollar Derivatives. Other financial institutions that are not members of the SIA (for example, many U.S. commercial banks and the U.S. branches of foreign banks) also deal in OTC Dollar Derivatives. We therefore believe that the number of affected taxpayers numbers in the hundreds.³

Similarly, the size of the OTC Dollar Derivative market is enormous. For example, by the end of June 2000 interest rate swaps outstanding (measured by notional principal amount) totaled approximately \$58.5 trillion, and OTC derivatives in general totaled \$103.9 trillion.⁴

All of these hundreds of dealers in OTC Dollar Derivatives apply the same accounting methodology to their OTC Dollar Derivative books. Section 475(a)⁵ requires a dealer in “securities,” including a dealer in OTC Dollar Derivatives, to “mark to market” its dealer positions in such securities at year-end; the resulting gain or loss is characterized in its entirety as ordinary income or loss. Moreover, under the special rule of section 475(b)(4) and Treasury regulation section 1.475(b)-1(c), a dealer in OTC Dollar Derivatives must apply the mark-to-market accounting method to any non-dealer positions in OTC Dollar Derivatives that it holds, except in extraordinary circumstances.

² We envision that a successful IIR Program for OTC Dollar Derivatives could readily be extended to over-the-counter swaps and other derivatives in any one non-functional currency, as well as to cross-currency derivatives. Similarly, if it is believed that the universe of OTC Dollar Derivatives products is too large a project to tackle all at once (a conclusion we would dispute, because U.S. securities dealers typically manage U.S. dollar interest rate risks and related credit risks in OTC Dollar Derivatives as part of a single “Dollar Book”), an IIR Program project that covered solely U.S. dollar fixed-for-floating interest rate swaps would nonetheless be an extremely productive exercise, which then readily could be extended to other OTC Dollar Derivatives.

³ By way of further illustration of this point, the International Swaps and Derivatives Association reports on its Web site that it has roughly 550 member institutions from 41 countries on six continents. <<http://www.isda.org>>.

⁴ Data on the Global OTC Derivatives Markets, Swaps Monitor (visited April 22, 2002) <<http://www.swapmonitor.com>>.

⁵ Citations to section number are to the Internal Revenue Code of 1986, as amended (the “Code”), and to the Treasury regulations promulgated thereunder.

Not only do these hundreds of securities dealers apply the same (mandatory) mark-to-market method of tax accounting for their OTC Dollar Derivatives books, but virtually all of these dealers implement that accounting method in a consistent manner, because they all face the same financial, commercial and regulatory constraints.⁶ In particular, there are no liquid secondary markets in which OTC Dollar Derivatives are traded. Accordingly, every dealer of which we are aware applies the mark-to-market method of accounting through the use of valuation models; these models take current interest rate and credit inputs and, using complex mathematical algorithms, calculate the values of the dealer's "books" of open OTC Dollar Derivatives.

While each major dealer's valuation model is proprietary to it, the OTC Dollar Derivatives market is enormously competitive (the bid-ask spread in "plain vanilla" fixed-for-floating interest rate swaps, for example, is in the range of only four basis points). As a result, those valuation models all produce closely commensurate results (because if they did not, a nonconforming dealer would consistently undervalue or overvalue certain derivatives, and therefore would do no business on one side of the market, and would do too much on the other).

Similarly, every dealer of which we are aware consistently applies the same valuation methodology for purposes of measuring the profitability of its OTC Dollar Derivatives desks (and indirectly the compensation of the executives working on that desk – themselves scarce and highly sought-after resources), for reporting its performance to the Securities Exchange Commission (or other regulators), for preparing its audited financial statements for shareholders, for its internal risk management protocols, and for calculating the size and nature of its hedging transactions. We return to this theme at the end of the letter.

