

OUTLINE OF ORAL TESTIMONY OF MARK S. PERWIEN
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HEARING ON PROPOSED REGULATIONS ON HEDGING TRANSACTIONS
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- In 1999, Congress provided specific statutory authority for ordinary gain or loss treatment for “hedging transactions”. Congress also explicitly broadened the standard for qualification as a hedging transaction from risk reduction to risk management. The proposed regulations do not properly implement Congressional intent with respect to the risk management standard. While the proposed regulations do in fact use the words “risk management”, the principal operative provisions of the proposed regulations appear to be substantively unchanged in many respects from the earlier 1994 regulations (which the Service felt obliged to base on the more narrow standard of risk reduction).
- Continued de facto adherence by the Service to risk reduction as the operative standard will call into question the “hedging transaction” status of many of the transactions that businesses and others now undertake on a daily basis in the ordinary course as an integral part of their risk management programs. The risk of adverse tax consequences created by character mismatches resulting from continued adherence to the risk reduction standard will also discourage continued financial innovation in risk management. This is contrary to the intent of Congress and financial regulators, and may increase business volatility and systemic risk.
- Congressional intent in replacing risk reduction with risk management as the operative standard can be implemented properly only if the proposed regulations are revised to extend hedging transaction status to all transactions undertaken in the ordinary course of business and alter the taxpayer’s exposure to one or more of the risks inherent in the taxpayer’s core economic activities. This definition of risk management will neither expose the Service to so-called “whipsaw” situations nor extend hedging transaction status to “speculative” transactions. Moreover, the resulting broad definition of risk “hedging transactions” will reduce the potential for character mismatches and the proposed definition of risk management is thus consistent with sound principles of tax policy.
- Under the proposed definition of risk management, the acquisition of an asset, or a borrowing, may (and should) frequently qualify as a hedging transaction, as will many so-called “gap hedges”.
- The Service should also exercise its authority under section 1221(b)(2)(A)(iii) to provide hedge transaction status to weather and energy supply derivatives. Likewise, the Service should permit hedges of dividend streams, overall profitability and other business risks that do not relate directly to interest rate or price changes or currency fluctuations with respect to ordinary property, ordinary obligations or borrowings.