

**COMMENTS RECEIVED FROM A JOINT WORKING GROUP REPRESENTING:
THE BRITISH BANKERS ASSOCIATION (BBA)
THE LONDON INVESTMENT BANKING ASSOCIATION (LIBA)
THE ASSOCIATION OF FOREIGN BANKS (AFB)**

**OECD REVISED DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO
PERMANENT ESTABLISHMENTS - PART III (ENTERPRISES CARRYING ON GLOBAL
TRADING OF FINANCIAL INSTRUMENTS)**

1. The British Bankers' Association (BBA), London Investment Banking Association (LIBA) and the Association of Foreign Banks (AFB) welcome the opportunity to comment further on the issues raised by Part III of the revised OECD Discussion Draft on the Attribution of Profits to Permanent Establishments (Enterprises carrying on Global Trading of Financial Instruments). We will be commenting separately on the revised Part II (banks). The three associations represent the large majority of UK and foreign owned banks and securities houses operating in the United Kingdom. Our representations have been drawn up by a working party which includes representatives of groups headquartered in eight countries, while the draft response was circulated for comment to over 300 banks and securities houses.
2. The OECD proposals are very important to the operations of our members in London, the city with the greatest number of international banks in the world. Hence we submitted written comments on the original 2001 proposals and participated in the discussions held in Paris in April 2002. In addition to these further written comments we look forward to participating in any future debate on the important issues raised here before any final decisions are taken.
3. We firmly believe that a further period of study will be required in order to arrive at an acceptable and workable solution. Hence we continue to urge that no immediate action be taken before all aspects have been fully worked out; in particular the relationship to Parts I, III and (if still to be issued) IV. Any implementation must also only be on a prospective basis to allow for necessary systems/law/treaty etc. changes. It is equally necessary for the commencement date to be coordinated if confusion, uncertainty and, inevitably, double taxation are to be avoided.

Detailed Comments

Numbering in this paper follows the paragraph numbers in Part III of the Discussion Draft

8. We note that the Discussion Draft excludes proprietary trading. We assume that where a proprietary trading book, ie one that does not include market making activities, is traded globally, the principles set out in the report should apply, with necessary changes (for example, credit risk may need a different approach). We assume "market making" just means dealing with customers, not full two-way pricing, as in the UK.

16. We would note that with most exchange traded derivatives, the customer in fact deals with a broker or similar as principal, and the broker deals with the exchange, or its central counterparty. While the broker may be called a "riskless principal", it does in fact take the customer credit risk, even though it does not take the market risk.
- 21ff. We fully agree that it is important to note that institutions choose the parts of the market in which they operate. We believe that this process, and the decision where to operate and how, in some circumstances are relevant considerations in performing the functional analysis of how the MNE operates, and should be taken into account in the transfer pricing methodology. This is discussed in more detail at 85ff. and 137ff. below.
26. As noted above, we believe that the role of the committee or similar that sets overall trading limits is important, and possibly can be underestimated.
53. We would note that in practice a trader will consider what market risk exposure he wants, and adjust his book accordingly; he is unlikely just to accept the position customer trades have given him per se. He may as well increase market risk as leave it outstanding or eliminate it.
59. We would note that Treasury functions have become more complex in recent years. Margining need not be cash - bond repos may be used, for example. OTC contracts can now be margined using credit support annexes or deeds, and margining and collateral management have increased in importance, and have virtually in some cases become an activity in themselves, as noted in 69.
61. A Treasury book will hold securities (eg "liquidity gilts") and also if it sees a structural surplus or deficit, may invest or fund it on a long-term basis now. Some institutions virtually have a "Longer term Treasury trading desk".
63. Another key advantage of the Treasury desk entering into these internal deals is that it allocates risks to those areas that deal with them, as set out in 51.
- 71/3. As noted at 21. above, we feel that the importance of the central allocation of risk limits described here is sometimes underestimated, and may need to be taken into account in a proper functional analysis of some global trading operations.
- 74/76 Operational risk management/Accounting/Product control. We agree that these functions are important in a profitable trade in financial instruments, and that their importance has been increasingly recognised in recent years. However, we believe that it still remains the case that this function is not a profit-creating activity, nor that managing operational risk should be seen as similar to managing market risk. It therefore should not attract a share of profits as its reward, but should be seen as a cost, to be rewarded either on a cost or cost-plus basis if no CUP can be identified.
78. We believe that the statement that "compensation will usually reflect ... the assets used ... in performing ... functions" can be ambiguous. Where a business uses assets, in one sense, the reward should include income those assets produce (eg dividends on shares). On the other hand, a business should be charged for the assets it uses, eg by imposing a funding cost. Arguably, where two centres trading independently produce similar gross profits, but one uses twice as many assets as the other, the second one should be more highly rated. Assets employed may be used as an indirect measure of level of business undertaken, and so as a factor in allocating profits in a formulaic apportionment, but we think that is a separate matter.

