Securities Industry Association
1425 K Street, NW • Washington, DC 20005-3500 (202) 216-2000 • Fax (202) 216-2119 •
www.sia.com, info@sia.com

August 17, 2005

CC:PA:LPD:PR (REG-100420-03)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20044

SUBMISSION REGARDING PROPOSED REGULATIONS
ESTABLISHING BOOK/TAX CONFORMITY SAFE HARBOR UNDER SECTION 475

The Securities Industry Association's (the "SIA's")[1] Committee on the Federal Taxation of the Securities Industry appreciates the opportunity to comment on proposed Treasury regulation section 1.475(a)-4 (the "Proposed Regulations"), published in the Federal Register on May 24, 2005[2] under section 475 of the Internal Revenue Code of 1986, as amended (the "Code").[3] The Proposed Regulations, if

[1] The Securities Industry Association brings together the shared interests of approximately 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 2004, the industry generated $236.7 billion in domestic revenue and an estimated $340 billion in global revenues. (More information about SIA is available at: www.sia.com

[2] 70 Federal Register 29,663 (May 24, 2005).

[3] Unless indicated otherwise, all section references in this letter are to the Code, or to Treasury regulations promulgated thereunder

finalized, would provide a "book/tax conformity safe harbor" that would allow dealers in securities and over-the-counter ("OTC") derivatives to mark their open positions to market for tax purposes using the same values that they use for financial accounting, regulatory, and other core business purposes.[4] This submission supplements our submission to the Internal Revenue Service (the "IRS") dated July 13, 2005, in which we discussed certain administrative issues related to the Proposed Regulations' rules concerning record-keeping and document production, by addressing the substantive rules of the Proposed Regulations.

As discussed in previous SIA submissions,[5] we believe that a book/tax conformity safe harbor is necessary to provide an administrable and reliable process for auditing taxpayer compliance with section 475. We therefore strongly support the IRS's efforts to implement such a safe harbor, as reflected in the Proposed Regulations. We also believe, in general, that the Proposed Regulations do an admirable job of balancing the competing interests of affected taxpayers and the IRS. As discussed in more detail below, however, we believe that the Proposed Regulations contain some requirements that, if not modified in final Treasury regulations, would serve to limit the utility of the

---

[4] Specifically, proposed Treasury regulation section 1.475(a)-4(c) provides that "eligible taxpayers" (*i.e.,* taxpayers eligible to avail themselves of the safe harbor) include securities dealers, OTC derivatives dealers, commodities dealers, and traders electing mark-to-market treatment under section 475(f). The comments contained in this letter, however, relate primarily to the treatment of securities dealers and OTC derivatives dealers, which constitute the membership of the SIA.

In this connection, while not strictly necessary, we recommend that a parenthetical phrase be added to the definition of an "eligible taxpayer" to confirm that the election is available to controlled foreign corporations that are themselves dealers in securities.

[5] *See, e.g.,* "Submission in Response to Advance Notice Regarding Safe Harbor Under Section 475," submitted by the SIA to the IRS on July 30, 2003 pursuant to the IRS "Advance Notice of Proposed Rulemaking: Safe Harbor for Satisfying Statutory Requirements for Valuation under Section 475 for Certain Securities and Commodities," 68 Federal Register 23,632 (May 5, 2003) (hereinafter, the "ANPR Submission"). A copy of the ANPR Submission was published in 2003 TNT 177-39 (July 30, 2003).

safe harbor to taxpayers without furthering the IRS's goal of ensuring the reliability of taxpayer valuations.

The three principal areas of concern addressed in this letter relate to: (i) the prohibition in the Proposed Regulations against valuation methodologies that permit values "at or near" the bid or ask price for the relevant position, (ii) the requirement that fluctuations in the values of positions be reflected on an income statement, as opposed to a balance sheet or other reliable financial report, and (iii) the limitation of the safe harbor to reports prepared in accordance with U.S. Generally Accepted Accounting Principles (U.S. "GAAP"), as opposed the GAAP of a non-U.S. jurisdiction. These points are discussed respectively under each of the headings below.

