

July 13, 2000

Ms. Suzanne J. Boule
Internal Revenue Service
290 Broadway
12th Floor
New York, NY 10007

Dear Ms. Boule:

On behalf of the Securities Industry Association,* this letter responds to your list of questions regarding the valuation of securities by members of SIA. With the exception of questions 9 and 10, the questions you pose appear to be designed to aid the Internal Revenue Service (the "Service") in the development of an alternative methodology for pricing securities for which no ready market exists. For the reasons discussed below, we believe that it is both unnecessary and unproductive for the Service to attempt to develop a methodology capable of producing independent estimates of the fair market value of dealers' securities for purposes of Section 475. We would encourage the Service to focus instead on developing procedures for insuring that the valuations dealers report for Section 475 purposes conform to the valuations dealers use for significant nontax purposes.

It is unnecessary for the Service to develop its own methodology for valuing securities because a dealer's valuations of its securities for nontax purposes generally will provide the Service with accurate measures of the securities' fair market values. In fact, the legislative history of Section 475 of the Internal Revenue Code indicates that Congress expected that dealers' financial statement valuations would generally be used for purposes of Section 475. In describing the reasons for enacting Section

* The Securities Industry Association is the trade association of the securities industry, representing more than 740 securities firms.

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475, for example, the House Ways and Means Committee Report for the Revenue Reconciliation Act of 1993 contains the following language: "Inventories of securities generally are easily valued at year end, and, in fact, are currently valued at market by securities dealers in determining their income for financial statement purposes and in adjusting their inventory using the LCM [lower of cost or market] method for Federal income tax purposes."*

The accurate valuation of securities is essential to a securities dealer's business of trading securities. A dealer relies on its pricing model to determine whether and when to buy and sell particular securities. If securities are undervalued, dealers will be more likely to sell securities without realizing full value and to pass up profitable buying opportunities; overvaluing securities means that a dealer will be more likely to acquire securities that produce inferior returns and to forego profitable opportunities to sell the securities it holds. Errors in the valuation of securities also produce inaccurate hedging, exposing the dealer to excessive risk or causing the dealer to incur unnecessary hedging expense. Thus, failure to value securities accurately causes dealers to lose profits to competitors, and more accurate pricing of securities gives a dealer a significant competitive advantage. As a result, a dealer devotes substantial resources to valuing securities as accurately as possible. Dealers apply state-of-the-art modeling techniques based on the latest academic research adapted to practical application by highly-trained in-house specialists. In addition to trading, dealers also must value their securities for other significant nontax purposes, such as general risk management, reports to investors and to the Securities and Exchange Commission and in the calculation of employee compensation. Typically, a dealer values its securities consistently for all of these nontax purposes, and uses the same valuations in marking to market for Section 475 purposes. The valuations are free from the influence of tax planning.

An attempt by the government to develop a reliable, independent valuation methodology would be

* H. Rep. 103-11, at 223 (1993).

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unproductive because it would be extremely costly, yet highly unlikely to improve upon the accuracy of dealers' own valuations. The models used by dealers undergo constant refinement in response to evaluation of the models in operation, changing market conditions and advances in financial theory. Models used by dealers today are more sophisticated than those used a few years ago, and today's models in turn will rapidly become obsolete. As a result, even assuming that the Service could approach the sophistication of dealers' current models, during the time it would take the Service to survey and reconstruct the valuation methods in use by dealers today, those methods will be superseded by newer models. So even if the Service were able to reproduce one year's models in time to conduct an audit of tax returns for that year, it is unlikely that the Service's alternative model could be modified quickly enough to be useful in subsequent years. Furthermore, the expense to the government of attempting to continually match the pace of innovation in dealers' valuation methodologies would be staggering.