82ff. We fully agree that the essence of trading in financial instruments (whether globally or not) is the assumption and management of risk. However, we think it important to distinguish between various categories of risk, and also to analyse how risk is assumed and managed.

We believe that different risks vary not just in degree of importance, but also in kind. We believe that market risk and its management is very much of the essence of trading in financial instruments. However, we believe that operational risk is not; it is important, but it does not create profit. It is more akin to the personnel function or health and safety management in a manufacturing environment, while market risk is more akin to the manufacturing process itself. We believe that operational risk and the other risks discussed in 93-95 should not be analysed similarly to credit and market risk, though to some extent the risks discussed in 94 include elements of credit and market risks.

It is also important to recognise that different teams will deal with various aspects of market risk. These functions can be considered under four headings:

Allocation of risk

The decision as to how much market risk a trading activity can assume will be set by senior management, and not the trading team, though the head of a trading team may well set a lower limit for certain sites or traders under his control. For example, the head of a global bond trading operation using a modified form of the separate enterprise trading model may well allow a separate trading book in another location only a low limit, to allow that location to service customers "overnight" without allowing it to build up a major position. However, it will remain the case that the main allocation of risk to a trading activity is a central function of the MNE, not under the control of the traders, but an external condition within which they have to operate.

Assumption of risk

This clearly is done by the traders, when deals are executed.

Managing of risk

Again, this will be done by the traders.

Monitoring

This will be done by a team separate from the trading function with separate reporting lines. This separation of function is a key aspect of internal control, and should be present in all trading operations.

85ff. In broad terms, credit risk limits are allocated, and credit risk is assumed, and monitored, as market risk is, and the central allocation of limits and the separation of the monitoring from the managing are equally important. Generally, the trader assuming credit risk by entering into a deal, as noted, does not do that with the object of taking credit risk and managing it himself, as would be the case with market risk. The trader simply knows the counterparty limit, set by the credit risk management function, and ensures that new deals do not breach it. However, as noted, the introduction of credit derivatives now has given rise to a situation in which credit risk has in one sense become another market risk to be traded and managed. It still may be the case that a credit derivatives trader has two sets of limits to observe - counterparty credit risk, relating to those with whom he deals, where he will have limits and deal with them similarly to his

colleagues trading interest rate swaps, and limits relating to the reference entities for his derivatives, which are his equivalent of market limits. There is further comment on transfer of credit risk and credit derivatives at 245.-250. below.

87. As noted in 69. it is increasingly common for the credit risks arising from OTC derivatives to be margined.

88. We would stress that the functions of credit risk management and monitoring should be strictly segregated, for internal control reasons. We agree that credit risk management and the related activity of collateral management are becoming independent activities.

98. We note that it is accepted that a trading team can set up business by entering into some form of joint venture with a well capitalised institution or with a suitable guarantee from such an institution. We would suggest that this could in some circumstances provide a useful model for functional analysis and identifying suitable arm's length rates for transfer pricing.

