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*By Electronic Delivery*

August 9, 2006

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OECD Centre for Tax Policy and Administration
2, rue Andre-Pascal 75775 Paris Cedex 16
France

Re: Invitation to Comment on Transactional Profit Methods

Dear Ms. Silberztein:

This letter responds on behalf of the Securities Industry Association ("SIA")[1] to the Invitation from Working Party No. 6 of the OECD Committee on Fiscal Affairs to comment on the application of the transactional profit methods which are described in Chapter III of the 1995 Transfer Pricing Guidelines (the "Guidelines"). We have set forth below comments in relation to certain of the Issues included in the List of Issues for Consideration attached to the Invitation.

Our comments address these issues principally in the context of global dealing operations, which present the most complex transfer pricing questions for our industry. We have used the term "global dealing" broadly to refer to any

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1 The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2005, the industry generated an estimated $322.4 billion in domestic revenue and $474 billion in global revenues. (More information about SIA is available at: www.sia.com.)

integrated operations in which a financial institution and its affiliates in two or more jurisdictions engage in cross-border financial services transactions (and not in the more limited sense of the proposed U.S. Treasury regulations on global dealing).

Issue 1 – Status of Transactional Profit Methods as Last Resort Methods

The traditional transaction methods described in the Guidelines – the comparable uncontrolled price method, resale price and cost plus methods – and other transaction-based methods are premised on the existence of an identifiable transaction. In the global dealing context, application of these methods requires an identifiable transaction between two participants in the global dealing operation. For example, one or more of the traditional methods may apply where one participant sells an inventory security or foreign currency to another participant, who then resells the security or currency to an unrelated customer. Similarly, one of the methods may apply where one participant enters into a derivative transaction, such as a swap, with a customer and then transfers the risk associated with that derivative to another participant through a back-to-back derivative transaction. The traditional methods may also apply where one participant pays a sales commission to another participant that serves as a salesperson for a product that originates with the first participant.

None of the traditional transaction methods work, however, in the case of a global dealing operation that follows a "non-transactional" model, *i.e*., an operation in which two or more participants combine their resources to create and sell a financial product to an unrelated customer and to hedge any risks associated with the product. In this situation, there are no separately identifiable transactions between the participants. The product in question is not sold from one participant to another and then resold to the customer. Rather, the participants contribute various elements – such as capital, trading, product design, and marketing -- to the creation and sale of the product and to the management of associated risks, and the resulting profit or loss is then allocated among them. This type of joint effort is characteristic of the global dealing operations conducted by many SIA members in a variety of financial products.[2]

Profit and loss from this type of global dealing operation typically is not allocated on a transaction-by-transaction basis with reference to particular customer transactions. Rather, profit or loss derived by the operation as a whole over some period of time is typically allocated among the participants based on their contributions to the joint effort over that period of time. The traditional transaction methods, with their focus on comparing specific controlled transactions with specific uncontrolled transactions, simply do not apply where

[2] Also common are hybrid operations that combine a transactional model for some functions with a non-transactional model for other functions. The traditional methods likewise do not work for these hybrid operations.

the amounts being allocated arise from a grouping of customer transactions entered into over a period of time.

As alternatives to the traditional transaction methods, the Guidelines provide that transactional profit methods may be used, including the profit split method and the transactional net margin method. These profit-based methods are described, however, as “last resort” methods, the use of which should be limited to exceptional situations where there are no data available or where the available data are not of sufficient quality to rely solely or at all on the traditional transaction methods. In fact, however, the traditional transaction methods frequently cannot be applied in the context of a global dealing operation, for structural reasons rather than a lack of available data. Consequently, transactional profit methods cannot be described as “last resort methods” in this context.

It is important, therefore, that the Guidelines acknowledge the importance of transactional profit methods in the context of certain highly integrated business operations, such as global dealing. Further, given their primary role in this context, we believe that the Guidelines should recognize a wider range of transactional profit methods, including profit-based service fee methods and other unspecified methods. (See the discussion under Issue 11 below.)

