Transcript of IRS Hearing on Proposed Rules (REG-107047-00) Regarding Hedging Transactions - May 16, 2001

MR. CARLISLE: Thank you.
Our next speaker is Mark Perwien from the International Swaps and Derivatives Association.

MR. MARK PERWIEN: Good morning. I'd like to thank you for allowing me to speak at this hearing. Previously, we have sent to the IRS the outline of the testimony that I'm going to give, so all of you can access it for text notes. I'm going to hit only a couple major points. The first point I think has been well covered, which is that Congress clearly intended in 1999 to expand what could qualify as a hedge from risk management -- I mean from risk reduction to risk management. I think even in the current rules of practice, there's a recognition that it's sometimes difficult to tell the difference.

I like to use the example of interest rate swaps and liabilities. An issuer may have a desire to issue fixed rate debt or to issue floating rate debt. I do not know which of those transactions -- issuing fixed rate debt or issuing floating rate debt -- is the less risky. If you issue fixed rate debt, you know that the coupon that you have to pay in the future is fixed. If you issue floating rate debt, you know that the value of your liability will stay relatively constant, and you know that it will be easier to get in and out of your liability if you have a change in your business needs.

So, I think that the current rules of practice do say that whether you're going from fixed to floating or floating to fixed, that you are -- they say you're reducing risk. But in reality, I think that's exactly what Congress had in mind when they put in the risk management system. I'll go to another case situation, which is the famous Corn Products (ph) case. Corn Products in that case was hedging the risk that their supplies -- increase in the price of corn would go up. And so they bought futures to buy corn. If all their competitors did not do this hedging technique and the price of corn went down, Corn Products would actually be in a worse position than they would've been if they hadn't entered into their hedging program at all.

And it's very important that a company be able to manage all of its price and other risks in the manner that they see as consistent with their view of the marketplace. That's what we expect dealers and producers to do. And I know that I worked for Salomon Smith Barney. In our role as a dealer, our customers are constantly very concerned that their transactions are considered hedging transactions. And the reason is that the code contains a whipsaw for taxpayers. If they are right in their hedging activities, but they don't meet the definition of hedge, and therefore are capital transactions -- if they're right, they get capital gains, which is very nice. But for corporations, it doesn't do you any good.

If they move money on transactions that they consider to be part of their business and the IRS does not, they have capital losses, and most of our customers have an extremely difficult time using capital losses. Most of our customers, like American Electric Power, have programs that they do think are part of their ordinary business activity, but do not necessarily reduce risk. Indeed, may from time to time, increase risk because they think that that's the way the commodity or the exposure that they have is going to be priced in the future.

Secondly, obviously the IRS is concerned about being whipsawed. And that's the basic reason why the Arkansas Best (ph) case was decided the way it was. Under pre-Arkansas Best law, taxpayers could take the view, if they won the coin toss and there was profit on a transaction, and it was a capital gain. And if they tossed the coin and it didn't come their way, that it was an ordinary loss. Clearly, that was what was (upset?) in the court in the Arkansas Best case. However, the current regulations and the proposed regulations call for same-day identification. If you have same-day identification, then neither the taxpayer nor the IRS can get whipsawed. Both will have ordinary gain and ordinary loss in their transactions.

The other character view that's important for both the IRS and taxpayers is timing. And I think from the IRS' point of view, and the taxpayers both, the current regulations under 446, which provides that the timing of a hedging transaction must be consistent with the underlying

economics of the business, is it protects the Service against timing whipsaws and if the Service thinks that there might be potential abuses, that they can always give more examples under the 446 reg to ensure that the timing of transactions makes sense.

My next point is that very often it is difficult to decide what a given transaction is hedging -- at the life insurance company, but if you have assets and you have liabilities and what you are trying to do doesn't match the assets to the liabilities, I don't know if I'm hedging the asset or the liability. Those kinds of ordinary business transactions, I believe and ISDA believes, should generate ordinary income and loss.

The last point I want to make is that the Service did ask for comments on whether it should exercise its authority to provide hedge transactions to other derivatives. Obviously, ISDA would like to -- ISDA's members would like to have customers be more willing to enter into derivatives with it. We think ordinary gain and loss does it. But we also think it's the right answer. There are taxpayers who use weather derivatives, energy supply derivatives to hedge their ordinary business activities. They should get ordinary income and loss on those.