107-108 We welcome the recognition that some commercial structures are best dealt with using profit-split methods. We agree that these can in practice give rise to difficult problems in determining the finer details of allocations, and where a fee arrangement for which a CUP can be constructed, it might be easier to follow that model. However, in certain situations a profit split can well be the best model, and not just a method of last resort.

108. We believe that the relationship between bonuses paid to dealers and profits generated by them is rarely as simple as set out here. Bonus levels may well reflect perceived future potential, or the general or particular possibility of the trader getting another job. The importance placed on factors such as how well a trader co-operates with colleagues is as likely to reflect the ethos of the employing MNE as the particular trading model used.

120-122 We agree with the factors discussed here which identify when the marketing function may be entitled to a positive amount even when the activity as a whole makes a loss, and think it is helpful in dealing with the wider issue of allocating a loss posed at 178.

129. We agree that proper functional analysis is needed when the complexities described here exist, and believe that this is an example of where the detailed consideration of risk discussed under 82ff. above is needed. There could be cases where the "trading" entity with the limited role is still performing little more than a selling or marketing role, and should be recompensed accordingly.

137ff. We feel that the discussion in this section, and particularly in 147., assumes that where one entity possesses capital, and another undertakes the trading, and the former assumes high levels of risk, there is unlikely to be a CUP, and that traditional methods might not be available. This seems to foster a view that these trading arrangements would not take place between otherwise unconnected parties, and that the capital owner could establish a p/e in the jurisdiction of the trader, which would be its dependent agent. We believe that the "hedge fund" model provides a good paradigm for this, where the investors place their capital at the disposal of the hedge fund managers, and that this could in some circumstances provide suitable CUPs for the remuneration of the trader, in the form of a profit-related fee. We would also add that this model does to some extent cope with the issue of allocating a loss posed at 178. - the investors suffer it. We feel this approach deserves more serious consideration than it is given in 148. In a typical hedge fund, the rights of the various parties and their risks and rewards would be very carefully set out in some detail. The investor in hedge funds, deciding where to allocate his capital, is acting very

similarly to the committee setting overall trading limits and risk limits discussed at 21.ff and 71.ff. The decision as to how much of the institution's resources to allocate to particular activities can be a key element in its overall profitability, and should be rewarded accordingly. It is not dissimilar to a department store's management determining how much floor space and staff to give to each department based on likely demand for the goods and the margins achievable.

150. We accept that the measure of profits to allocate is a familiar issue, but would hope that some recommendations could be provided. It seems to us that in general it must be preferable wherever possible to follow the accounts of the taxpayer. Enterprises carrying on global trading of financial instruments will need for their own purposes to keep accurate accounting records, and will be under considerable regulatory constraint to do so. While the basis of recognition of taxable profits in different jurisdictions occurs in other activities, it is most acute in this area, and we should have thought this solution should be most acceptable. It is difficult to see how double taxation can be avoided if jurisdictions use different measures of profit. Similarly, where use of regulatory capital is relevant, we would hope that jurisdictions would accept wherever possible the methodologies used by the enterprise's lead regulator, if any.
151. We would note that minimising the activities combining to produce a pool of profits to split, by excluding the treasury book, as considered here, would again help allocate a loss.
- 166/7. As noted at 82ff. above, it is important to distinguish between monitoring risk, allocating risk limits, and assuming risk, as well as distinguishing between market and credit risk. We would add that the decision, likely to be taken at a high level, as to which trading activities should be undertaken, and the amount of such business, should be taken into account, possibly in the reward for the provision of capital; again, the hedge fund model is relevant.
171. We believe that the importance of compensation as the determining factor may be over-emphasised, and should not be applied too mechanistically. The matters noted relating to bonuses at 108. above apply here too. In practice, it would be difficult to split any compensation package between the amount relating to performance and that unrelated to performance.
173. We believe that the issue of double counting by using overlapping factors may be over-emphasised. We would agree that this should be taken into account when weighting factors, but feel that a better result may be obtained by using more, if overlapping, factors suitably weighted, rather than concentrating on a few exclusive factors.
178. Dealing with losses under a transactional profit split method. We agree that the problem is difficult, and think it will have to be accepted that a different formula may be needed to deal with profits than with losses, either modifying or not using some factors when a loss is realised. It is common to do this in commercial partnerships, where one partner may bear a larger proportion of losses than profits, or certain allocation factors may be used only in a profit or in a loss situation. As suggested at 120. and 151. above, the problem should be minimised if possible by reducing the functions that need rewarding using this method. Volume-based factors would clearly still be appropriate. Marketers could well be rewarded on a profit-share only when there are profits, leaving the traders to share in a loss; possibly in these circumstances, a minimum level of sales commission could be thought appropriate, as would probably have to be paid to a third-party broker. Remuneration clearly would be inappropriate as a direct allocation factor, and the only practical solution may be to omit it. That said, it is possible that traders would be rewarded to recognise their efforts in minimising losses in difficult market circumstances, and if it were thought essential to recognise this in the profit split method, a portion of the loss would have to be allocated in inverse proportion to the traders' remuneration. We believe that this sort of