A. Prohibition Against Values "At or Near" the Bid or Ask Value.

Proposed Treasury regulation section 1.475(a)-4(d)(3) requires that, in order to be eligible for the benefit of the book/tax conformity safe harbor, a dealer's valuation methodology may not permit values for positions that are "at or near" the bid or ask side of the market. Specifically, proposed Treasury regulation section 1.475(a)-4(d)(3)(i) reads as follows:

> "Except for eligible positions that are traded on a qualified board or exchange, as defined in section 1256(g)(7), the valuation standard used for the applicable financial statement of an eligible taxpayer must not permit values at or near the bid or ask value. Consequently, the valuation described in § 1.471-4(a)(1) generally fails to satisfy this paragraph (d)(3)(i). The restriction in this paragraph (d)(3)(i) is satisfied if a resulting value is closer to the mid-market value than it is to the bid or ask value."

In considering the above-quoted language, we note as an initial matter that we agree with the basic proposition that OTC derivatives in particular should be valued in accordance with an adjusted mid-market methodology, and should *not* be valued by a system under which long positions are simply marked to the bid side of the market and short positions to the ask side. As discussed in previous SIA submissions regarding section 475, and as acknowledged in the preamble to the Proposed Regulations, a primary purpose of dealer valuation models for OTC derivatives is to recognize in income currently the net present value of any spreads that a dealer has captured through entering into a hedged portfolio of OTC derivatives. A valuation methodology that systematically eliminates the present value of anticipated future net income by marking long positions in OTC derivatives to the bid side of the market and short positions to the ask side would fail to accomplish this purpose.

While we agree with the basic concept that OTC derivatives in particular should be valued in accordance with an adjusted mid-market methodology, we do not believe that it follows from this observation that the IRS should set a regulatory floor on values that may be produced by those adjusted mid-market valuation models. Such an attempt to regulate taxpayer valuation models on a substantive level would be contrary to the fundamental premise underlying the book/tax conformity safe harbor, which is that the IRS will *accept* taxpayer valuations, provided that the taxpayer can demonstrate the trustworthiness of its valuations by showing that it uses the same values for tax purposes as it does for important non-tax purposes. We would encourage the IRS not to deviate from this basic principle lightly, because values removed from the scope of the safe harbor will have the potential to give rise to the same controversies and frustrations that necessitated the safe harbor in the first place.

In addition to our general concern about any valuation rule in the area of OTC derivatives that deviates from the basic principle of book/tax conformity, there are certain aspects of the specific formulation of proposed Treasury regulation section 1.475(a)-4(d)(3)(i) that have given our member firms cause for concern. These concerns fall into two general categories, which are addressed under the two headings immediately below:

1. The Scope of the Rule. As currently drafted, proposed Treasury regulation section 1.475(a)-4(d)(3)(i) is too broad, because the Proposed Regulation does not provide an adequate exception for dealer positions in *physical* securities — that is, traditional debt and equity instruments. Specifically, we believe that the exception provided in the above-quoted language for "eligible positions that are traded on a qualified board or exchange" is intended generally to include liquid physical securities and to exclude OTC derivatives — thereby making the requirements of the book/tax conformity safe harbor consistent with the widespread and longstanding practice among securities dealers of marking long positions in physical securities to the bid side of the market and short positions to the ask side of the market.[6] As discussed in more detail below, however, there are many physical securities (including almost all debt securities) that are *not* traded on a "qualified board or exchange," and the current exception for exchange-traded positions therefore reaches only a subset of the positions that we believe it is intended to reach.

