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Internal Revenue Service
Room 5226
Post Office Box 7604
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Washington, D.C. 20044

Attention: CC:PA:RU (REG-100420-03)

Re: Proposed Sec. 475 Book-Tax Conformity Safe Harbor

Ladies and Gentlemen:

This letter is submitted on behalf of the International Swaps and Derivatives Association, Inc. (“ISDA”) in response to the request of the Internal Revenue Service (the “Service”) for comments on a proposed safe harbor that taxpayers could use to satisfy the mark-to-market (“MTM”) valuation requirements of section 475 of the Internal Revenue Code (the “Code”) with respect to certain securities and commodities. A possible framework for the proposed safe harbor was described in an Advance Notice of Proposed Rulemaking (the “Notice”), as published in the Federal Register for May 5, 2003 (68 Fed. Reg. 23632).

ISDA is an international organization, and its more than 600 members in 46 countries include the world’s leading dealers in over-the-counter swaps and other private bilateral derivatives contracts (collectively “OTC derivatives”).¹ ISDA welcomes the publication of the Notice. Consistent with its prior recommendations,² ISDA believes a safe harbor should be established under section 475 to enable dealers to value their OTC

¹ A list of ISDA’s primary members is attached as Exhibit A.

² ISDA’s earlier recommendations to the Service and the Department of the Treasury are set forth in letters dated September 21, 1999 and May 9, 2000. For the convenience of the Service and the Treasury Department, portions of those letters are incorporated in this submission and the complete texts of both letters are available on ISDA’s website at www.isda.org.

derivatives using the same MTM methods they use under generally accepted accounting principles (“GAAP”) for financial reporting purposes. A safe harbor based on such book-tax conformity, and buttressed by a requirement that book valuations be used for non-tax business purposes, would (1) carry out the intent of Congress; (2) result in an appropriate determination of fair market value under section 475 in accordance with applicable tax principles; (3) clearly reflect dealer income; (4) reduce administrative burdens both for the Service and dealers; and (5) and reduce the risk that income from global trading would be overtaxed or undertaxed.

Part I of this letter summarizes the legal and policy considerations supporting the adoption of a safe harbor for OTC derivatives, Part II contains a general description of the “adjusted mid-market” method, and Part III responds to the specific questions raised by the Service and the Treasury Department in the Notice.

I.

A Book-Tax Conformity Safe Harbor Should be Provided for OTC Derivatives

Section 475(a) generally requires a dealer in securities to include securities that constitute inventory in the dealer’s inventory at fair market value and to mark certain of its non-inventory positions in securities to market annually. Specifically, in the case of securities that are not inventory in the hands of the dealer (such as OTC derivatives) and are held at the close of the taxable year, the dealer must take into account, for federal income tax purposes, gain or loss as if those securities were sold for their fair market values on the last business day of the taxable year.

OTC derivatives (such as interest rate and foreign currency swaps) are bilateral contracts in which the creditworthiness of the dealer’s counterparty is a material factor. For this and other reasons, OTC derivatives contracts are not freely assignable and there is no active secondary market for such contracts. Indeed, as explained in an *amicus* brief filed by ISDA and other associations in the Bank One litigation³ (the “Association Brief”), when a dealer enters into an OTC derivatives contract with a counterparty, the dealer expects to remain a party to the contract for the duration of its stated term. If a

³ 120 T.C. No. 11 (May 2, 2003).

termination is required, the dealer typically either negotiates a termination with the counterparty or enters into a second contract that offsets the first.⁴

Given the absence of market quotations, dealers currently use the adjusted mid-market method to determine the value of their OTC derivatives contracts under GAAP for financial and regulatory reporting, as well as for federal income tax purposes and in a broad range of important internal non-tax management functions. As described in Part II, the adjusted mid-market method determines values of OTC derivatives contracts by calculating the present value of the anticipated future net cash flows from those contracts.

The Notice states that the Service and the Treasury Department are considering the issuance of proposed regulations “that, by allowing values used on a financial statement to be used on a tax return, would provide an elective safe harbor for satisfying the statutory requirement [of section 475] to value securities and commodities.” As discussed in this Part, there are compelling policy reasons why a safe harbor should be provided under section 475 based on conformity of tax return values with the values used by dealers for their OTC derivatives contracts for financial reporting purposes.⁵ Specifically, a safe harbor based on book-tax conformity would carry out Congressional intent in enacting section 475, result in an appropriate determination of fair market value under section 475 in accordance with applicable tax principles, clearly reflect dealer income, reduce administrative burdens for both the Service and dealers, and reduce the risk that income from global trading would be overtaxed or undertaxed. Indeed, ISDA believes that there is no practical alternative, either for the Service or for dealers, to the use of GAAP valuations to determine the fair market value of OTC derivatives under section 475.

A. Congress Contemplated Such a Safe Harbor

Section 475 is based largely on a legislative proposal advanced by the Treasury Department in January 1992. In advocating book-tax conformity, the Treasury Department in its proposal noted that the MTM method used by securities dealers

⁴ Association Brief at page 10. In addition to ISDA, the Association Brief was filed on behalf of the American Bankers Association, the Institute of International Bankers, The New York Clearing House Association (L.L.C.), the Securities Industry Association and the Wall Street Tax Association.

⁵ Although section 475 applies to a broad range of securities and commodities, this letter focuses solely on OTC derivatives contracts.

“. . . represents the best accounting practice in the trade or business of dealing in securities and is the method that most clearly reflects the income of a securities dealer.”⁶

When section 475 was enacted in 1993, Congress properly decided not to mandate specific valuation methods, but the report of the House-Senate conference committee stated that “. . . the conferees expect that the Treasury Department will authorize the use of valuation methods that will alleviate unnecessary compliance burdens for taxpayers and clearly reflect income for Federal income tax purposes.”⁷ The need for administrative guidance anticipated by Congress a decade ago and now contemplated by the Notice is apparent in the case of financial instruments such as OTC derivatives contracts for which there is no active secondary market.

B. Proper Determination of Fair Market Value

The MTM requirement of section 475 requires dealers to answer a specific question of fact: what would a willing buyer pay to a willing seller (the dealer) for the dealer’s OTC derivatives contracts on the last day of the taxable year? As noted earlier, an OTC derivatives dealer generally expects to remain a party to the contracts it enters into for the entire terms of those contracts and thus to collect the expected net cash flows from those contracts. Dealers view their OTC derivatives on a portfolio basis, rather than on a position-by-position basis, for many purposes. For example, dealers use the portfolio perspective to determine their net exposure to one or more types of risk and often enter into both sides of a particular type of contract (such as an interest rate swap) in order to offset the risks in their portfolios.

Accordingly, in ISDA’s view, the fair market value of a dealer’s OTC derivatives should be determined under section 475 by reference to what a willing and knowledgeable buyer would pay for a dealer’s OTC derivatives portfolio.⁸ In such a hypothetical purchase of a dealer’s OTC derivatives portfolio, the buyer would obtain the right to receive a stream of income over the terms of the dealer’s book of OTC derivatives contracts. As illustrated in Part II, the adjusted mid-market method results in

⁶ U.S. Department of the Treasury, Budget Proposals (January 1992).

⁷ H.R. Rep. No. 213, 103rd Cong., 1st Sess. 616 (1993).

⁸ As explained elsewhere in this submission, the portfolio approach will frequently result in smaller adjustments (i.e., higher valuations) than would occur if valuations were made on a contract-by-contract basis.

appropriate determination of fair market values by taking into account the factors that a knowledgeable and willing buyer would find material, including market risk, credit risk, liquidation costs, funding costs, and administrative costs.

The law is clear that the factors for which dealers make adjustments to mid-market values must be taken into account under section 475 because a proper determination of “fair market value” (the section 475 requirement) requires consideration of all relevant financial data and other factors as of the date value is determined.⁹ Accordingly, any valuation method used for section 475 must not, and the adjusted mid-market method does not, ignore the types of financial data and other relevant factors that buyers and sellers typically consider. Specifically, in the case of OTC derivatives contracts, a knowledgeable buyer would take into account the risk that some payments might not be made as well as the costs of collecting payments and managing the contracts themselves.