Each of the transactional profit methods should be available in circumstances where the arrangement between the global dealing participants is designed to compensate each participant for its contribution to a joint effort leading to the creation and sale of third-party customer transactions and the management of associated risks. In that context, the methods should be available for the allocation of profit or loss derived from reasonable groupings of customer transactions, determined along product lines and occurring over reasonable periods of time. Arrangements involving intra-participant sales of financial products, or the execution of other identifiable financial transactions such as back-to-back swaps between participants, could continue to be addressed by the traditional transaction-based methods.

Further, the choice of a particular method (whether a profit-based method or a traditional transactional method) would be made on the basis of the particular facts and circumstances, including the structure of the operation, the existence of identifiable transactions among the participants or the lack thereof, the manner in which the participants allocated the risks of the global dealing operation among themselves, and the relative values of their contributions to the overall profitability of the joint operation. The method chosen should ensure that each participant receives appropriate compensation based upon the taxpayer’s particular facts and circumstances.

Issue 4 – Application of Transactional Profit Methods and Consideration of Risks

An issue of central importance to the application of transactional profit methods in the context of a global dealing operation is the treatment of capital and, in particular, the allocation of a return to capital that reflects the business risks borne by the capital provider. Under any profit-based method, the return allocated to capital should be based on a functional analysis, taking into account both the type and degree of risk borne by the capital provider (e.g., market risk, credit risk, legal risk, operational risk) and any contractual arrangement among the participants designed to shift risk away from the capital provider (and the fact that the capital provider will retain the cost of carry amount, as discussed below).

It is not unusual among financial institutions for the capital provider to receive all residual profit and loss from a global dealing operation where the capital provider bears all of the market and credit risk associated with the operation. Other participants in this situation typically receive a fee or some type of profit-based compensation for services. To accommodate this situation, the Guidelines should state clearly that a capital provider may receive an allocation of the residual profit or loss, after compensating other functions, such as trading and marketing, under an appropriate methodology.

On the other hand, if the capital provider contracts with the other participants in a global dealing operation to bear none of the market risk and only credit risk (like a lender), then it is normally appropriate to allocate the capital provider a market-based interest-rate type of return. Numerous other variations are possible between these two extremes. For example, the capital provider may share the residual profit or loss with the other participants in the global dealing operation. Therefore, it is important that the Guidelines reflect that the return allocated to capital may vary according to the risks assumed by the capital provider and the value of its contribution to the overall operation (and taking into account the fact that the cost of carry amount has already been allocated to the capital provider).

In this regard, we note that Part III of the Discussion Draft on the Attribution of Profits to Permanent Establishment prepared by Working Party 6 (herein the "Discussion Draft") appears to ignore these functions in allocating and sourcing the return to capital. Instead, the Discussion Draft effectively attributes capital to the location in which it is "employed," as determined solely by the location of the trading and marketing personnel. While this approach may be appropriate in certain situations, it is inappropriate in others. The Discussion Draft fails to recognize that in other situations an appropriate amount of profit may be allocated to the trading and marketing functions through a fee for services or other profit-based compensation, and the remaining profit allocated to the home jurisdiction of the capital provider where market, credit and other risks are borne.

Issue 6 – Application of a Profit Split Method: Determination of the Profit to Be Split

It is often appropriate to apply a transactional profit method with respect to operating profit from a global dealing operation (rather than, for example, gross profit). In determining operating profit, however, financial institutions normally take into account the “cost of carry” charged by the firm’s internal treasury function to the global dealing participant that provides the capital and serves as the booking location. Accordingly, the Guidelines should reflect that operating profit or loss from a global dealing operation may be reduced by the cost of carry prior to allocation under one of the profit-based methods. The effect of reducing operating profit or loss by the cost of carry is that gross revenues in an amount equal to the cost of carry remain with the capital provider (rather than being allocated away to another participant).

Cost of carry may be determined by a firm’s treasury department in a variety of ways. For example, some firms may base the cost of carry on the actual or estimated cost of the firm’s external financing, while other firms may charge a rate based on the opportunity cost of the capital provided or a rate comparable to the return that an external bank or equity investor would have required from the operation. However determined, the cost of carry is applied against the income of the global dealing operation in order to measure profitability for management reporting purposes. A global dealing operation cannot be conducted without capital, and the global dealing operation does not have “free” access to the firm’s capital. Rather, the cost of carry represents the effective cost to the firm of utilizing its capital in the global dealing operation. Although it is not an actual external expense, it is similar in the sense that the capital provider cannot obtain and furnish its capital unless it earns that minimum amount.

