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Mr. Jeffrey Owens
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Organisation for Economic Co-operation and Development
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Dear Mr. Owens:

On behalf of the Securities Industry Association,[1] I am pleased to submit the following comments in regard to the Discussion Draft on the Attribution of Profits to a Permanent Establishment and, in particular, the revised versions of Parts I (General Considerations) and III (Global Trading) of that Discussion Draft as released in August 2004 (herein, the "Discussion Draft"). SIA members are active participants in the financial markets of most OECD countries and the issues addressed in Part III of the Discussion Draft are of particular significance to our operations.

Our comments first address several important points on which we believe greater focus is warranted than has been the case to date: (i) the determination of whether a local broker-dealer subsidiary constitutes an independent or dependent agent of an affiliated nonresident enterprise and the effect that the language of the Discussion Draft will have on that analysis, (ii) the factors examined in attributing profits to a dependent agent permanent establishment ("PE") in the relatively rare circumstances when such a PE will exist and (iii) the "hedge fund" model as a comparable for transfer pricing purposes and, more generally, the failure of the Discussion Draft to acknowledge and respect contractual arrangements that may exist among affiliated enterprises with regard

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1 The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. 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 2004, the industry generated an estimated $227.5 billion in domestic revenue and $305 billion in global revenues. (More information about SIA is available at: www.sia.com.)

to the allocation of risk. We then address more briefly certain additional comments made in more detail by other commentators and with which we agree.

A. Dependent Agent Permanent Establishment

Paragraph 269 of Part III of the Discussion Draft reiterates the statement made in Part I that the Report does not examine the issue of whether a PE exists under Article 5(5) of the Model Tax Convention. Instead, the Discussion Draft aims to address the manner in which profit should be attributed to a dependent agent PE in circumstances where such a PE has been determined to exist. Paragraph 269 further emphasizes that the discussion of this question is "not predicated on any lowering of the threshold of what constitutes a PE under Article 5".

These statements recognize that the existence of a dependent agent PE is more appropriately a topic to be addressed in connection with the ongoing review of the Commentary to Article 5. In fact, however, the subsequent discussion focuses on one highly unusual fact pattern and concludes that, because KERT functions are performed in a local broker-dealer subsidiary, the profits of the global trading book as a whole should be attributed to a dependent agent PE. Notwithstanding the statements in Paragraph 269, this discussion appears to collapse the necessary two-step analysis into a single step, and could be read to imply that it is the performance of KERT functions by the local broker-dealer that has created the PE. In fact, the application of OECD principles to factual situations in which significant KERT functions are performed by a local broker-dealer subsidiary in a host country will more often lead to the contrary conclusion – that the local broker-dealer subsidiary is an independent agent of other nonresident affiliates participating in a global trading operation and therefore does not constitute a PE of those nonresident enterprises under Article 5(5). Further, in the circumstances where a dependent agent PE may exist, we believe that the narrow focus on KERT functions ignores the value of capital raising and capital and risk management as well as other significant functions typically undertaken in the home office or another centralized location of a securities firm and thus results in an overallocation of profit (or loss) to the dependent agent PE. We have addressed these points below in more detail.[2]

[2] We understand that, at the October 2004 Paris Consultation, Working Party 6 acknowledged that drafting errors had been made in Section C (Associated Enterprises) of Part III – specifically, that the KERT analysis should not have been applied here – and that Part III would be revised to indicate that the KERT analysis applies only after a conclusion has been reached under Article 5 of the Model Tax Convention that a separate legal entity in a host country constitutes a dependent agent PE of a nonresident enterprise.