In addition, the adjusted mid-market method is entirely consistent with the three core requirements of section 475 set forth in the Notice. Values are determined as of the last business day of the taxable year (as discussed in more detail below), gains and losses arising from changes in values each year are reflected in income, and gain or loss on dispositions during a year are computed by reference to the value at the end of the prior year.

Thus, the adjusted mid-market method results in an appropriate determination of values in accordance with the “fair market value” standard and does so in a manner that is otherwise consistent with the requirements of section 475.

C. Clear Reflection of Income

The adjusted mid-market method is a method of valuation that best implements the MTM method of accounting requirement of section 475 and “clearly reflects” a dealer’s income. In addition, the adjusted mid-market method produces results that satisfy other tax norms. Most importantly, it prevents the mismatching of income and the

⁹ See Treas. Reg. 1.1001-1(a) and the other authorities cited at pages 4-6 of ISDA’s submission dated September 21, 1999.

deductions associated with that income by accelerating both income and associated expenses that have not yet been realized.

The adjusted mid-market method is, in ISDA's view, the best available method for valuing OTC derivatives contracts. ISDA is not alone. As noted in the Associations' Brief,¹⁰ the adjusted mid-market method has been recommended by the Group of Thirty, an independent non-profit group comprised of private sector representatives, and the Office of the Comptroller of the Currency; it is compatible with the views of the Board of Governors of the Federal Reserve; and it is consistent with GAAP. There is a general trend toward convergence of accounting methods globally, including MTM methods. Institutionally, the Financial Accounting Standards Board (the "FASB"), which is subject to oversight by the Securities and Exchange Commission (the "SEC"), is working with the International Accounting Standards Board (the "IASB") to achieve this objective. In practice, ISDA understands that, for example, many dealers use the same OTC derivatives valuation methods for financial and regulatory reporting in the United Kingdom, a major international financial center for OTC derivatives, as they use in the United States.

There are other significant factors that ensure that, in practice, the adjusted mid-market method will be applied accurately by dealers. As discussed elsewhere in this submission, dealers use this method in financial reports to shareholders, creditors and others, to comply with regulatory requirements, and in a broad range of important internal non-tax management functions. They thus have strong incentives to determine and report values fairly. Moreover, as also discussed elsewhere in this submission, dealers are under significant competitive pressures to value their OTC derivatives as accurately as possible.

A safe harbor permitting dealers to use financial statement valuations for their OTC derivatives portfolios to comply with section 475 would be consistent with well-established precedents involving the application of the "clear reflection" of income standard in closely analogous areas of the tax law. For example, in exercising the authority granted by Congress in section 471(a) to issue regulations governing accounting

¹⁰ *Id.* at 17-18.

methods for inventories, the Service and the Treasury Department have followed Congressional intent by focusing on the need to “give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business”¹¹ and have authorized the use of values as shown in taxpayers’ books to determine the cost of goods on hand for tax purposes.¹² Similarly, in regulations concerning the last-in, first-out method of accounting, the Service and the Treasury Department have conditioned the use of that method on book-tax conformity.¹³

Further precedent for the proposed section 475 safe harbor can be found in Rev. Rul. 74-223,¹⁴ where the Service permitted commodities dealers to value certain futures contracts entered into as hedges using the same MTM methods they used for book purposes. In concluding that the book method resulted in a clear reflection of income for tax purposes, the Service stated:

This system of bookkeeping is the only accurate and correct system that has been devised that truly reflects the net profit or loss of any given year’s business. . . . It is the system in use, approved by auditors who certify to the correctness of his financial statements which are the basis of his credit, and it is the system accepted by his bankers for all of his financial transactions and the only system which would not be false and misleading.

Consistent with these precedents, in 1991, the Service and the Treasury Department issued proposed regulations providing a mark-to-market election for dealers in OTC derivatives. Under these proposed regulations, a dealer would have been permitted to elect mark-to-market accounting for tax purposes only if the dealer valued “. . . all of the derivative financial instruments it holds in its capacity as a dealer or trader (or as hedges of such transactions) at market for purposes of computing its net income or loss on its applicable financial statement . . . and the dealer or trader uses the same method of valuing those instruments on its income tax return.”¹⁵

¹¹ Treas. Reg. 1.471-2(b).

¹² Treas. Reg. 1.471-2(d).

¹³ Treas. Reg. 1.472-2(e).

¹⁴ 1974-1 C.B. 23.

¹⁵ Prop. Treas. Reg. 1.446-4, 56 Fed Reg. 31,350 (1991). This proposed regulation was rendered moot by legislation that ultimately led to the enactment of section 475.

D. Use of Financial Reporting Values Would Reduce Administrative Burdens and Costs and Ensure Accuracy

ISDA believes that allowing book-tax conformity for OTC derivatives contracts will avoid substantial costs for both the Service and dealers. If dealers are not permitted to value their OTC derivatives in the same way they do under GAAP for financial reporting purposes, the result will be endless disputes as to the value of particular positions and the propriety of particular valuation practices. The protracted litigation in the Bank One case demonstrates that resolution of valuation issues under section 475 on a case-by-case basis would be wholly impractical and prohibitively expensive for both the Service and dealers. In this connection, it should be noted that some of the larger derivatives dealers may have many thousands of open contracts on their books at any one time.¹⁶ Thus, a safe harbor based on book-tax conformity may be a practical imperative for both the Service and dealers.

Indeed, ISDA believes that there is no practical alternative to the use of GAAP financial reporting values for OTC derivatives contracts to comply with section 475. As ISDA has pointed out in its prior submissions, however, the Service could in theory promulgate an alternative valuation method. Unless any such alternative method properly takes into account all relevant factors such as credit risk, however, some taxpayers may assert that the alternative method does not properly determine fair market value. On the other hand, if the alternative did take into account all relevant factors, valuation disputes with taxpayers could be pervasive. Taxpayers may for example challenge the weight given by the Service to particular factors or assert that their book methods produce more accurate valuations.

In ISDA's view, even if it were possible for the Service and the Treasury Department to develop, constantly update and administer an alternative methodology for determining the fair market value of OTC derivatives, it is unlikely that any such alternative would be as accurate as the adjusted mid-market method now used by dealers. As discussed elsewhere in this submission, dealers use the values determined under the

¹⁶ The volume of contracts held by many dealers is one of the reasons why many of the valuation adjustments are made on a portfolio-wide basis.

adjusted mid-market method for financial and regulatory reporting and a broad range of non-tax business purposes. These uses, together with the competitive pressures discussed elsewhere in this submission, provide strong incentives for dealers to determine their values as accurately as possible.

Furthermore, the adjusted mid-market method was developed and is applied by dealers independent of tax considerations. Indeed, as discussed elsewhere in this submission, this method results in an acceleration of taxable income in certain instances in which it is applied and there is no systematic bias for undervaluing OTC derivatives positions. Moreover, a dealer's tax professionals generally do not participate in the development or implementation of the dealer's valuation methods.¹⁷ Even if a dealer's tax professionals participated in the process, it is highly unlikely that they could influence management to create a bias towards undervaluing a portfolio because the very important non-tax uses of these valuations (as described elsewhere in this submission) would be viewed by management as clearly outweighing any tax benefits resulting from an undervaluation.¹⁸

ISDA also believes that a "shadow" or "tax only" method of valuation would necessarily have fewer safeguards to ensure accurate valuations than exist with respect to the adjusted mid-market method. All dealers have strong systems of internal checks and balances, including stress testing procedures, to ensure accurate valuations for financial reporting and internal management uses. Moreover, the financial statements of virtually all major dealers are subject to independent audits that, as explained elsewhere in this submission, involve a specific and detailed review of the dealer's valuation methodology for OTC derivatives. None of these safeguards would be present with respect to any alternative method prescribed by the Service and the Treasury Department.

In short, any alternative to a safe harbor based on book-tax conformity would be significantly more costly and inherently less reliable. In contrast, book-tax conformity, buttressed by a requirement of non-tax business use, will, as Congress contemplated,

¹⁷ Association Brief at 39.