Therefore, it is appropriate that the capital provider retain an amount of gross revenue equal to the cost of carry, and that this amount reduce the operating profit or loss that is subsequently allocated under a profit-based method. Mechanically, the profit-based methods could be applied as the second stage of a two-stage process. In the first stage, any function that is to receive a return not based on profits would be allocated that return. For example, if the taxpayer had determined that it was appropriate for the back office function to receive a “cost-plus” return, that return would be calculated and allocated to the participant providing the back office function. In the second stage, after all non-profit-based returns have been calculated and allocated, operating profit would be determined. Alternatively, a “total profit split” could allocate profit in a single calculation, without any functions receiving a non-profit based return. In either case, the cost of carry would be applied to reduce operating profit. As noted above, the effect of this reduction is that an amount of gross revenue equal to the carry amount will remain with the capital provider/booking entity. Once operating profit has been computed, it would be allocated, in accordance with one of the profit-based methods, among the participants that are to receive profit-based returns. As discussed below, those participants could include the capital provider, in which case the capital provider would retain both the cost of carry amount and an additional profit-based amount.[3] Failure to address cost of carry in this manner produces distortive results, because the return allocated to the capital provider is then too low in relation to the value of its contribution, while the return allocated to other global dealing participants is artificially high.

The cost of carry that is taken into account for tax purposes should be the same amount that is used for management reporting purposes. In other words, a firm would not be permitted to apply a cost of carry computed solely for tax purposes. Further, we believe that the cost of carry amount used for management reporting purposes should be presumed to be an arm's length amount, in view of the fact that the global dealing operation is only one of many business lines competing for the firm's capital.

Finally, it is important to understand that cost of carry is not an external expense, and reducing operating profit or loss by the cost of carry amount does not mean that external interest expense is being allocated under the profit-based method. Rather, the firm's actual external borrowing cost, and other external costs associated with raising capital, would continue to be allocated separately. Cost of carry is a purely internal measurement that should be used as a proxy for allocating a portion of the global dealing income to the function of providing capital. Once this allocation is made, it becomes necessary to "back out" the cost of carry from the operating profit that is allocated to participants receiving a profit-based return.

Issue 8 – Application of a Profit Split Method: How to Split the Profit

1. Losses. The Issues list requests comments on differences in the application of a profit-based method that may arise where the result to be allocated is a loss rather than a profit. In this regard, we recommend that the Guidelines make clear that a taxpayer using a profit-based method need not allocate both profits and losses among all participants. While some securities firms do choose to share profits and losses from a global dealing operation among all participants, not all firms choose to do this. Regulatory constraints in particular countries often prevent a regulated participant from sharing in losses booked in a related participant. Alternatively, the business arrangement among the participants may be that one participant bears all residual loss (and receives all residual profit) from the operation, while the other participants receive only a share of positive profit, if any. Requiring the sharing of losses in all

[3] We note that where no other participant receives a profit-based return, and all residual profit or loss remains with the booking entity/capital provider, cost of carry is effectively irrelevant because operating profit does not need to be computed for allocation to other participants. Cost of carry is included by default in the amount retained by the capital provider.

circumstances would effectively impose a partnership arrangement on the participants, when in fact the business arrangement may be very different.

In addition, the profit-based methods should not preclude the allocation of losses to the function of providing capital. As indicated above, it is quite common among securities firms for the capital provider to receive all residual profits and losses from a global dealing operation (as its return for bearing the risk of the operation) while other participants receive a fee or some type of profit-based compensation. The Guidelines need to accommodate this type of arrangement.

2. Comparables. There are virtually no uncontrolled transactions that can serve as true comparables for the transfer pricing analysis of a global dealing operation. As a practical matter, unaffiliated institutions simply do not establish joint operations to develop and market securities. In that context, it would be very useful for the OECD to prepare and publish a description of the various acceptable profit-based methods that have been used by international taxpayers to allocate profit and loss from global dealing operations. A good source of acceptable methods would be the methods that have been used in bilateral or multilateral advance pricing agreements. This could serve as guidance for both taxpayers and tax administrators in reaching agreement on methodologies that allocate income fairly among jurisdictions and avoid taxation of the same income in multiple jurisdictions.