consideration makes it harder to find a "one size fits all" methodology, and taxpayers can only construct sensible methodologies based on a proper analysis of their own circumstances.

- 179ff. We believe it important in considering the allocation of profits to reflect assets used and risks assumed to distinguish between assigning assets and using assets. Where senior management of an enterprise allocate a portion of the available resources to a particular trading activity, they are actively affecting its profits, and we believe this should be recognised; our comments at 137ff. above concerning a hedge fund model apply here. It is arguable that the traders using resources should be charged rather than rewarded for so doing, which this would achieve. Using "risks assumed" as a factor could in some circumstances be seen as an appropriate form of volume measure.
- 187/8. We are not persuaded that the conclusion: "Accordingly, it is not possible for one part of the enterprise to be treated as possessing the capital needed to support a certain amount of risks assumed where those risks have been properly attributed to another part of the enterprise .." follows logically from what precedes it. If the PE is to be treated as a separate entity, if no-one in that PE is involved in allocating capital to it, that function being carried out at head office, the logical solution may be to ascribe the reward for efficient use of capital to the location that does this. We see no reason why if appropriate head office should not be seen as a hedge fund investor, and the PE as the hedge fund manager. If the WH is to be used, we think it should be followed through as far as it is of use. Here there is a clear business relationship, similar to one existing between independent parties, and it seems obvious to follow it.
- 212/3. As you are aware, it is thought to be debatable whether the WH really does require a PE to be considered to have the same credit rating as the whole enterprise. Leaving that issue aside, we believe that the implications of this for the global trading of financial instruments is different from those for banking. The prime object of trading in financial instruments is to make profits by assuming and managing market risk, not credit risk, and unlike in normal banking, managing the credit risk may in fact be done elsewhere than where the main trading/profit creating activity takes place. Where allocating credit limits and managing credit risk does not take place in the PE, we see no logical reason why the reward for so doing should not be recognised in that other place, and it could well be in some circumstances that a guarantee fee or similar charge should be made.
214. We appreciate the validity of the reasons set out here for treating capital and funding issues similarly for banking and trading financial instruments. However, while there may be reasons for applying the same treatment to banks in their traditional roles as lenders and borrowers and to non-bank deposit taking institutions we think they do not apply here. We believe that pure banking activities may well require a different treatment from trading financial instruments, whether carried out by a bank or not. However convenient it may seem, we see no logical reason for applying rules that may suit a bank in its traditional activities of borrowing and lending to a non-bank that trades financial instruments simply because some banks trade financial instruments.
235. May we again stress that we see no logical reason why it is impossible for the WH to allow any circumstances in which the provision of capital is an identifiable activity requiring a proper reward. We think this can clearly be happening in some enterprises, and that suitable models (eg the "hedge fund" one) exist to allow a proper allocation of income to it.
- 245-250 Risk management functions and internal transfers of risk. We believe firmly that where "mirror swaps" are used as described, and of course subject to the caveats given, they should be