¹⁸ For example, to defer \$4 in federal and state income taxes, a dealer would have to produce a \$10 reduction in pre-tax earnings as reported on its financial statements, plus distort the valuations used for risk management, compensation and other non-tax business purposes.

result in reduced costs and administrative burdens and result in an appropriate determination of fair market value under section 475 in accordance with applicable tax principles.

E. Income from Global Trading in OTC Derivatives

As noted by ISDA in its letter of September 21, 1999, a number of other major industrial countries require securities dealers to compute their income for tax purposes based on their income as determined for financial reporting purposes. If the United States uses the same approach, it will be starting with the same base these other countries do in allocating income of a global dealing operation among the different jurisdictions in which the operation is conducted. If the United States does not start with the same base as its trading partners, a securities dealer would be subject to tax on more (or less) than 100 percent of its worldwide income in a particular year, even if all jurisdictions use the same method for allocating that income. In contrast, use by all countries of the same base would eliminate one major potential source of over or under taxation of a dealer taxable in a number of different jurisdictions.

II.

The Adjusted Mid-Market Method

A. Overview

Dealers are required by GAAP to determine the fair value of their OTC derivatives as of the last business day of each reporting period (including year-end). The adjusted mid-market method is used by dealers to comply with the “fair value” requirement of GAAP with respect to their OTC derivatives portfolios. Statement of Financial Accounting Principles (“FAS”) 133, as amended¹⁹ contains specific guidance with respect to derivatives instruments and hedging transactions. A Broker-Dealer guide, issued by the American Institute of Certified Public Accountants with the approval of the FASB, specifically acknowledges the recommendation of the Group of Thirty (the “G-30”) that the adjusted mid-market method be used to determine the value of OTC derivatives.²⁰

¹⁹ FAS 133 (as amended by FAS 149), “Accounting for Derivatives Instruments and Hedging Activities.”

²⁰ “Brokers and Dealers in Securities,” section 7.14.

The basic theory and approach of the adjusted mid-market method, which is now used by all dealers to value their OTC derivatives contracts under GAAP, is set out in a 1993 G-30 report, as follows:²¹

Mid-market valuation is a marking practice that values a derivatives portfolio at the middle of the current market (the average of bid and offer prices) less specific adjustments. In bid/offer marking, the portfolio is marked to the bid or offer side of the market. Marking to mid-market less adjustments specifically defines and quantifies adjustments that are implicitly assumed in the bid/offer model.

Once mid-market values or prices have been determined, future cash flows are generated based on implied forward curves and prices. These cash flows are then discounted back using a zero coupon curve which is generated from the mid-market interest rate curve. The net present value of cash flows represents the mid-market value of the portfolio. Similar calculations are made under the bid/offer method.

Even in a perfectly matched portfolio, mid-market valuation does not reflect the true value of the portfolio. Although a matched portfolio has no market risk, the failure of one counterparty to perform its obligation can result in a loss. Furthermore, even a matched portfolio must be managed from an operational standpoint. Therefore, two adjustments have to be made, reflecting expected future credit costs and administrative costs. As the assumption of matched portfolio is dropped and more complex portfolios are examined, two additional adjustments should be made: one for close-out costs and another for borrowing and investing costs.²²

B. Dealer Applications of the Method²³

Under the adjusted mid-market method, dealers generally begin the valuation process by using the *mid-market values* produced by a mathematical model. Dealers then make adjustments to these mid-market values in order to determine the actual value of their OTC derivatives under GAAP. The adjusted mid-market method replaced an earlier method under which a dealer's long and short positions under its OTC derivatives were

²¹ In 1993, the G-30 was co-chaired by former Federal Reserve Chair Paul Volcker.

²² Group of Thirty, "Derivatives: Practices and Principles," (1993).

²³ The discussion in this section is taken from ISDA's May 9, 2000 letter to the Service and the Treasury Department. Based on a survey conducted during the preparation of this submission, ISDA believes that this discussion accurately describes industry practices.

valued at the bid and offer rates, respectively. In contrast to this earlier method, the adjusted mid-market method generally produces higher initial valuations and thus accelerates the reporting of taxable income by dealers. ISDA believes that the fact that this change in valuation methods resulted in the acceleration of taxable income is further evidence that dealer valuations of their OTC derivatives portfolios are not tax-driven.

As noted, dealers make adjustments to mid-market values to determine the actual value of their OTC derivatives positions. The aggregate amount of these adjustments cannot exceed the bid-offer spread and thus the resulting “*adjusted* mid-market values” do in fact result in the acceleration of income, as compared to the prior method based on bid or offer value. The principal adjustments made by dealers are discussed below. In this connection, it should be emphasized that the G-30 report quoted above, together with the authorities cited in Part I. C. of this submission, specifically provide that the valuation adjustments discussed below are necessary components of any system that determines the fair value of an instrument, such as an OTC derivatives contract, for which no active secondary market exists.

1. Mid-Market and Model Adjustments. As noted, dealers generally begin by using an estimate of mid-market values produced by a model. Before making the specific portfolio adjustments described below (“mid-market adjustments”), a dealer makes model adjustments to ensure that the values produced by the model are as accurate as possible. These adjustments may be positive or negative. They may be necessary until a dealer’s model can be revised to take into account a particular factor or economic condition. These adjustments may be based on internal research, on comparison of results produced by two different models or on observed prices of trades in the market. Where the estimate produced by one model is adjusted because a comparison to another model yields a different valuation, the adjustment may be referred to as a “model adjustment” or a “model fair value adjustment”.

2. Portfolio Adjustments. Adjustments grouped together as “portfolio adjustments” fall into three general categories. The first includes adjustments for the effects on value of risks of changes in market factors; they are discussed below under “Market Risk Adjustments”. The second includes adjustments for potential losses from counterparty default; they are discussed below under “Credit Adjustments”. The

remaining category includes adjustments for the effect on value of expected costs of maintaining a position in derivatives, including but not limited to servicing.

a. Market Risk Adjustments. Market risk adjustments are often broken down by dealers into subcategories based on the kind of market risk that each adjustment reflects. Market risks include both risks that are potentially hedgeable (bid/offer adjustments), risks for which no direct hedge exists (unhedgeable risk adjustments), and risks that may be hedgeable only with difficulty because the dealer has a particularly large position in the risk (concentration adjustments). Bid/offer adjustments and unhedgeable risk adjustments are generally more significant than concentration adjustments.

i. Bid/Offer Adjustments. Bid/offer adjustments reflect a portion of the interdealer bid/offer spread for positions creating risks that are potentially hedgeable, but that have not yet been hedged. Thus, some dealers describe these adjustments as “hedging fair value adjustments”. These adjustments reflect uncertainty that the dealer will be able to close out an unhedged position at the mid-market price, and instead would have to accept another dealer’s offer price.

Bid/offer adjustments effectively adjust value by some or all of the difference between the mid-market value and the bid or offer price, and change the reported value by up to one half the bid/offer spread, but only to the extent that the position has not been hedged. Once a position – or a particular risk created by a position – has been hedged, this adjustment is reversed and the value of the position is increased accordingly. Thus, as soon as the hedge is in place, a portion of the bid/offer spread is brought into income.

Bid/offer adjustments are sometimes broken out into a number of different components, each reflecting a different kind of risk that might be hedged separately. It is very important to note that these components never, in the aggregate, exceed the bid/offer spread, because a dealer could always enter into an offsetting position, rather than hedging separately each individual kind of risk.

The extent to which bid/offer adjustments are broken into different components, and the names used for those components, vary widely from dealer to dealer. The largest and most sophisticated dealers tend to break down their bid/offer adjustments more finely than others.

Conceptually, the distinctions between the different components are not particularly relevant to ISDA's position: all components are alike in that they measure the effect of hedgeable risks on value.

Each of the components of bid/offer adjustments must be taken into account to measure accurately the prices at which derivatives held by dealers would change hands in the relevant market.