Issue 11 – Other Methods

As indicated above, we believe that the profit-based methods in the Guidelines should be expanded to recognize a wider range of transactional profit methods, including profit-based service fee methods and other unspecified methods that may be appropriate in particular facts and circumstances.

A profit-based service fee method could apply in situations where the capital provider bears all or substantially all of the risk associated with the global dealing operation and the other participants receive profit-based compensation for providing trading and possibly marketing functions. This situation often arises when the other participants are regulated entities that are not permitted to share in losses realized by the capital provider, or where the contractual relationship between the affiliates provides that the capital provider will assume all of the credit and market risk. The trading function would typically receive profit-based compensation, which might be determined as a percentage of positive profit (if any), as a dollar amount determined by reference to the traders' bonus compensation or in some other manner. If the trading function were located in more than one participant, the total amount allocated to the trading function would be divided among those participants using a factor such as headcount (appropriately weighted) or trader compensation.

The marketing function could be compensated either with a sales commission or in a manner similar to the trading function. The appropriate type of compensation would depend upon the degree to which the marketers were involved in designing and tailoring the financial product. A marketer who had little or no input in product design would normally be compensated with an arm's length commission, while a marketer who was integrally involved in tailoring a product to the needs of particular customers might receive a profit-based compensation.

In a variation of this method, the traders may be compensated in two components – one intended to cover their costs and the other designed to reward them for profitability, while the capital provider receives all residual profit or loss. This method is similar to arrangements used by hedge funds, and hedge funds might serve as comparables for certain global dealing operations with appropriate adjustments if necessary. In the context of a global dealing operation, the trading function might receive a fee computed as a percentage of net asset value under management as a proxy for the costs that it incurs. Alternatively, the trading function could be allocated a specific percentage of gross revenues or positive profit as cost compensation.[4] In addition, the trading function would receive an agreed percentage of net operating profit as compensation for its trading contribution. That percentage might be a flat percentage regardless of profitability, or it might start out at a relatively low level but then increase once a "hurdle" rate of return was reached. As in the case of the trader compensation method, marketers would be compensated in a manner appropriate to the particular role that they play, whether as salespeople or as participants in product design.

We note that Paragraphs 158 through 160 of the Discussion Draft reject the suggestion that a hedge fund might serve as a useful transfer pricing model – in particular, by providing an appropriate comparable for determining a reward to capital. Although Paragraph 159 indicates that the hedge fund model may be appropriate for proprietary trading, Paragraph 160 concludes that the hedge fund model is not useful for customer businesses which "tend to be driven primarily by commissions and spreads rather than trading gains". We believe that this conclusion reflects an inappropriate generalization with respect to the manner in which global trading operations are conducted. Global trading is an evolving business in which trading gains and principal transactions – in conjunction with customer transactions – are becoming increasingly significant. Moreover, this conclusion, together with the general emphasis of the Discussion Draft on profit split methods, fails to give weight to the contractual relationships that may actually exist between affiliated enterprises engaged in global trading.

4 Another alternative is that actual trading costs may be reimbursed and traders receive just an agreed percentage of net operating profit as a return for their trading contribution; this situation, however, is quite similar to the profit-based compensation method.

The Guidelines and the Discussion Draft should reflect instead that the transfer pricing analysis should begin by examining the contractual arrangements between the two enterprises in relation to the assumption of risk. The transfer pricing methodology and the appropriate comparable should then be chosen in light of those arrangements, and any other relevant facts and circumstances. Neither the Discussion Draft nor the Guidelines should summarily reject any existing business model as a potential comparable, including a hedge fund model.

3. Unspecified Methods. Finally, the Guidelines should make clear that alternative methods for allocating operating profit or loss are possible and may be more appropriate than the specified methods, depending upon the business arrangement among the participants.