Before offering a recommendation for amending the current exception under proposed Treasury regulation 1.475(a)-(d)(3)(i) for exchange-traded positions, we believe that it is useful to review briefly the reasons underlying the current practice

[6] The practice of marking long positions in physical securities to the bid side of the market and short positions to the ask side is explicitly permitted under U.S. GAAP. *See* American Institute of Certified Public Accountants, Audit and Accounting Guide *Brokers and Dealers in Securities*, paragraph 7.08.

among securities dealers of marking positions in physical securities to the bid or ask side of the market, as that practice differs from the general approach to valuing OTC derivatives by reference to adjusted mid-market values.[7] The accounting practice of marking "longs to bid" and "shorts to ask" is necessary in the case of physical securities to reflect the fact that — in contrast to the case where a dealer enters into an OTC derivatives position and then captures a spread by hedging that position — the dealer does *not* capture a spread merely by purchasing a physical security at the bid side of the market that it may or may not be able to sell to a customer at a profit on a later date (or by entering into a short position with respect to a physical security that it may or may not close out at a profit on a later date). The fundamental difference between mark-to-market accounting for derivatives, on the one hand, and physical securities, on the other, is that a dealer enters into the former with a view to retaining that position on its books indefinitely, but buys physical securities into inventory for the purpose of resale to customers.

Any valuation practice that required a dealer to recognize in income on a current basis dealer spreads in respect of the simple purchase of a physical security into inventory would run the risk, for example, of rewarding a trader that bulks up a position in physical securities at year-end merely to capture credit for the resulting mark-to-market income. By contrast, in those cases where a dealer in fact captures a spread in respect of a physical security without actually selling the security (for example, by using the security as a hedge of an offsetting derivatives position), it generally is the

[7] For a more detailed discussion of the issues related to mark-to-market accounting for physical securities, *see* the ANPR Submission at 19-22.

practice among our member firms for the dealer to take the net present value of that spread into income on a current basis under its mark-to-market accounting model.[8]

Because of the rapid turnover of dealer inventory in physical securities, the practice of marking long positions to the bid side of the market and short positions to the ask side does not lead to significant deferrals of income or loss.[9] Finally, the method of valuing long positions in physical securities to the bid side of the market and short positions to the ask side is consistent with the principles for valuing inventory under section 471, and with the manner in which the majority of securities dealers value physical securities for financial accounting purposes.

We therefore recommend that the book/tax conformity safe harbor should be available for dealers that follow the traditional practice of marking long positions in physical securities held in inventory to the bid side of the market and short positions in physical securities established in ordinary customer trading to the ask side. As a practical matter, for the reasons described in footnote 9, this recommendation in most cases has relevance only to debt instruments, not equities.

We believe that the exception provided in proposed Treasury regulation section 1.475(a)-4(d)(3)(i) "for eligible positions that are traded on a qualified board or exchange" is intended to achieve a result consistent with our recommendation. The

---

8 For a more detailed discussion of this issue, *see* Letter from Edward D. Kleinbard on behalf of the SIA, to Lon B. Smith, Office of Assistant Chief Counsel, IRS, regarding "Advance Notice Regarding Proposed Safe Harbor Under Section 475," published in 2003 TNT 227-38 (November 12, 2003).

9 In the case of equity securities, changes in the relevant markets over the last several years — including the advent of "electronic trading networks" and the "decimalization" of the Nasdaq market — have all but eliminated bid/ask spreads for liquid equity securities (in many cases lowering the relevant spreads to less than a penny per share). (These developments in the equity markets are also discussed in more detail in the letter cited in note 8, above.) As a result, the question of when a dealer should recognize a spread on equity securities has been rendered largely moot, and many dealers (though not all) have responded by marking equity securities to the "closing price" at which the securities were last bought or sold on the relevant valuation date, rather than by reference to a bid or ask price.

requirement as currently formulated, however, removes many highly liquid physical securities — particularly debt instruments — from the scope of the exception. The relevant definition of "qualified board or exchange" for these purposes is contained in section 1256(g)(7); although the term includes all major U.S. securities exchanges and commodities exchanges, it does *not* include liquid OTC markets. Almost all trading of debt instruments — including U.S. Treasury securities — is conducted exclusively (or predominantly) through OTC markets, and *not* through an exchange.

Therefore, assuming that the intention in fact is to allow dealers to benefit from the book/tax conformity safe harbor in respect of physical securities without requiring them to revamp their decades-old (and uncontroversial) practices for marking physical securities to market for both tax and commercial purposes, we recommend that the reference to a "qualified board or exchange" be replaced with a term that would include liquid OTC markets as well. One possibility would be to require that positions eligible for the exemption be traded on an "established financial market," employing for this purpose a definition of that term that is based on Treasury regulation section 1.1092(d)-1(b).