The most important and widely used component of the bid/offer adjustment is for "delta", which relates to risk of changes in the prices of the underlying instruments. In the case of interest-rate derivatives, for example, delta adjustments represent risks of change in interest rates.

ii. Unhedgeable Risk Adjustments. Adjustments for unhedgeable risk reflect the costs that would be incurred in closing out a particular contract because there is no direct hedge against the risk the contract creates, leaving the dealer at least partly exposed. These adjustments are particularly likely to be necessary for "exotic" contracts that entail unusual risks. Accordingly, these adjustments are particularly important for larger dealers with a wide range of sophisticated products. Unhedgeable risk adjustments are quite distinct from, and do not duplicate, the bid/offer adjustments referred to above.²⁴ Some institutions refer to unhedgeable risk adjustments as "liquidity adjustments" or "liquidity fair value adjustments". Others use those terms more broadly to refer to all market risk adjustments.

iii. Concentration Adjustments. Concentration adjustments reflect additional costs that would be incurred in closing out a particular contract because the dealer holds an especially large position in the risk or risks it

²⁴ An alternative adjustment for certain exotic contracts is discussed in Part III.

creates. Conceptually, concentration adjustments can be viewed as similar to, but distinguishable from, both bid/offer adjustments and liquidity adjustments. Like bid/offer adjustments, concentration adjustments relate to a risk that is hedgeable, but only with difficulty because of the size of the dealer's position in the risk.

ISDA recognizes that the legislative history indicates that blockage discounts are not to be considered in applying section 475. Concentration adjustments are, however, different from blockage discounts. Blockage discounts reflect the depressing effect on price of simultaneous availability of a large number of similar items. Concentration adjustments relate to the total amount of a particular kind of risk a dealer is subject to, without regard to the number of different items it holds that create that risk.

b. Credit Adjustments. Dealers use dynamic credit adjustments that reflect changes in the creditworthiness of their counterparties. As far as ISDA is aware, all major dealers follow this methodology in valuing their OTC derivatives portfolios. Adjustments for default risk are of two general kinds. The first includes allowances for anticipated credit losses, and the second includes the cost of capital held to cover unanticipated credit losses.

i. Adjustments for Anticipated Defaults. These adjustments (sometimes called "unearned credit spread adjustments") are made to reflect the risk that the dealer will not receive payments because of anticipated defaults by the counterparty. These adjustments generally take into account netting arrangements and collateral. Thus, adjustments that dealers actually make for credit risk tend to be lower than adjustments that would be made if netting arrangements and collateral were ignored.

For example, assume that a dealer with a high credit rating has two positions with a poorly-rated counterparty and that one position is marked according to the dealer's pre-adjustment model at a \$10 gain and the other at a \$10 loss. If the two positions are viewed separately, the dealer would make a downward credit adjustment reflecting the risk of default on the \$10 it projects the counterparty will owe on the gain position, but it would

not make an adjustment on the amount it projected it would itself owe. This would result in a net negative MTM valuation on the two positions together. In contrast, by netting the gain and loss positions for credit adjustment purposes, there will be no downward adjustment.

ii. Capital Charge for Unanticipated Credit Losses. In addition to the cost of anticipated credit losses, some dealers may make adjustments for a capital charge for bearing the risk of unanticipated losses. Such a charge would be reflected in the prices at which market participants are willing to enter into derivatives transactions. These adjustments reflect the cost of the return that must be paid to capital held to absorb the risk that credit losses will exceed the highest anticipated level. Adjustments for the cost of unanticipated losses are appropriate since the risk of such losses is inherent in a portfolio as of any valuation date.

c. Administrative and Other Portfolio Adjustments. Other portfolio adjustments include, but are not limited to, the following:

i. Servicing Adjustments. These adjustments are also known as “maintenance adjustments” or “administration adjustments” or “administrative fair value adjustments” or “future operational costs adjustments”. They reflect the anticipated costs of servicing (e.g., monitoring compliance and processing payments) particular contracts, and include systems costs and operational costs. They also may include documentation costs (i.e., legal and other costs of preparing and revising documentation for particular contracts). It is important to note that a different – and more expensive – kind of servicing is required for derivatives than for debt and equity securities. Derivatives generally are bilateral contracts in which a potential two-way payment flow must be administered.

ii. “Pending Due Diligence” Adjustments. These adjustments are also known as “market risk valuation due diligence” adjustments. They reflect uncertainties about the values of contracts until due diligence can be completed. They may be necessary where, for example, an unusually

high volume of contracts is entered into at the same time, so that due diligence cannot be completed quickly. Such adjustments may also be necessary when a small number of contracts are so complex that due diligence is delayed. Derivatives for which due diligence has not been completed are appropriately valued taking this factor into account. A seller would be willing to accept less, and a buyer would be willing to pay less, for a position for which this work has not been performed.

It should be emphasized that these adjustments are reversed once a dealer completes its due diligence. This process would normally be quite short (i.e., an adjustment would likely be reversed within a calendar quarter).

iii. Investing and Funding Cost Adjustments. Another cost of maintaining a position in a derivative is the cost of borrowing or investing funds required or produced because of cash flow mismatches over its life. Adjustments for these costs are sometimes called “cash management” adjustments. Some dealers do not separately adjust for these costs. Dealers do not estimate expected funding costs on a position-by-position basis to compute these adjustments. Instead, they net expected cash flows to compute borrowing or investment needs, resulting in smaller adjustments. At first blush, it might be argued that each position should be valued based only on expected funding costs for that position, but it would not be appropriate for a dealer to do so because the dealer is required to invest or borrow only on an aggregate basis. Moreover, as in the case of expected credit losses, netting produces lower adjustments, and thus higher taxable income, assuming book methods are used for tax purposes.

C. Differences in Determining Adjusted Mid-Market Values are Not Relevant to a Safe Harbor Based on Book-Tax Conformity and Use of Such Values for Non-Tax Purposes

1. General Observations. Although different dealers use a variety of names and categories for the adjustments described above, all have the same purpose; namely, adjustments are designed to determine fair market value accurately. None of these

adjustments merely reflect general costs of being in the securities business that would not be taken into account by buyers and sellers of particular positions in the market. All the kinds of adjustments discussed previously reflect factors that participants in derivatives markets must and do take into account in determining fair market values.

These variations in nomenclature and technique do not indicate that different dealers are using different valuation methods to determine the fair market value of their OTC derivatives contracts. Instead, these variations indicate that the manner in which a single method of valuation (the adjusted mid-market method) is applied is constantly evolving as dealers search for the specific techniques that will produce the most accurate valuations of their respective OTC derivatives contracts. These differences in nomenclature and technique are all compatible with GAAP and should be irrelevant under a safe harbor based on book-tax conformity, particularly where, as is proposed here, the safe harbor will require non-tax business uses. As described below, that requirement, together with competitive pressures, will ensure dealers have incentives to determine and report values accurately.

For these reasons, the section 475 safe harbor should not seek to identify and prescribe a particular manner in which the adjusted mid-market method must be applied. The requirement of book-tax conformity, buttressed by a requirement of non-tax business use, will result in accurate valuations.

2. Use for Financial Reporting and Non-Tax Use Ensures Accurate Values. A dealer generally must determine the value of its OTC derivatives positions for a number of different non-tax purposes. These include satisfaction of external non-tax legal and regulatory requirements and internal management needs. As illustrated by the examples below, dealers have strong incentives to measure the value of their OTC derivatives positions fairly for these purposes and to take into account appropriately all factors that determine fair market value for tax purposes.

A dealer that is publicly-held (including a dealer that is an affiliate of a publicly-held entity) must value its positions in OTC derivatives for financial reporting purposes using MTM methods. Furthermore, in the case of dealers that are regulated, these valuations affect the amount of capital that must be maintained. Thus, dealers that are publicly-held and/or are subject to regulation have strong incentives not to undervalue

their OTC derivatives positions. A dealer that undervalues its positions will understate its profits, which in turn will reduce the amount of its retained earnings available to serve as regulatory capital and, if publicly traded, lead to the undervaluation of the dealer's stock.

In addition to these external requirements, internal management considerations require that dealers accurately value OTC derivatives both to manage risk and to compensate key personnel. Dealers strive constantly to manage their exposure to risks, including interest rate, equity and foreign currency risks, as well as credit exposures to third parties. To manage these exposures effectively, dealers must be able to measure the values of their OTC derivatives contracts at all times. A dealer that does not have a reliable system in place for accurately determining the fair market value of its OTC derivatives positions cannot effectively monitor and manage its exposures to various kinds of market risk.