In addition to which, there are risks that are not necessarily interest rate, price changes or currency fluctuations that are business risks. Supply contracts come within that rubric. Supply contracts may be said to hedge price risks, but very often the reason that they're entered into is to ensure sources of supply and, therefore, they are part of the taxpayer's ordinary business activities and should be treated as ordinary.

At this point, that completes my testimony. And then, I'd like to take questions.

MR. CARLISLE: At various points in your written submission, you proposed a standard for risk management that it generally include any transaction undertaken in the ordinary course of business that alters a taxpayer's exposure to one or more risks that are inherent in its core economic activities.

MR. PERWIEN: Right.

MR. CARLISLE: On page seven, you proposed a specific definition that it would be one that alters the taxpayer's exposure to a risk that is inherent in the trade or business. Is there any difference between trade or business and core economic activities? Did you -- is there any distinction you intended?

MR. PERWIEN: No, no.

MR. CARLISLE: No.

MR. PERWIEN: You might prefer one or the other and you see it --

MS. RICKS: You mentioned as transactions that should be included as hedging transactions, transactions where it's hard to tell whether the hedge is a hedge of the asset or the liability. Under FAS 133, is that going to make it easier to implement the hedging rules and take that concern away?

MR. PERWIEN: I'm not sure that FAS 133 makes things easier or harder. And I think the concerns are a little bit different. FAS 133 addresses the need of financial accountants to give more transparency to a business' activities. And as we all know, there were what led to the promulgation of FAS 133 was that certain companies were taking huge derivative risks. And it was not in their balance sheet or in their income statement. And shareholders were surprised. And that shouldn't happen.

So the exception -- and hedging is one of the exceptions to the Mark-to-Market, which of course provides plenty of warning as to whether or not economics are going up or down -- was meant to adjust FAS 133 in situations where it might be misleading. Most things under financial accounting are not on Mark-to-Market. So if you have a transaction where one side of the transaction is not Mark-to-Market and the other side is, FAS 133 increases your volatility. And that's been one of the critiques that the industry has had of 133, that it doesn't always provide for that matching. And I hate for the tax reg to adopt something where the two sides of a transaction are not matching.

MS. RICKS: But under FAS 133, taxpayers now have to ID the underlying item or --

MR. PERWIEN: Yeah. And that is, from my point of view as a tax person at a firm, is helpful. And to that extent, the identification is made for -- absolutely correct on that.

MS. RICKS: Under your definition of risk management, transactions to increase risk would be included?

MR. PERWIEN: Yes, as long as it's part of the activity of the business. And that's why I gave the corn products example. Whether you think that the prices of your inputs are likely to go up or down or the prices of your outputs are likely to go up or down, there is inherently an exposure to prices that you, as a market participant, are going to want to be a part of. So as long as you're dealing with corn derivatives, I would say that, to the extent that it's part of your normal risk activities and that your management has approved the program, that yes, it should be ordinary.

MS. RICKS: Okay. Well, under the regulations, anticipatory hedges of your need for corn are already covered. And so the corn products fall within something that's already covered under the regs?

MR. PERWIEN: It may or -- I don't think we can think of everything in writing the regulations, which is why ISDA felt it would be good to go to a standard that referred to the normal activities of the taxpayer in their business.

MS. RICKS: Can part of a taxpayer's normal activities be to enter into a futures transaction to profit from, you know, the rise of the market -- the market increase of the futures contract without an underlying risk associated with it?

MR. PERWIEN: I think, if it's part of the corporation's risk management policies, it can.

MS. RICKS: You know, the risk management standard is part of the overall structure of a provision that relates to hedging transactions. Hedging transactions has as its (feel?), a core of price protection. Is what you're proposing further than transactions that just give you price protection or altering a company's exposure or trying to lessen a company's exposure to risk?

MR. PERWIEN: Well, I think it's altering a company's exposure to risk.

MS. RICKS: But hedging usually has a concept of reducing risk, doesn't it?

MR. PERWIEN: Again, I'm not -- there is always two exposures. You have an exposure to prices going up or an exposure to prices going down. And I think any company has both exposures.

MR. CARLISLE: Thank you.

MR. PERWIEN: Thank you.