1. Effect of the Discussion Draft

The discussion beginning with Paragraph 272 of the Discussion Draft indicates that where a dependent agent PE is found to exist under Article 5, (i) the dependent agent enterprise should be rewarded for the services it provides to the nonresident enterprise, usually by means of a fee and (ii) the dependent agent PE should be attributed the assets and risks of the nonresident enterprise relating to the functions performed on its behalf by the dependent agent enterprise, together with sufficient free capital to support those assets and risks. This latter analysis is to focus on the nature of the functions carried out by the dependent agent on behalf of the nonresident enterprise and, in particular, whether the dependent agent undertakes "key entrepreneurial risk taking" ("KERT") functions. The Discussion Draft notes in particular that the skills and expertise of the employees of the dependent agent are likely to indicate whether trading, negotiating and risk management functions are being performed by the dependent agent on behalf of the nonresident enterprise.

The Discussion Draft concludes in Paragraph 273 that the foregoing analysis will generally show that the ability to assume the risks of a transaction is found in the nonresident (booking) enterprise and, therefore, that there are likely to be profits (or losses) over and above the arm's length service fee paid to the dependent agent enterprise. The Discussion Draft illustrates this conclusion by describing a "commonly occurring situation where the trades of a broker dealer in the host country are booked in the accounts of a nonresident enterprise".

The facts of the example in Paragraph 273 vary significantly from the most common organizational pattern for multinational securities firms in that the principal described in the example is a "special purpose enterprise" that has no employees and has a broker-dealer subsidiary. For the reasons discussed in Section A.2 below, it would be unusual in practice for a local broker-dealer subsidiary to be acting on behalf of a special purpose booking entity. Arguably, therefore, the example may be of little relevance to the most common circumstances. Nonetheless, the presence of the example is troubling, particularly in view of the absence of any additional examples that more accurately describe the facts of multinational securities firms. In particular, we are concerned with the conclusion of the example that, because KERT functions are performed in the broker-dealer subsidiary, the profits of the global trading book as a whole should be attributed to a dependent agent PE of the nonresident enterprise, minus an arm's length fee.

The Discussion Draft emphasizes in Paragraph 278 that the above analysis is only applicable if a dependent agent PE is found to exist under Article 5(5). The Discussion Draft fails to reflect, however, that the KERT functions themselves – which are cited in the Discussion Draft to justify the attribution of profit to a PE – in fact are more likely to support the conclusion that the broker-

dealer subsidiary is an independent agent and thus does not give rise to a dependent agent PE of the nonresident enterprise in the first place. In particular, as discussed below, the existence of a sophisticated group of traders with local market expertise, a broad customer base and relatively broad discretion will normally support a characterization of a local broker-dealer subsidiary as an independent agent.

We are concerned that the Discussion Draft's detailed focus on the unlikely circumstance described in Paragraph 273, and its focus on the KERT functions of a local broker-dealer subsidiary as the basis for attribution of profit to a dependent agent PE, obscures the independent vs. dependent agent analysis. Therefore, we recommend that the Discussion Draft be supplemented with further explanatory language illustrating the analysis of whether a local broker-dealer subsidiary is to be treated as a dependent or independent agent and demonstrating that in many common circumstances that analysis will lead to the conclusion that the subsidiary is an independent agent. Ideally, that discussion would be provided by Working Party 1 in its Commentary to Article 5, and the Discussion Draft and any resulting Commentary under Article 7 would refer explicitly to that discussion.

2. Independent vs. Dependent Agent Status

Many large financial service firms, and particularly securities dealers, operate globally through local broker-dealer subsidiaries. The primary reason for this is that the laws and regulations of many countries effectively require operation as a separate, locally organized entity in order to facilitate compliance with local rules and local regulatory supervision of front office activities, internal operations, capital adequacy and management. Each local broker-dealer or broker-dealer group will typically employ its own staff of traders and/or marketers, as well as middle and back-office personnel. Traders employed by a local broker-dealer may have a range of responsibilities, including the ability to enter into trades that "are booked in the accounts of a nonresident enterprise" as described in Paragraph 273 of the Discussion Draft.

Typically, only one locally-organized broker-dealer entity in a multinational firm will have the legal ability, operational infrastructure and trading expertise to engage in securities transactions in a particular host country. As a consequence, nonresident enterprises in the group will need to use that local broker-dealer as their agent in order to execute customer transactions in the host country. In this situation, the traders of the agent broker-dealer perform substantially all of the activities related to the transaction (including execution of contracts), but will do so on behalf of the nonresident principal entity.