Dealers must also value their OTC derivatives in order to determine contributions to profitability made by employees who structure, trade and market these contracts. Unless a dealer can accurately measure fair market value, it cannot accurately determine the contribution made by particular business units or individuals to its overall profit or loss. For dealers, these contributions are an important factor both in determining the compensation of particular individuals and in making decisions regarding lines of business and business units. Thus, both firms and affected individuals have strong incentives to ensure that the values of OTC derivatives contracts are accurately determined.

3. Competitive Pressures Provide Additional Incentives to Value OTC Derivatives Accurately. A dealer's traders generally use their adjusted mid-market valuations to decide what positions to take on (or hold) and which to pass up (or terminate) and the prices at which such transactions are entered into or terminated. If a particular adjustment used by a dealer tended to produce a book valuation below true market value, its traders would forgo contracts that would make profits for the firm. A dealer making such an adjustment would repeatedly lose transactions – and profits – to competitors with more accurate valuation methods. Thus, ISDA does not agree with the notion that a dealer's OTC derivatives generally are likely to be worth more (or less) in the market than shown on the dealer's books net of all adjustments.

In addition, if a dealer's book valuations of its OTC derivatives were below true market value, its traders could easily create book profits by disposing of positions at prices in excess of book. Thus, dealers will make every effort to ensure that their book values are not below market, so that their traders are not encouraged to create profits by selling positions. If, despite the dealer's efforts, some positions are undervalued on its books, the problem will rapidly correct itself as traders cull their portfolios and unwind undervalued positions to create profits. Thus, dealers strive to value their OTC derivatives positions accurately, – neither undervaluing nor overvaluing them.

In summary, dealers face intense competitive pressures to use only valuation adjustments that result in accurate estimates of the prices at which particular OTC derivatives portfolios would change hands in the market. A dealer would continually lose profits to its competitors if its book methods systematically undervalued positions by making adjustments for costs that other dealers would not generally take into account. Thus, in evaluating a section 475 safe harbor based on book-tax conformity, it is important to keep in mind that dealers make adjustments for one reason, which is to determine fair market value as accurately as possible. Indeed, as ISDA has previously pointed out, dealers hope to gain a market advantage by refining their adjusted mid-market models so that they measure fair market value more accurately than those used by their competitors. If one dealer uses a lower value than another dealer for a given position, it is doing so because it believes the second dealer is overpaying. Competitive forces will demonstrate which of the two was correct. If the dealer using the lower valuation was correct, the other dealer will lose money by overpaying, and if the dealer using the lower valuation was incorrect, it will lose profits to its competitor. In short, dealers are in competition with each other to do exactly what section 475 requires: to determine the fair market value of their OTC derivatives positions as accurately as possible.

III.

Responses to Specific Questions Raised in the Notice

A. Principle One: MTM Methodology for Financial Reporting.

1. “Sufficient Consistency” with Section 475. The Notice states that to qualify for the safe harbor, an MTM methodology used for financial reporting purposes should

be “sufficiently consistent” with the requirements of an MTM methodology used for section 475. To ISDA’s knowledge, all dealers now use the adjusted mid-market method for both financial reporting under GAAP and complying with section 475. There is thus no difference between the MTM methodologies used by dealers for these two purposes. The same method, the adjusted mid-market method, is used for both.

ISDA believes that the MTM methodology used by dealers to value their OTC derivatives under GAAP for financial reporting purposes (as generally described in Part II) is consistent with the requirements of section 475. As discussed in Part I.B. of this submission, the adjusted mid-market method properly determines values in accordance with the “fair market value” standard of section 475 and is also consistent with the three core section 475 requirements identified by the Service in the Notice. Specifically, under the adjusted mid-market method, values are determined as of the last day of each taxable year, gains and losses arising from changes in values each year are reflected in income, and gains and losses on dispositions during a year are computed by reference to the values at the end of the prior years.

In connection with the foregoing, it should be noted that while all dealers do value their OTC derivatives contracts as of the last business day of the year as required by GAAP, some dealers have procedures to address situations where the market for such contracts on that day is less liquid than usual. For example, a dealer may use data from the most recent reasonably liquid-market date and then adjust that data to reflect changes in value between that earlier date and the last business day of the year. Similarly, for reasons of administrative feasibility, some firms make credit adjustments several days before the end of a month (including at year-end), while others make such adjustments with greater frequency. Finally, and reflecting the fact that time may be required to collect all relevant data, some firms may calculate their administrative adjustments several days after the end of a month (including at year-end). In each of these cases, however, the resulting values are still treated under GAAP as having been determined “as of” the last business day of the year. Thus, these modest systems and model differences that lead to variations in dealer practices that are acceptable under GAAP should be irrelevant to a safe harbor based on book-tax conformity, particularly when the conformity requirement is buttressed by a condition of non-tax business use.

More broadly, ISDA believes that, at least in the context of valuing OTC derivatives, there are no substantive differences between the GAAP concept of “fair value” and the section 475 standard of “fair market value” and that the differences perceived by the court in the Bank One case are either non-existent or so immaterial that the former should be considered as “sufficiently consistent” with the latter for purposes of the safe harbor.²⁵

To summarize, the adjusted mid-market method, as applied by dealers under GAAP to value their OTC derivatives contracts, also satisfies the “fair market value” standard of section 475 and clearly reflects a dealer’s income with respect to those contracts. Moreover, because dealers use the same values for financial reporting and a broad range of other important non-tax purposes, they have incentives to be as accurate as possible. As discussed elsewhere in this submission, dealers also face competitive pressures to have accurate valuations.

2. Does GAAP permit the valuation of OTC derivatives at the bid price? Under the adjusted mid-market method, the pre-adjustment values of OTC derivatives contracts are determined at the middle of the market and thus reflect the interdealer bid/offer spread. As noted, the adjusted mid-market method is consistent with GAAP and it results in *higher* initial valuations than were previously obtained under an earlier method in which OTC derivatives were initially valued at either the bid or offer price.

As also noted, ISDA believes that the adjusted mid-market method is now applied universally by dealers. Moreover, dealers have a strong practical incentive to continue to use that method “. . . because a mid-market valuation system requires a dealer to construct and process only one swap rate yield curve (the mid-market curve), rather than separate bid and offer curves. This improves accuracy and also reduces computer processing times; the latter point is particularly important for swaps books of major dealers.”²⁶

²⁵ The Tax Court’s expert witness in the Bank One case concluded that “the elements of ‘fair market value’ and ‘fair value’, when the definitions of the terms are construed literally, were inconsequential when applied to [Bank One’s] swaps.” Bank One Corporation, 120 TC. No. 11, slip opinion at 210 (May 2, 2003).

²⁶ Association Brief at 18.

3. Does GAAP permit downward adjustments from mid-market values for future administrative, hedging, or financing expenses? As discussed in Part II, all dealers make adjustments from mid-market values, including adjustments for administrative, hedging and financing expenses. These adjustments are typically made on a dynamic and portfolio-wide basis and the costs taken into account in those adjustments generally are determined on a marginal or incremental basis.

These types of adjustments are necessary in order for a dealer properly to determine the fair market value of its OTC derivatives contracts under both GAAP and section 475. The adjusted mid-market method determines values by reference to the present value of the anticipated *net* cash flows from a dealer's derivatives contracts. This net cash flow approach is entirely consistent with the determination of fair market value under section 475. While a willing and knowledgeable buyer would make a payment to a dealer in order to acquire the right to receive the expected future cash flows from the dealer's OTC derivatives contracts, the buyer would net against those payments an amount based on the costs and losses it would expect to incur in realizing those cash flows.

The fact that, in accordance with GAAP, these adjustments include *future* expenses is not inconsistent with the requirements of section 475. As discussed in ISDA's prior submissions, a section 475 valuation method must take into account all factors that are relevant to determining fair market value, even though such factors include costs that could not be deducted, as of a particular year-end, under other accounting methods. Just as the MTM method (in contrast to accrual methods) requires recognition of unrealized appreciation, the MTM method requires consideration of *future* costs that affect value. The basic principle of matching requires that such unrealized costs be taken into account in the same way that unrealized gains are taken into account.