Since, for the reasons discussed above, dealers' nontax valuations will generally provide accurate measures of fair market value, we would suggest that it would be more beneficial for the Service to develop procedures for determining that the securities valuations reported by dealers for tax purposes represent the same valuations employed for significant nontax purposes. Questions 9 and 10 on your list are examples of the sorts of questions that would be useful in making such a determination.

For example, question 9 asks whether dealers' models are arbitrage free. By this, we assume you mean that all portfolios having the same risk and return characteristics are priced identically, so that opportunities to profit from pure arbitrage are eliminated. The answer to this question is yes: a securities dealer's models are designed to be arbitrage free. Arbitrage-free pricing enables dealers to identify profitable trading opportunities and hedge their portfolios appropriately. As discussed above, because the valuation of securities is the heart of a dealer's business, dealers devote great attention, focus and expense to such valuations, and they

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are as accurate as possible.* A dealer's use of a model that was not arbitrage free in valuing its securities for Section 475 purposes might therefore suggest that the valuations were tax motivated. On the other hand, the use of an arbitrage free model in valuing securities for Section 475 purposes is an important indication that the dealer's valuations are not influenced by tax planning.

Question 10 asks whether a dealer uses more than one model for trading and back office purposes. The answer to this question is no. Dealers' pricing models generally do not differ for trading and back office purposes, for important business and regulatory reasons. As we have indicated, dealers typically use the valuations they employ in trading for all purposes: in reports to investors and to regulators such as the Securities and Exchange Commission, for internal risk management and to determine employee compensation, because the fair market value of a security is the relevant valuation for each of these purposes. Since it is widely recognized that, as a matter of business necessity, a securities dealer must value its securities as accurately as possible, investors and regulators insist that these valuations be employed in financial reports. A dealer's key employees are compensated based on these same valuations because fair market values provides the most direct measure of an employees' contributions to the dealer's profits. A dealer's use of valuations not based on fair market values would impose significant costs on the dealer, not only the involvement in unprofitable transactions and inadequate hedging of portfolios noted above, but also general exposure to excessive risk, overpayment or underpayment of employees and loss of key employees, potential liability to investors and penalties for regulatory noncompliance. Therefore, a dealer's consistent use of valuations for nontax and tax purposes is

* More specifically, dealers generally follow the recommendations of the Group of Thirty and value their portfolios based on mid-market levels less specific adjustments, such as unearned credit spread, close out costs, investing and funding costs and administrative costs. Group of Thirty Global Derivative Study Group, Derivatives: Practice and Principles, Appendix I, at 6 (1993).

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an indication of the reliability of the tax valuations, and a lack of consistency a sign that the tax valuations may be tax driven.

We presume that you have concerns about the sources of the valuations a dealer reports for Section 475 purposes. If it is helpful, therefore, here are some questions the Service could ask to address those concerns, either through regulatory guidance or in the course of an audit, with an indication of the likely answers in the case of a typical dealer:

- ! Are the values of securities reported for Section 475 purposes the same as those reported on the dealer's financial statements?
- " Generally dealers consistently use the value of securities determined for financial accounting purposes for all other valuation purposes.
- ! For what other nontax purposes does the dealer use the values of its securities reported on its financial statement?
- " As noted above, dealers generally also use book values in reports to regulators, for internal risk management and in determining employee compensation.
- ! For what purposes, if any, does a dealer use an alternative model to value its securities?
- " In general, a dealer does not rely on more than one model to value securities at any one time.
- ! Are there any reasons why the book values of a dealer's securities should systematically differ from fair market values?
- " In general, a dealer's model should not systematically underestimate or overestimate fair market values.

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We would be happy to provide further assistance in this matter, including the determination of how dealers' valuations of securities for nontax purposes could be properly used for Section 475 purposes. In addition, we are attaching a copy of a letter that we recently sent to the Assistant Secretary and the Deputy Assistant Secretary for Tax Policy concerning this subject.

Very truly yours,

Saul Rosen
Chairman, Committee on
The Federal Taxation of
The Securities Industry