2. Requirement That Values Be Closer to Mid-Market Than Bid or Ask. As discussed earlier in this letter, we agree with the basic proposition that OTC derivatives should be valued in accordance with an adjusted mid-market methodology (as opposed merely to being marked to the bid or ask side of the market). We see no justification, on either a theoretical or practical level, for the requirement that values of derivatives be closer to the unadjusted mid-market value than to the bid or ask value. We do not believe that the requirement furthers the goal of ensuring the reliability of a taxpayer's valuation methodology — *i.e.,* we do not understand the requirement's apparent presumption that a position's actual value could not in fact be closer to the bid or ask side of the market than to an unadjusted mid-market value. To the contrary, it is entirely possible, particularly in the case of illiquid "exotic" derivatives, that a dealer could incur various risks in connection with an OTC derivatives position that are either very difficult or very expensive to hedge, and as a result the dealer quite appropriately could mark the *unhedged* position, for all relevant commercial and financial accounting purposes, very near the bid or ask price. If the position in fact were hedged at later date (which would almost always be the case, although it may sometimes take a dealer weeks or months to put on an effective hedge for certain risks), the dealer would revalue the instrument, thereby reflecting as income the net present value of the income captured through the combination of the "exotic" derivative and its hedges.

Proposed Treasury regulation 1.475(a)-4(d)(4), Example 5, illustrates the application of the "nearer to mid" requirement. The example describes an OTC derivatives dealer that maintains a balanced portfolio of interest rate derivatives and keeps its market exposure within certain desired limits. Because the dealer's "adjustments for all risks and costs, including credit risk, future administrative costs, and model risk, consistently cause the adjusted value to be at or near the bid value or ask value," the example concludes that the dealer's methodology is improper. Aside from the fact that values produced by the taxpayer's methodology fell outside of the range required by the above-quoted language, however, the example gives no indication that the dealer's adjustments were otherwise inappropriate, or that the taxpayer reported values inconsistently for tax and non-tax purposes.

While we agree that a system of simply marking "longs to bid" and "shorts to ask" is not appropriate in the case of OTC derivatives, we similarly cannot agree with the example's underlying assumption that adjustments that bring a position's value closer to the bid or ask value than to the unadjusted mid-market value are *a priori* inappropriate. The appropriate check on taxpayer electivity in this area is *not* a "nearer to mid" rule, but rather the Proposed Regulations' requirement that the values in question also be employed for financial accounting purposes (and in appropriate cases satisfy the significant business use standard of proposed Treasury regulation section 1.475(a)-4(j)).

As discussed above, the "nearer to mid" requirement undermines the basic purpose of the book/tax conformity safe harbor, which is to achieve an administrable audit process under section 475 by *accepting* a taxpayer's valuations, but only on the condition that the taxpayer demonstrate the trustworthiness of the valuations by showing that the valuations are reported consistently for both tax and important non-tax purposes. If a taxpayer's valuation methodology produces values that are closer to the bid or ask value than to the unadjusted mid-market value, the appropriate inquiry should be whether the taxpayer is using this valuation methodology consistently for important non-tax purposes. If the value is so used, then the premise of the book/tax conformity safe harbor is that the value is trustworthy.

In addition, it would be extremely difficult on a practical level for the IRS to monitor compliance with the "nearer to mid" requirement (or for taxpayers to establish compliance), for at least two reasons. First, because different individual positions have different bid/ask spreads associated with them, the only way to administer the "nearer to mid" requirement is to determine a meaningful net value for each component of a dealer's portfolio on a position-by-position basis, so that these individual values could then be compared to their corresponding bid/ask spreads. As discussed in our submission of July 13, 2005, however, many valuation adjustments are made on a *portfolio* basis, in order capture the various synergies and other changes to a portfolio's value that arise when different economic positions are combined with one another. A *pro rata* allocation of such portfolio adjustments among the individual positions in a portfolio in order to derive a value for each position would be arbitrary in result. Accordingly, we do not believe that there is a reliable means of determining values on a position-by-position basis in order to monitor compliance with the "nearer to mid" requirement.