The question then arises as to whether the actions of the agent broker-dealer should be treated as giving rise to a PE of the nonresident principal in the host country. Under Article 5 of the Model Tax Convention, an independent

agent acting in the normal course of its business generally does not give rise to a PE of another enterprise. On the other hand, a dependent agent that habitually exercises authority to conclude contracts in the name of the nonresident principal can constitute a PE of its principal.

In general, we believe that a local broker-dealer subsidiary functioning as the agent of nonresident affiliates in local securities markets will qualify as an independent agent of its nonresident principals, and thus should not be treated as a PE of its nonresident principals. The Commentary to the 2003 version of the Model Tax Convention (the "2003 Commentary") provides that an independent agent must be "independent of the enterprise both legally and economically".[3] The 2003 Commentary then lists a number of factors that should be considered in determining whether an agent is independent. The application of these factors will normally result in the conclusion that a local broker-dealer subsidiary of a multinational securities firm is independent. As discussed in more detail below, this is because local broker-dealers typically maintain independently adequate capital as required by local regulators, earn diversified revenue streams from unrelated local customers and transactions, are independently managed and regulated, employ significant workforces, and possess locally specialized expertise.

a. "Comprehensive control". The 2003 Commentary states that "[w]here the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. … An independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. He will not be subject to detailed instructions from the principal as to the conduct of the work."[4] In this regard, the 2003 Commentary notes that parent company control as a shareholder is not relevant to this "control" test.[5]

As a factual matter, a local broker-dealer acting as agent normally will **not** be subject to the comprehensive control of the nonresident principal, because the local broker-dealer will have its own management for business, regulatory and operational reasons. That local management will direct how the broker-dealer operates in the local markets and complies with local regulatory rules. Although the nonresident principal may set "risk limits" for the agent, this type of limitation does not restrict the agent's operation within those limits. Moreover, the nonresident principal normally does not possess the required expertise on local

[3] Commentary to Article 5, Paragraph 37.

[4] Paragraph 38.

[5] Paragraph 38.1

markets that would be needed to exercise comprehensive control, even if one of the parties so desired. The principal will therefore leave the arrangement and execution of the transaction to the agent. Finally, the agent broker-dealer will normally have its own extensive business with other unrelated customers and will operate that business with complete independence.

b. "Special skill and knowledge". The 2003 Commentary also states that "[t]he fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence".[6] In general, the nonresident principal will be relying on the skill and knowledge of the agent broker-dealer, and in particular its workforce of experienced local traders.

c. "Number of principals". The 2003 Commentary lists as an additional factor the number of principals represented by the agent, noting that "[i]ndependent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time."[7] Typically, a local broker-dealer acting as agent for a nonresident affiliate will also act in an agency capacity for hundreds or thousands of unrelated customers over the course of a year. Broker-dealers routinely purchase and sell physical securities as agents for customers, particularly when they are not themselves "market makers" in the security. Broker-dealers typically also exercise discretionary authority as agent for many different unrelated customers, whether to execute transactions for those with "discretionary accounts" or to facilitate securities lending by a customer. In particular, most multinational securities firms provide agency services for institutional customers, including pension funds, private equity funds, hedge funds and other sophisticated investors who purchase derivatives and other complex financial instruments that are the same or similar to the types of products involved in global dealing operations. Although it is unlikely that a local broker-dealer will act as agent for an unaffiliated nonresident broker-dealer, we believe that the services performed for other unrelated customers are sufficiently analogous to the agency services provided on behalf of nonresident principals to support a conclusion that the local-broker dealer is acting as an independent agent and in the ordinary course of its business as such

d. "Entrepreneurial risk". The 2003 Commentary states that "[a]nother important criterion will be whether the entrepreneurial risk has to be borne by the person or by the person the enterprise represents."[8] The entrepreneurial risk of operating a broker-dealer is – like that of any other business -- the risk that