Under an accrual method of accounting, the all events test and the economic performance requirement must be met before liabilities can be taken into account under such a method. Likewise, taxpayers generally may not deduct reserves based on actuarial estimates of expenses, even though certain reserves are taken into account for financial

accounting purposes.²⁷ These principles are, however, irrelevant under section 475. Dealers applying a MTM method of accounting are neither permitted nor required to apply the principles of other methods. Thus, the all events test, like the realization requirement, is not relevant to methods used to determine fair market value under section 475.

4. Does GAAP permit one or more redundant downward adjustments from mid-market values for credit risk? As explained in Part II, dealers make adjustments to mid-market values to reflect credit risk. These adjustments are typically made by dealers on a portfolio-wide basis reflecting the widespread use of ISDA master netting agreements. This results in a netting of positions and thus in a smaller adjustment than might be necessary if credit adjustments were made on a contract-by-contract basis. Credit adjustments are an integral part of the adjusted mid-market method under GAAP. They are also essential to the proper determination of the fair market value of a dealer's OTC derivatives contracts under section 475 because a prospective and knowledgeable purchaser of the right to receive the future cash flows from the dealer's book of OTC derivatives contracts would take into account the risk of non-payment in determining the price it would pay to the dealer for that right.

The Notice appears to suggest that the Service does not disagree in principle with the fact that credit adjustments must be made to mid-market values in order to determine the fair market value of a dealer's OTC derivatives contracts under section 475. Instead, it appears that the Service may believe that such an adjustment is redundant since mid-market values as determined by a dealer's mathematical model use discount rates based on a counterparty's credit rating. This is not the case.

The mathematical models used by most dealers employ discount rates that assume that counterparties have the same credit rating (e.g., an AA rating) and that they have exactly the same level of creditworthiness. In fact, however, not all counterparties do have the same credit rating, and creditworthiness varies to certain degrees even within the same general ratings category. Dealers make adjustments to mid-market values to reflect these facts. For example, if a counterparty has less than an AA rating, a downward

²⁷ See, e.g., United States v. General Dynamics Corp., 481 U.S. 239 (1987).

adjustment is made to mid-market value since it does not appropriately reflect the counterparty's credit rating. Moreover, even if a counterparty has an AA rating, a modest adjustment may be made to reflect differences between the hypothetical AA credit rating assumption underlying the interest rate curves used in valuation models and the actual creditworthiness of the particular counterparty. This occurs when a dealer, in order to increase the precision of its valuations, makes its own internal credit assessments of counterparties in order to supplement the ratings issued by credit ratings agencies. Credit adjustments made by dealers do take into account collateral and other factors that directly reduce credit risk with respect to a counterparty, but the presence of these elements does not automatically make any further marginal credit adjustments redundant. For example, collateral may be provided for periods that are shorter than the terms of all of a dealer's OTC derivatives contracts with the same counterparty and, in such cases, dealers may make credit adjustments with respect to the non-collateralized portion of the revenue stream.

As is true in the case of certain other adjustments to mid-market values, dealer practices may vary with respect to certain aspects of the credit adjustment process. For example, a firm may make upward adjustments to mid-market values where counterparties have credit ratings that are higher than that used in their models. In addition, one dealer may reflect its own credit in its valuations while another dealer may not. Variations such as these are inevitable given the continuing evolution of the adjusted mid-market methodology, systems constraints and similar factors. The variations in dealer techniques with respect to credit adjustments are all permissible under GAAP and reflect dealers' efforts to value their respective OTC derivatives portfolios as accurately as possible. They should therefore have no relevance under a safe harbor based on book-tax conformity that is buttressed by a requirement that the valuations be used for non-tax business purposes to ensure reliability.

5. Types of adjustments that are currently used for financial statement purposes. Part II contains a description of many of the types of adjustments to mid-market values that are currently used by dealers for financial reporting purposes in accordance with GAAP. As discussed elsewhere in this submission, the fact that some dealers may use different labels for their adjustments or compute one or more of those adjustments

differently than do other dealers does not mean that dealers are using a different method of MTM accounting. All dealers are using the adjusted mid-market method and employing techniques intended to value their own respective OTC derivatives contracts as accurately as possible. The differences in nomenclature and technique in applying the adjusted mid-market method are all compatible with GAAP and thus should be irrelevant under a safe harbor based on book-tax conformity.

In ISDA's view, as explained elsewhere in this submission, it is critical to the efficacy of the proposed section 475 safe harbor that the Service and the Treasury Department condition the application of the safe harbor only on book-tax conformity and the use of book values for financial reporting and non-tax business purposes. If the safe harbor instead mandates use by all dealers of either an alternative method, or a single set of enumerated techniques in applying the adjusted mid-market method, the objective of the safe harbor to establish estimates of fair market value that are consistent with section 475, clearly reflect dealer income *and* reduce administrative burdens on the Service and taxpayers will not be accomplished.

6. FASB's consideration of fair value reporting of derivatives and the valuation of cash flows. The FASB has devoted, and continues to devote, substantial consideration to fair value reporting. For example, it has recently undertaken a study to explore the application of fair value reporting for a broader range of financial assets and liabilities. This project is an important one and ISDA welcomed the decision of the FASB to proceed. At the same time, however, ISDA does not believe that this undertaking has special significance to the consideration of a safe harbor under section 475 based on book-tax conformity. The FASB appears to have no inclination to abandon or alter the basic tenets of the fair value standard. The FASB's goals are to make the application of that standard more accurate and to apply it to a broader range of assets and liabilities. This is consistent with the policy considerations behind a safe harbor based on book-tax conformity.

In addition to the fair value project described in the preceding paragraph, the FASB's Emerging Issues Task Force (the "EITF") has undertaken a project intended to

improve financial reporting with respect to certain OTC derivatives.²⁸ This project, commonly referred to as EITF 02-3, is intended to provide guidance (in the form of minutes of EITF meetings prepared by the FASB staff) as to the type of evidence required in order for a dealer to recognize income, for financial statement purposes, at the inception of an OTC derivatives contract. The project was originally undertaken in the wake of well-publicized overstatements of value of energy-based OTC derivatives contracts.

Under EITF 02-3, a dealer may not recognize an unrealized gain at the time it enters into an OTC derivatives contract unless the fair market value of that contract is obtained from a quoted market price in an active market, is otherwise evidenced by comparison to other observable current market transactions, or is based on a valuation technique that incorporates observable market data. If none of these criteria is satisfied, then under EITF 02-3 the transaction price is treated as the best information available at the inception of the contract. In such a case, the “initial spread” determined under the dealer’s own valuation methods as of the date of inception may not be immediately taken into income by the dealer for financial reporting purposes.

While the recognition of the income represented by the initial spread between the transaction price and the value determined by the dealer using its normal valuation methodology may be deferred under EITF 02-3 and taken into income at a later date, subsequent changes in the valuation of the position are not affected and such changes are taken into income on a current basis. EITF 02-3 is a new rule and there is as yet no specific guidance as to the manner in which the initial spread should be reflected in income.

The application of EITF 02-3 may be illustrated by reference to an exotic OTC derivatives contract that, using the dealer’s standard valuation methodology, has a value at inception of \$10x. If the actual transaction price for the contract was \$0 (because no upfront payment was made by either party) and the evidentiary requirements of EITF 02-3 are not satisfied with respect to the contract, the dealer would not be entitled to

²⁸ EITF Issue No. 02-3: “Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities.”

recognize income of \$10x at inception for financial statement purposes. If, however, as a result of market developments, the contract thereafter increased in value by \$5x, that increase would be reflected in the dealer's income on a current basis for financial statement purposes, regardless of whether the \$10x has been taken into income as of that date.