Second, OTC derivatives dealers do not, as a general matter, maintain records of the bid/ask spreads of individual positions for any meaningful period of time. Accordingly, dealers would have to revise their internal information systems significantly and undergo a considerable administrative burden in order to demonstrate compliance with a "nearer to mid" requirement in an audit of mark-to-market values, particularly where the audit occurs years after the relevant values have been determined and reported for tax and non-tax purposes.

For the reasons discussed above, we believe that it is counterproductive for the IRS to attempt to mandate minimum values that may be generated by a taxpayer's mark-to-market valuation models, and that the IRS should instead accept or reject a taxpayer's values based on whether the values are reported consistently for both tax and important non-tax purposes. If the IRS nonetheless decides to adopt a regulatory floor for such values, then we believe that the current requirement in the Proposed Regulations should be replaced with a requirement that a taxpayer's valuation methodology not permit values for open positions in OTC derivatives that fall outside of the bid/ask spread. Unlike the current requirement, a requirement that values be kept within the relevant bid/ask spread has a theoretical justification, because the bid/ask spread represents the upper and lower limits of the price at which a given position would be closed out. It generally would be non-economic for a dealer to maintain a long position if the dealer thought that the position was worth less than the price that could be realized by closing out that position on the terms offered by another dealer. For this reason, we are not aware of any valuation methodologies that value positions outside of the bid/ask spread, and believe that, as a practical matter, dealers could be expected to comply with a requirement that a taxpayer's valuation adjustments never bring a position outside of the spread.[10]

B. <u>Requirement That Changes in Value Flow Through Income Statement</u>.

Proposed Treasury regulation section 1.475(a)-4(d)(2)(ii) requires that, in order for a valuation method to be eligible for benefits of the book/tax conformity safe harbor, changes in the value of a given position recorded under the method must be reflected specifically on the taxpayer's *income statement* (as opposed to its audited balance sheet or other reliable financial reports). Although most changes in the value of mark-to-market positions do in fact appear on income statements, there are some cases where reliable, audited valuations, prepared in accordance with U.S. GAAP, are not reflected on an income statement, and we believe that proposed Treasury regulation

[10] While dealers do not maintain historical bid-ask spread data, we envision that a dealer would be able to demonstrate on audit that the dealer's then-current valuation model values securities (or portfolios of securities) within bid and ask values.

section 1.475(a)-4(d)(2)(ii) is incorrect in its implicit assumption that only values reflected on an income statement are trustworthy.

First, in the case of a bank, certain changes in mark-to-market valuations are recorded on the bank's *balance sheet* and labeled as "other comprehensive income" ("OCI"), but do *not* appear on the income statement. This treatment applies to "available for sale" securities (*i.e.,* certain marketable equity securities and debt securities that the bank may sell prior to maturity), as well as to certain hedges of such securities (for example, "cash flow" hedges, such as a floating-to-fixed interest rate swap that allows a bank to convert interest on a floating rate bond into a more predictable stream of cash flows).[11] This treatment also applies to certain derivatives contracts entered into by a bank to hedge exposure to equity investments in non-U.S. subsidiaries (*e.g.,* certain currency hedges).[12]

As a general matter, banks often elect to treat "available for sale" securities as securities "held for investment" for purposes of section 475 — and thus "elect out" of mark-to-market tax accounting for such securities as a means of limiting differences between taxable income and amounts recorded on the income statement. In the case of hedges of investments in foreign subsidiaries, however, and in those cases where "available for sale" positions are in fact marked to market for tax purposes, we do not agree that such positions should fail to qualify for the book/tax conformity safe harbor, simply on the grounds that changes to value are recorded as OCI, rather

[11] For a more detailed discussion of the issues relating to amounts included in OCI, *see* Letter from Edward D. Kleinbard on behalf of the SIA, to Suzanne Boulé, Office of the Chief Counsel, IRS, regarding "Advance Notice Regarding Proposed Safe Harbor Under Section 475," dated October 30, 2003 and attached as an exhibit to this submission.