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[6] Paragraph 38.3

[7] Paragraph 38.6

[8] Paragraph 38.

revenues will not cover expenses. This risk is necessarily borne by the local broker-dealer itself. We are aware of no jurisdiction in which regulators would permit an enterprise organized in that jurisdiction to assume the entrepreneurial risk associated with an affiliated broker-dealer located in another jurisdiction.

e. Economic independence. In addition to the above, we note that regulated broker-dealers will normally have their own substantial capital/equity bases in order to comply with local regulations. These regulatory requirements therefore result in a degree of economic independence that may not be present in other types of unregulated agency arrangements.

Each of the above factors serves as an indicator of independent status. Obviously, the facts and circumstances of each particular situation must be examined, and we acknowledge that there may be circumstances in which a local broker-dealer agent cannot be characterized as independent of its principal. However, we believe that it is important for the OECD to recognize, and for the Discussion Draft and Commentary to reflect, that the manner in which multinational securities firms conduct global operations will more likely result in the conclusion that local broker-dealers serve as independent agents of their nonresident affiliates acting in the ordinary course of an agency business. As discussed above in Section A.1, the language of the Discussion Draft seems to assume the opposite conclusion.

3. KERT Approach to Attribution of Profit

Finally, even where a local broker-dealer subsidiary is determined to be a dependent agent of a nonresident enterprise, the focus of the profit attribution analysis on KERT functions – as defined in the Discussion Draft – ignores the existence of important capital and risk management functions in the home location of the nonresident enterprise. More specifically, the Discussion Draft generally defines KERT functions with reference to “front-line” activities undertaken by traders, and then concludes that capital must follow those functions. This conclusion ignores the fact that risk management and capital raising functions will more commonly be undertaken in the home office of the nonresident enterprise, and that these functions – and the people who perform them – are equally important to the success of the global trading operation. Attribution of residual profit to a dependent agent PE will often be inappropriate where the traders in a local broker-dealer subsidiary have been adequately compensated with an arm’s length return, and significant capital-related functions are being performed by the nonresident enterprise itself. Related to the foregoing, we recommend that consideration be given to expanding the definition of a KERT function to include risk management and capital-related functions. As noted above, we believe that these functions are equally important to the success of a global trading operation as the trading function, and therefore deserve equal weight in the profit attribution analysis.

B. Alternative Transfer Pricing Models

Paragraphs 158 through 160 of the Discussion Draft reject the suggestion made by numerous commentators that a hedge fund might serve as a useful transfer pricing model – in particular, by providing an appropriate comparable for determining a reward to capital. Although Paragraph 159 indicates that the hedge fund model may be appropriate for proprietary trading, Paragraph 160 concludes that the hedge fund model is not useful for customer businesses which "tend to be driven primarily by commissions and spreads rather than trading gains".

This conclusion reflects an inappropriate generalization with respect to the manner in which global trading operations are conducted. As others have pointed out, global trading is an evolving business in which trading gains and principal transactions – in conjunction with customer transactions – are becoming increasingly significant. Moreover, this conclusion, together with the general emphasis of the Discussion Draft on profit split methods, fails to give weight to the contractual relationships that may actually exist between affiliated enterprises engaged in global trading.

The Discussion Draft should reflect instead that, where the facts support the treatment of a local broker-dealer subsidiary as an independent agent of a nonresident enterprise (as we believe they generally will), the transfer pricing analysis should begin by examining the contractual arrangements between the two enterprises in relation to the assumption of risk. The transfer pricing methodology and the appropriate comparable should then be chosen in light of those arrangements, and any other relevant facts and circumstances. The Discussion Draft should not summarily reject any existing business model as a potential comparable, including the hedge fund model. We understand that the March 2005 meeting of Working Party 6 discussed subsequent submissions on the hedge fund model, and that further consideration is being given to including the hedge fund model as a comparable method. We look forward to reviewing any revisions of the Discussion Draft that result from this reconsideration.