Although the scope of EITF 02-3 has been expanded to include all OTC derivatives, it will not in fact apply to the overwhelming majority of OTC derivatives contracts, such as most interest rate and foreign currency swaps. In the case of these contracts, observable market data that satisfies one of the three alternative standards contained in EITF 02-3 is and will continue to be available. Instead, EITF 02-3 will have its principal impact in the case of so-called "exotic" OTC derivatives contracts, such as certain energy contracts. Moreover, it should be emphasized that EITF 02-3 does not change the definition of fair value even in the comparatively limited cases to which it is likely to apply. Rather, it sets forth evidentiary rules that must be satisfied before a dealer can recognize, for financial statement purposes, the dealer spread at inception produced by the dealer's valuation models. As noted above, where those rules are not satisfied, the recognition of the profit represented by the initial spread is only deferred and income attributable to changes in value resulting from subsequent events are reflected in income on a current basis.

ISDA believes that where EITF 02-3 applies for financial reporting purposes under GAAP, the adjustment resulting from its application should be respected under the safe harbor in accordance with the overarching principle of book-tax conformity in the valuation of OTC derivatives under section 475. As noted elsewhere in this submission, while fair value itself has a meaning that is consistent with section 475 principles, efforts are continually underway to make the valuation techniques under GAAP more precise. Moreover, dealers will have an incentive to base their valuations on existing observable data as much as possible in order to avoid unnecessary reductions in financial statement income and there are ongoing efforts in the marketplace to make such data available.

B. Principle Two: Financial Statements and Business Use

The Notice states that to qualify for the safe harbor, the taxpayer must have a strong incentive to report values fairly. ISDA agrees with the view expressed in the

Notice that the two factors most relevant in establishing that a dealer has a strong incentive to report values fairly are the use of those values for financial reporting purposes and use of those reported values in the dealer's business for non-tax purposes.

Permitting book-tax conformity where these tests are satisfied will ensure that valuations are as accurate as dealers can make them. Because dealers must determine the fair market value of their OTC derivatives contracts for a broad range of external reporting and regulatory requirements and because those values are relevant to numerous internal non-tax business and management decisions, dealers have strong incentives to measure the value of their derivatives positions fairly and to take into account appropriately all factors that are relevant to the determination of fair market values. Thus, use of the values determined for financial reporting and non-tax business and management purposes will carry out the purposes of section 475.

1. Reporting of Values on a Financial Statement. The Notice identifies certain types of financial statements and seeks comment on whether those statements (or others) are appropriate for the safe harbor. In ISDA's view, an audited financial statement that is provided to the SEC, any regulatory body, or to shareholders or creditors should qualify for the safe harbor. This category of audited financial statements should include statements issued by an entity other than the dealer where those statements contain data based on the dealer's OTC derivatives valuations, such as the audited financial statement of an entity (e.g., the dealer's corporate parent) with which the dealer entity is consolidated for financial statement purposes. (In some such cases, the dealer itself may not issue a separate audited financial statement.)

In this connection, it should be noted that independent auditors give direct attention to a dealer's MTM valuations (including in cases where the dealer's valuations are reflected in the audited financial statements of the dealer's parent entity). The audit process was described as follows in the Association Brief:

Financial accountants do not simply accept a swaps dealer's implementation of mark-to-mark accounting at face value. Instead, independent auditors carefully review those calculations every year. The purpose of these independent audits is to verify the reasonableness of a swaps dealer's valuations and to ensure that the swaps and derivatives contracts are fairly stated in accordance with GAAP. In particular, auditors contemporaneously review the swaps dealer's methodology to

ensure (i) that all the appropriate facts relevant to the value of the swaps have been considered, (ii) that the valuation procedures are reasonably and consistently applied, and (iii) that the underlying documentation supports the valuation. Auditors require that every swaps dealer's valuation model, at a minimum, address (i) the market factors that affect swap values, (ii) credit factors, (iii) liquidity factors, and (iv) transaction costs.

As part of their procedures, auditors (i) value representative transactions in a swap dealer's book using valuation methods independent of the swaps dealer's tools, (ii) independently validate the appropriateness and accuracy of the market data used in the model, and (iii) evaluate the appropriateness and completeness of the dealer's market value adjustment – all to ensure that the swaps dealer's valuation reflects fair value. If the auditor concludes that a swaps dealer's valuation procedures are inadequate or questionable, the auditor will be compelled to issue a qualified opinion to identify any material departure of the swaps dealer's valuation procedures from GAAP. (Footnotes omitted.)²⁹

In this connection, ISDA believes it is important for the Service to structure the safe harbor so that it will be compatible with the global nature of the financial services business. Specifically, some dealers that are subject to section 475 are affiliates of non-U.S. entities that are not subject to SEC reporting requirements (which mandate financial reporting based U.S. GAAP). Where the adjusted mid-market valuations of such a dealer are incorporated in an audited financial statement issued by the dealer's non-U.S. parent, the parent's financial statement should in ISDA's view be treated as sufficient to meet the requirement of the safe harbor that valuations be used for financial reporting purposes. The fact that such a statement may be prepared in accordance with non-U.S. GAAP to comply with the requirements of non-U.S. regulatory bodies generally should be immaterial.

2. Use of Financial Statement Values in Dealer's Business. As discussed in detail in Part II, dealers use OTC derivatives valuations determined under the adjusted mid-market method and reported in their financial statements for a broad range of important non-tax business purposes. Specifically, and in addition to meeting financial, regulatory and other external requirements, dealers use such OTC derivatives values for the following non-tax purposes: (a) to manage market and credit risk, (b) compensate key personnel, (c) evaluate lines of business, and (d) to determine which transactions to

²⁹ Association Brief at 34-35.

enter into (or hold) and which transactions to avoid (or terminate), and the prices at which such transactions are entered into or terminated. ISDA believes that the safe harbor should provide that the requirement of significant non-tax business use will be treated by the Service as satisfied if the dealer takes the profit and loss (“P & L”) effects of the adjusted mid-market values into account in making decisions with respect to one or more of the four non-tax business uses identified in the preceding paragraph.

For this purpose, however, a dealer should not be required to use adjusted mid-market values as the sole criterion in making such decisions. For example, the manner in which the P & L statement effects of OTC derivatives valuations are taken into account may vary from one dealer to another. In the case of some dealers, the P&L effects of these values are applied on a trader-by-trader basis, while other dealers may use these P&L effects to determine the bonus pool for a business unit and then allow the unit’s management to allocate the pool to and among the individual traders by taking into account additional factors. More recently, some dealers have begun to add other factors to their compensation (e.g., adherence to codes of ethics). Nevertheless, the P&L effects of OTC derivatives valuations remain a critical part of the compensation decision-making process. Similarly, while a dealer’s valuations are taken into account in determining the prices at which positions are entered into or terminated, actual prices are necessarily affected by other factors as well.³⁰

3. Application of the safe harbor to related party transactions. The Notice indicates that the Service and the Treasury Department are uncertain whether the safe harbor should encompass OTC derivatives contracts between related parties. ISDA believes that the safe harbor can and should be applied in such cases. ISDA understands that dealers generally value such contracts in the same way they value third-party contracts under the adjusted mid-market method, except that some dealers do not make credit adjustments with respect to related party transactions. Moreover, ISDA is not aware of any evidence that related party transactions receive substantially less regulatory

³⁰ In certain limited instances, a dealer may hold OTC derivatives contracts that are subject to section 475 but are not marked to market for financial reporting purposes. ISDA believes that, in such cases, it would be desirable to apply the safe harbor if the contracts are valued using the same methodology used by the dealer for its OTC derivatives that are marked to market for financial reporting purposes and the values are used for one or more non-tax business purposes by the dealer.

scrutiny than do third-party transactions. Indeed, it is often the case that at least one party to such a transaction is a regulated entity and, where this is true, there is regulatory scrutiny with respect to pricing. ISDA believes that related party transactions can be verified by the Service. If the Service concludes that section 482 is not adequate to prevent potential abuse in related party transactions, it could require that, as now occurs, related party contracts generally be valued under the same methodology as third-party contracts, but disregarding certain adjustments such as credit adjustments, which will generally have the effect of increasing values.