[12] The U.S. GAAP treatment of such derivatives is addressed by Financial Accounting Standard 52.

than recorded on the income statement. There is no reason to believe that the procedures in place at a bank for valuing positions reflected in an OCI account would be any less rigorous than the procedures for valuing the positions in a bank's trading book that are reflected on the income statement — or that a bank would be any less concerned with the accuracy of amounts reflected in OCI than amounts reflected on an income statement.

Furthermore, it is uncommon for complicated valuation issues to arise in the case of a bank's "available for sale" securities and the hedging transactions that are reflected in OCI. Those positions tend to be relatively straightforward instruments for which there are readily available market prices, and the chances of any significant difference between the values accorded to such positions on a taxpayer's financial statements and the values that the IRS could reasonably accord them under tax principles (applied without reference to the safe harbor) are extremely low. We therefore do not believe that there exists any utility in creating what amounts to an exception from the book/tax conformity safe harbor for valuations that will be among a taxpayer's least complicated and least controversial. For these reasons, we recommend that the IRS make the book/tax conformity safe harbor available for positions that are recorded as OCI on a taxpayer's balance sheet.

Another concern raised by the requirement that changes in values be reflected on an *income statement* relates to U.S. branches of foreign banks. Specifically, such U.S. branches are required to file "call reports" on a quarterly basis with the Federal Reserve or the Office of the Comptroller of the Currency ("OCC"). Such reports are filed in accordance with U.S. GAAP, are audited by outside accountants, and effectively are standalone balance sheets for the U.S. branch, which allow the relevant banking authority to ensure that the branch is adequately capitalized relative to the risks it has incurred. In addition, in the preamble to the Proposed Regulations, the IRS has indicated that such call reports constitute “applicable financial statements” for purposes of the book/tax conformity safe harbor. While a U.S. branch of a foreign bank will produce a U.S. GAAP income statement for purposes of preparing its standalone balance sheet presented in the call report, the call reports themselves do *not* contain any income statement. We therefore believe that the IRS should amend the Proposed Regulations to clarify that call reports filed with the Federal Reserve or the OCC are in fact eligible to qualify as “applicable financial statements” under the safe harbor.

As in the case of OCI discussed above, our suggestion that the IRS clarify the treatment of call reports amounts to a request that the IRS recognize the validity of taxpayer values that are prepared for significant non-tax purposes, even where changes to those values are not technically reported on an *income statement* presented to a third party. Reports filed with a U.S. banking authority by a U.S. branch of a foreign bank for purposes of determining capital adequacy are clearly used for a core non-tax function of the branch, and the notion that the branch would understate the value of its portfolio to the Federal Reserve or the OCC in order to reduce taxable income is not credible. In other words, we believe that the fundamental premise behind the book/tax conformity safe harbor (*i.e.,* that valuations are trustworthy if they are used for core non-tax purposes) holds just as true in the case of values used for call reports that present only a branch's balance sheet as it does in the case of values that are reflected on a publicly available income statement.

C. Requirement of U.S. GAAP.

Under proposed Treasury regulation 1.475(a)-4(h), only financial statements prepared in accordance with U.S. GAAP are eligible for the book/tax conformity safe harbor. This requirement could have the effect of making the book/tax conformity safe harbor unavailable to foreign financial institutions that are required to pay taxes on U.S. dealer operations but that file their financial statements under the GAAP of a non-U.S. jurisdiction. For example, as in the case of certain global dealing books, a U.S. branch or subsidiary of a foreign financial institution could engage in activities that would be attributed to the United States for U.S. federal income tax purposes, but that would be recorded on the books of a non-U.S. affiliate. In such a situation, it is likely that there will be no U.S. GAAP financial statements in respect of such activities, and accordingly, such activities would not be eligible for the book/tax conformity safe harbor under the current terms of the Proposed Regulations.