recognised for tax purposes. If a Centralised Product Management model is used, with different PEs marketing and only one managing the market risk, then we think this is the only sensible model to use. It may well be that the enterprise, possibly for regulatory reasons, has a subsidiary rather than a branch in one location, and that subsidiary has to enter into mirror swaps to allow the MNE to manage risk centrally, but let the local customers contract with the local entity. If possible, we feel the branches, as similar separate enterprises under the WH, should be treated similarly. We also feel that where the single enterprise with several PEs is set up in this way, there should be no theoretical need to enter into formal deals with the risk-managing PE to allow this treatment to apply. We fully agree that if this is done, proper transfer pricing analysis will be required, as set out. Where, for example, a PE's (or indeed subsidiary's) role on a full analysis is really just to sell the derivative risk-managed elsewhere, that should suffice and allow it to receive a salesman's reward. Again, we see no reason why this should not be done where credit risk is managed in one location, if appropriate using credit derivative prices as a means of allocating profits. Under a standard credit derivative, one party (the "protection buyer") pays a periodic swap fee to the "protection seller" in respect of a stated notional amount of the "reference asset" (the traded debt concerned). If there is no "credit event" (typically insolvency, default on particular classes of debt) affecting the reference assets, no further payments are made. If there is a credit event, the protection buyer has the right (depending on the terms of the agreement) either to deliver the notional amount of reference asset in return for its par value, or to be paid the difference between par and market value. It must be stressed that while one might expect the protection buyer to hold the reference asset, this is not a requirement of the derivative, and it could well be a financial trader taking a market position. A credit derivative typically does require the reference entity to have issued marketable debt, and credit events are strictly defined, but their pricing clearly provides a sound CUP on which a proper transfer price for assuming credit risk could be based, and their existence does demonstrate that now credit risk, like market risk, can be priced, transferred and traded between independent third parties. We see no theoretical reason why it should necessary formally to enter into a contract for the obvious transfer pricing model to be used, though we fully accept that for practical reasons it would be advisable for an enterprise to document its procedures and pricing methodology.

252. We agree with the view that the above analysis should not be ruled out simply because in some circumstances it could be used for tax avoidance purposes; as stated, basic transfer pricing and anti-tax avoidance legislation should be used to prevent abuse.
254. We agree that the questions of internal funding, and allocation of funding costs, should be dealt with in accordance with the particular circumstances of the enterprise concerned.
- 256ff. We feel that the issue of dependent agent PEs is complex, and probably needs more analysis; we are not sure that the current guidelines still remain appropriate in present circumstances, taking into account the increasing globalisation of businesses which may have to operate in separate legal entities, for regulatory reasons. It would be helpful if any review of the issues raised by the concepts of permanent establishments and dependent and independent agents recognised this. Where the legal structures of enterprises, and possibly also their booking policies and accounting methods, are dictated by local regulators, it is impractical to have a requirement for totally different analyses to be used for tax purposes. A rigorous application of current theory could well result in an entity paying tax on profits it cannot report in a jurisdiction in which it cannot legally act. An immediate short-term solution could be to recognise that recent developments have made the traditional interpretation of these concepts outmoded, and they should be reinterpreted to give a regulated entity, as described, the status of an independent agent. That said, it is appreciated that this goes beyond the remit of the current paper. We agree with the view that under a full and proper functional analysis, the dependent PE may well have minimal

net profits, but that does not eliminate all issues in jurisdictions where fiscal grouping does not extend to branches, and also where there are material penalties for not submitting full returns which do not relate to the tax involved, for example, where this may result in the taxation of gross income with no relief for expenses. Equally, issues may arise if the home jurisdiction uses a credit relief rather than exclusion method for dealing with double taxation.

We believe that a productive line of investigation could again be the hedge fund model; the local entity may in fact act as an independent hedge fund manager, and hence fall within an updated definition of an independent agent. It is fully accepted that the transfer pricing model used would have to respect and reflect this reality.

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