Issue 12 – Other Issues

Finally, we would like to reiterate here the substance of comments we have previously made in connection with the Discussion Draft that any discussion regarding the allocation of profit from a global dealing operation clearly reflect the analytical structure of the Model Tax Convention.

Under Article 5 of the Model Tax Convention, an independent agent acting in the normal course of its business generally does not give rise to a permanent establishment of another enterprise. On the other hand, a dependent agent that habitually exercises authority to conclude contracts in the name of the nonresident principal can constitute a permanent establishment of its principal.

When analyzing a global dealing operation that involves two or more related participants, the first step must be to determine whether a participant in the host country is a dependent or independent agent of a participant in another country under Article 5. If the host country participant is determined to be an independent agent, then Article 9 and the Guidelines should be applied to determine the appropriate amount of income or loss to be allocated to the participant in the host country and to the other participants. This allocation is final, in the sense that any amount attributed to a participant outside the host country cannot subsequently be reattributed to a permanent establishment in the host country.

Where the participant in the host country is a dependent agent, Article 9 and the Guidelines still apply to determine the amounts properly allocable to the host country and non-host country participants. In the limited circumstance where a dependent agent habitually exercises authority to conclude contracts in the name of a nonresident principal, a portion of the amount allocated to the nonresident principal may be attributed under Article 7 to a permanent establishment of the nonresident principal in the host country. However, Article 9 and the Guidelines should always play the primary role in determining the amount of income from a global dealing operation that is allocable to a host country. A host country should not seek to attribute profits to a permanent establishment as a means to adjust the results of a transfer pricing analysis.

In fact, we believe that in the majority of global dealing situations, the outcome of the agency analysis under Article 5 will be that the local participant is an independent agent of other nonresident affiliates participating in a global trading operation and therefore does not constitute a permanent establishment of those nonresident enterprises under Article 5(5). Many large financial service firms, and particularly securities dealers, operate globally through local broker-dealer subsidiaries. The primary reason for this is that the laws and regulations of many countries effectively require operation as a separate, locally organized entity in order to facilitate compliance with local rules and local regulatory supervision of front office activities, internal operations, capital adequacy and management. Each local broker-dealer or broker-dealer group will typically employ its own staff of traders and/or marketers, as well as middle and back-office personnel. Traders employed by a local broker-dealer may have a range of responsibilities, including the ability to enter into trades that "are booked in the accounts of a nonresident enterprise." Typically, only one locally-organized broker-dealer entity in a multinational firm will have the legal ability, operational infrastructure and trading expertise to engage in securities transactions in a particular host country. As a consequence, nonresident enterprises in the group will need to use that local broker-dealer as their agent in order to execute customer transactions in the host country. In this situation, the traders of the agent broker-dealer perform substantially all of the activities related to the transaction (including execution of contracts), but will do so on behalf of the nonresident principal entity.

In general, we believe that a local broker-dealer subsidiary functioning as the agent of nonresident affiliates in local securities markets will qualify as an independent agent of its nonresident principals, and thus should not be treated as a permanent establishment of its nonresident principals. The Commentary to the 2003 version of the Model Tax Convention (the "2003 Commentary") provides that an independent agent must be "independent of the enterprise both legally and economically". The 2003 Commentary then lists a number of factors that should be considered in determining whether an agent is independent. The application of these factors will normally result in the conclusion that a local broker-dealer subsidiary of a multinational securities firm is independent. This is because local broker-dealers typically maintain independently adequate capital as required by local regulators, earn diversified revenue streams from unrelated local customers and transactions, are independently managed and regulated, employ significant workforces, and possess locally specialized expertise. In that context, application of a transfer pricing method under Article 9 and the

Guidelines will be the first and only step in determining the appropriate amount of profit that is allocable to the host country.

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Thank you for your consideration of our views. Please do not hesitate to contact me (at 202.216.2031 or pmcclanahan@sia.com) or Emily McMahon of Sullivan & Cromwell, SIA's outside counsel on this matter (at 202.956.7675 or McMahonE@sullcrom.com), if you have any questions or would like any additional information regarding the foregoing.

Sincerely,

/s/

Patricia McClanahan
Vice President and Director for Tax Policy
Securities Industry Association

Cc: Mary Bennett
Jacques Sasseville