C. Additional Comments

We have noted below certain other significant points that have been addressed in more detail by other commentators, with whose comments we generally agree.

1. Deference to the Host Country

As an organization that includes many members with truly global operations, we are concerned about the general deference shown in the Discussion Draft to the ability of a host country to conduct its own transfer pricing analysis, without regard to the analyses being performed in the other jurisdictions

in which the taxpayer conducts its operations. While we recognize that each country will necessarily apply the principles of the Discussion Draft in the context of its own tax laws, we believe that it defeats the underlying objective of the Discussion Draft to sanction a regime in which a single financial institution may be subject to multiple transfer pricing methodologies in respect of the same business and the same income. In effect, the Discussion Draft will have served only to enhance the technical ability of each jurisdiction to perform its own analysis, without providing any assurance that the results of these analyses will be compatible and will not result in multiple taxation. We believe, therefore, that the Discussion Draft should provide a presumption in favor of the transfer pricing methodology chosen by the taxpayer, as long as that methodology is consistent with the approach of the Discussion Draft, appropriate for the facts and circumstances, and universally applied with respect to all business locations. The Discussion Draft should explicitly discourage individual taxing authorities from applying alternative methodologies, unless the method chosen by the taxpayer violates one of the foregoing criteria.

2. KERT Approach to Asset Attribution

We agree with other commentators that the Discussion Draft's reliance on an analysis of KERT functions to attribute assets among global trading locations will not be administrable, because it will result in fragmentation of asset ownership and/or frequent changes in asset location. The result will be to raise numerous issues regarding sourcing of income, withholding tax, foreign tax credits and other collateral issues that will overwhelm the competent authority process. Instead, assets should be attributed to a single location. In general, this single location should be the booking location, though anti-abuse rules could modify this general rule where necessary.

3. Credit Derivatives

We agree with prior commentators that internal transfers of credit risk, including between branches, should be respected. Specifically, credit derivative transactions, or payments of guarantee and similar fees, between related entities or between branches should be given effect when undertaken on an arm's length basis. Many financial institutions engaged in global trading prefer to centralize management of credit risk, usually in the home office. A failure to acknowledge the shifting of this risk from external locations to the home office will result in inappropriately high allocations of profit to trading locations – reflecting unrealistic assumptions about the degree of risk borne in those locations and insufficient compensation of the home office for the credit risk which it bears as a business matter. Credit derivatives are increasingly available in the financial markets and we do not believe that there will be significant obstacles to determining arm's length pricing for this.

4. Transition Period and Grandfather Rule

We agree with the recommendations made recently by Ernst & Young that the OECD approach outlined in the Discussion Draft should be applied prospectively only, i.e., no earlier than the beginning of the first taxable year commencing after the publication of the final Report and the adoption of any related changes to the Model Tax Convention and the Commentary. Tax authorities should be encouraged not to use the Report in examining taxable years prior to this effective date. In addition, to the extent that the OECD approach would attribute any existing asset to an entity or location that is different from the entity or location to which the asset is currently attributed, the asset should be treated as having been transferred on an arm's length basis to its current site prior to the effective date of the Report (subject to any adjustments that a taxing authority could make under existing principles). We believe that these effective date and grandfather rules are essential to a smooth transition to the OECD approach. Although we understand that Working Party 6 may view certain aspects of the Discussion Draft as mere clarifications of existing principles, there are a number of new concepts and guidelines to be applied (e.g., the concept of "key entrepreneurial risk taking functions"), and a number of the issues addressed in the Discussion Draft have been the subject of considerable debate over many years. Accordingly, we believe that the final Report should provide that the OECD views the new approach as a significant change and recommends that member countries implement the new approach with the same types of transitional measures that would accompany a change in law.

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Please do not hesitate to contact me (at 202.216.2031 or pmcclanahan@sia.com) if you would like any additional information regarding the foregoing.

Sincerely,

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