Although we acknowledge the IRS's legitimate interest in ensuring that the book/tax conformity safe harbor is not available unless the financial statements of the relevant dealer are prepared under a sound set of accounting principles, we believe that the current limitation to U.S. GAAP — which apparently does not even contemplate that the GAAP of another jurisdiction could ever be deemed acceptable by the IRS — is too narrow and will make the safe harbor unavailable in cases where it may be in the interests of both taxpayers and the IRS for the safe harbor to apply. In this regard, we note that the SEC and the International Accounting Standards Board ("IASB") are engaged in an ongoing project to achieve convergence between U.S. GAAP and the IASB-promulgated "International Financial Reporting Standards" ("IFRS").[13] In addition, we understand that IFRS, as promulgated by the IASB (although not necessarily as adopted by all jurisdictions),[14] contains rules for marking securities and OTC derivatives to market that are similar to fair value accounting under U.S. GAAP. It is further expected that IFRS and U.S. GAAP will continue to converge, and that many non-U.S. jurisdictions will incorporate IFRS into their domestic accounting rules. Accordingly, the GAAP of many non-U.S. jurisdictions may eventually become acceptable for purposes of the book/tax conformity safe harbor, even in cases where the rules of a jurisdiction may be unacceptable at the present time.

Although we believe that the IRS should consider the possibility that the GAAP of some non-U.S. jurisdictions could be acceptable for purposes of the book/tax conformity safe harbor, we would not recommend that resolution of this issue be

---

13 For a discussion of the issues raised by the convergence project and the progress made to date, *see* Donald T. Nicolaisen, Chief Accountant, SEC, *A Securities Regulator Looks at Convergence*, 25 Northwestern Journal of International Law and Business, No. 3, 661 (Spring 2005); Mary Tokar, *Convergence and the Implementation of a Single Set of Global Standards: The Real-Life Challenge,* 25 Northwestern Journal of International Law and Business, No. 3, 687 (Spring 2005).

14 In this regard, we note that the European Union has generally adopted IFRS for all listed companies in the European Union in respect of their consolidated financial statements; as part of that process, the European Union specifically adopted in November, 2004 International Accounting Standard 39 ("IAS 39"), the accounting standard within IFRS that governs fair-value accounting for financial instruments. The European Union did, however, modify the operation of IAS 39 for European companies through two "carve outs," which mitigated in certain respects the application of IAS 39 to European issuers in respect of : (i) the rules under IAS 39 related to hedge accounting, under which hedged items and their hedges are both marked to market and (ii) an election under IAS 39, pursuant to which an entity may mark to market any financial asset or liability, including the entity's own debt. For a discussion of the European Union's position on IAS 39, *see* European Commission Press Release, "*Accounting Standard: Commission Endorses IAS 39*," November 19, 2004; IP/04/1385, available at http://europa.eu.int/rapid/pressReleasesAction.do?reference=*IP/04/1385&format=HTML&aged=0&language=EN&guiLanguage=fr*. *See also* "*IAS 39 Financial Instruments: Recognition and Measurement — Frequently Asked Questions (FAQ)*," European Commission Memo/04/265, Brussels, November 19, 2004, available at http://europa.eu.int/rapid/pressReleasesAction.do?reference=MEMO/04/265&format=*HTML&aged=1&language=EN&guiLanguage=en*.

allowed to cause significant delay in the finalization of the safe harbor. Rather, we would suggest that the IRS reserve for itself the power to identify, through the issuance of subsequent notices, non-U.S. jurisdictions with mark-to-market financial accounting regimes that are considered acceptable for purposes of the book/tax conformity safe harbor. Such an approach would allow the IRS the flexibility to expand the scope of the safe harbor as it determines appropriate, rather than to reject all non-U.S. GAAP financial statements — even in cases where those statements produce mark-to-market valuations that are consistent with U.S. principles and where the use of the book/tax conformity safe harbor could produce a more streamlined and reliable audit process.

* * * * *

Thank you for your consideration of our views. Please do not hesitate to contact me (at 202-216-2031) or Edward Kleinbard of Cleary, Gottlieb, Steen & Hamilton, SIA's outside counsel on this matter (at 212-225-2480), with respect to any aspect of your ongoing work on the proposed regulations.

Patti McClanahan
Securities Industry Association

Exhibit attached (referenced in N. 11)