In summary, while every dealer's proprietary OTC Dollar Derivatives valuation model has its own unique details and inputs, there is a remarkable consistency across the dealer community (i) in the use of such models and (ii) in the fundamental design and operation of those models. This consistency in model design and application means that the mark-to-market accounting methodologies of dealers in OTC Dollar Derivatives are ideally suited to a consistent industrywide IRS examination process.

Our third reason for proposing that an IIR project be opened in respect of the mark-to-market accounting methods of dealers in OTC Dollar Derivatives is that the current case-by-case approach to the factual issue of the valuation of such contracts is enormously wasteful of resources both at the IRS and among taxpayers, and inevitably will lead to differences of result that could give one firm a material advantage over another. The cost and complexity of case-by-case valuation exercises in this area are perfectly demonstrated by the size of the record (and the IRS legal team) in *Bank One*

⁶ This point is developed in more detail in Brief of Amici Curiae American Bankers Association et al., *Bank One Corporation v. Commissioner* (Docket Nos. 5759-95; 5956-97) (United States Tax Court) (hereinafter "*Bank One Brief*").

Corporation v. Commissioner,⁷ now *sub judice* before the Tax Court. In that case, the IRS and the taxpayer introduced the expert opinions of four sets of experts, and the Tax Court itself took the extraordinary step of directly retaining two more experts. The case, when decided, will be the first judicial opinion on how to value OTC Dollar Derivatives (in particular, fixed-for-floating interest rate swaps), but it will not be the last word on the subject, because in the end the case will address only one particular taxpayer's valuation methodologies, and then only in respect of taxable years that stood, if not at the infancy, then certainly in the adolescence of the industry. We frankly do not believe it in the interests of the IRS or the dealer community to contemplate dozens of future litigations on the scale of *Bank One*, each addressing the factual OTC Dollar Derivatives valuation methodologies of a different dealer.

The IIR Program offers the promise of developing an examination methodology that will enable the IRS to perform efficient, consistent and comprehensive examinations of the factual accuracy of the mark-to-market accounting methods of OTC Dollar Derivatives dealers. We recognize that the IRS has legitimate objectives in verifying dealers' mark-to-market accounting methods, and the resulting market valuations of OTC Dollar Derivatives. To accomplish these objectives, we suggest that the IIR mark-to-market project develop procedures to verify that a dealer is employing the *same* mark-to-market valuation methodology consistently for tax, accounting, management reporting (including compensation) and risk management purposes. As has been developed in other contexts,⁸ there are competing constituencies behind each of these uses, and the use of the same valuation methodology consistently for all of these purposes means, first, that the resulting methodology is free of any systemic bias, and second, that the resulting valuations of OTC Dollar Derivative contracts are trustworthy.

We recognize that the IRS may be skeptical that dealers use the same valuation methodologies for all the disparate purposes listed above, and that in fact there are constituencies with different agendas behind those disparate purposes, whose competing interests ensure that the resulting system is free of systemic bias. Our response to this skepticism is that testing the veracity of these assertions would be exactly the point of the IIR project. We are confident, of course, of the outcome of this analysis, but we fully accept that the IRS needs to be convinced. Assuming (as we expect) that the IRS does come to agree on these fundamental points, then the IIR project will need to develop criteria for vetting that a particular dealer in fact is consistently using the same mark-to-market valuation methodology for a variety of important tax and non-tax purposes. Valuations produced by a model that satisfies these criteria for being certified as bias-free would be viewed as satisfying the fair market value standard of section 475.

⁷ Docket Nos. 5759-95; 5956-97.

⁸ *Bank One Brief; A Short Course in Valuing Derivatives*, 94 Tax Notes 380 (January 21, 2002); *Some Thoughts on Market Valuation of Derivatives*, 91 Tax Notes 1173 (May 14, 2001).

If we can answer any questions that you might have concerning this proposal, or if we can provide any further assistance to your deliberations, please do not hesitate to contact me at 212-762-6800.

Sincerely,

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

Cc: Dave Robison
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