C. Principle Three: Recordkeeping and Record Production

1. General Observations. The Notice indicates that, under the safe harbor, examinations of returns would focus on how the values that are used for financial reporting purposes relate to gain or loss on the tax returns and that taxpayers would have to retain records to show that (a) the same value used on the financial statement was used on the tax return, (b) no security subject to section 475 and reported under the required methodology on the financial statement was excluded in the application of the safe harbor, and (c) only securities or commodities subject to section 475 have been carried over to the tax return under the safe harbor.

ISDA agrees that the Service does need to verify these three items. ISDA also believes that the Notice implicitly, and properly, indicates that the safe harbor verification and reconciliation process will be limited to confirming conformity between the values used for financial reporting purposes and those used on the tax return and will not include an independent examination by the Service of the specific techniques by which the financial statement values were determined in accordance with GAAP. As discussed elsewhere in this submission, the requirements that the values be used for financial reporting purposes and for non-tax business purposes provide adequate assurance that the values will be determined as accurately as possible. Stated more directly, the Service's verification should be limited to confirming book-tax conformity and the presence of the required non-tax business use.

ISDA also believes that, in prescribing the safe harbor, the Service should clearly identify a methodology that generally will be used by the Service to verify book-tax conformity. In ISDA's view, for OTC derivatives contracts, the Service should follow a

two-step approach in verifying conformity. First, the values used on the tax return should be traced to the taxpayer's general ledger (and sub-ledgers and other records that support the general ledger entries). Second, a determination should be made that the general ledger values are properly reflected in the qualifying financial statements (either of the taxpayer-dealer itself or of the entity with which the taxpayer-dealer is consolidated for financial statement purposes). In connection with this second step, ISDA would expect that in cases where the qualifying financial statement is an audited financial statement (or if the dealer's values are reflected in an audited consolidated financial statement of an affiliate), the section 475 "Accelerated Issue Resolution Program" should assist the Service in determining how to confirm that the general ledger values have been properly reflected in the financial statement. In ISDA's view, the independent audit process that results in an unqualified opinion, as described above, should be sufficient to ensure that the ledger values have been properly reflected in the dealer's financial statements.

2. Pooling and "Single Position" Verification. The Notice seeks comments on how OTC derivatives are pooled for purposes of financial reporting, how they are pooled for tax reporting and how the Service can verify the basis determination of a single position contained in the pool if that position is sold or settled in the year following the mark and other positions in the pool are not sold.

As noted elsewhere in this submission, dealers tend to hold their OTC derivatives contracts until maturity and thus may have a substantial number of such contracts at any one time. Dealers generally organize their outstanding OTC derivatives positions, together with certain related hedges, into "books". There may be a book for a particular type of financial risk (e.g., interest rates), managed by the traders responsible for each book, etc.³¹ These pools are generally used for both book and tax purposes.

Under the adjusted mid-market method, the initial mid-market values are determined on a contract-by-contract basis and recorded separately in the dealer's general ledger or in a sub-ledger. These values are directly verifiable by the Service, as are any contract-specific adjustments. The portfolio adjustments made by a dealer (e.g., credit adjustments) are typically reflected in the appropriate sub-ledgers on an aggregate basis

³¹ Association Brief at 12.

and gain or loss is then calculated, also on an aggregate basis, and reported in the general ledger. This is the gain or loss that is used for financial reporting purposes. When a position is terminated, it is removed from the portfolio and the year-end portfolio adjustments related to that position would thus not be included in the year-end valuations.

Thus, the Service will be able to examine separately the gain or loss for a position reflecting the model valuations and contract-by-contract adjustments, and should also be able to examine the portfolio adjustments made with respect to changes in the portfolio during the year. In short, each element that determines the adjusted mid-market values can be separately examined and verified by the Service. Because of their very nature, however, it would be extremely difficult, if not impossible, for the Service to deconstruct a dealer's portfolio adjustments to determine the actual effect of those adjustments on gain or loss for a single position.

In ISDA's view, the Service does not need to verify the computation of gain or loss on a position-by-position basis in order to administer the safe harbor properly. Verification of that kind is unnecessary in the context of a safe harbor based on book-tax conformity and buttressed by a requirement of non-tax business use. If conformity is absent, that fact will be evidenced by a Schedule M adjustment related to fair value on the dealer's income tax return. Thus, the Service should be able to verify the manner in which unadjusted profit or loss has been computed and that this computation, and the portfolio adjustments used to ascertain fair market value, appropriately reflect those OTC derivatives contracts that were terminated during the year.

3. Effect of Consolidation and Deconsolidation. The Notice also requests comments on the effect of consolidation and de-consolidation on determining whether the same OTC derivatives will be reflected on both the financial statements and taxable income.

ISDA does not believe the Service will encounter verification difficulties in this respect. Under GAAP, fair value is still determined for transactions between entities that are consolidated for financial reporting purposes and those values are reflected in the appropriate sub-ledgers and other supporting documentation. From the appropriate sub-ledgers, and the supporting documentation, the Service can identify the fair market value that should be used in the dealer's tax return to comply with section 475.

4. Records to be Retained and Taxpayer-Specific Agreements. The Notice indicates that the Service is considering rules that would require electing taxpayers to maintain specific records and supporting documentation. The Notice also indicates that the Service is contemplating a procedure under which taxpayer-specific agreements on record retention would be used. ISDA has no objection to the use of taxpayer-specific agreements, but urges the Service to include a set of reasonable record retention requirements in the safe harbor so that taxpayer-specific agreements would be used principally in the case of special situations.

IV.

Concluding Statement

ISDA welcomes this opportunity to comment on the proposed section 475 safe harbor. A safe harbor for OTC derivatives based on book-tax conformity, and a requirement of use of book valuations for financial reporting and non-tax business purposes will satisfy the requirement of section 475 to determine fair market value in accordance with applicable tax principles, carry out Congressional intent, result in the clear reflection of dealer income, reduce costs and administrative burdens for both the Service and dealers and reduce overtaxation or undertaxation of income from global trading operations.

ISDA believes it is useful for the Service and the Treasury Department to receive information on the manner in which dealers apply the adjusted mid-market method to value their OTC derivatives portfolios for financial reporting purposes. ISDA, however, also believes that it is critically important that the Service and the Treasury Department not use the differences in nomenclature and techniques that exist among dealers either to conclude that a safe harbor should not be prescribed or that such a safe harbor should be based on a single set of techniques mandated in the safe harbor following a survey of dealer practices. In this connection, even if all dealers were required to make the same types of adjustments, they would likely not make identical determinations of value because their assumptions regarding creditworthiness of counterparties, projected future market changes, etc. would not be identical.

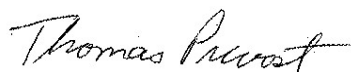
Thus, for the reasons set forth in this submission, the Service and the Treasury Department should use the discussion of dealer practices to confirm that, as is in fact the

case, the differences in nomenclature and techniques simply reflect the evolving nature and increasing sophistication of the valuation process and attempts by dealers to value their respective OTC derivatives portfolios as accurately as possible. Thus, in ISDA's view, the touchstones for a section 475 safe harbor for OTC derivatives should be limited to book-tax conformity and a requirement that such book valuations be used for non-tax business purposes to ensure that such valuations may be relied upon for tax purposes.

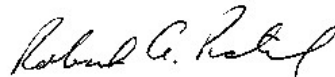
ISDA recommends that the Service and the Treasury Department permit dealers to elect to apply the book-tax conformity safe harbor to all prior open taxable years. It would be entirely appropriate to provide such an election. From a policy perspective, the promulgation of a book-tax conformity safe harbor will reflect a decision by the Service and the Treasury Department that the adjusted mid-market method results in an appropriate determination of the fair market value of a dealer's OTC derivatives portfolio under section 475. Where a dealer has in prior years used such values both for financial reporting purposes and non-tax business decisions, ISDA believes there are compelling policy reasons why such elections should be available. Moreover, if such elections are not permitted, there is a substantial risk the valuation disputes with taxpayers of the very type the safe harbor is intended to avoid will continue.

ISDA appreciates this opportunity to comment on the proposed safe harbor and requests that representatives of the Service and the Treasury Department meet with ISDA members to discuss the relevant issues in greater depth.

Very truly yours,



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