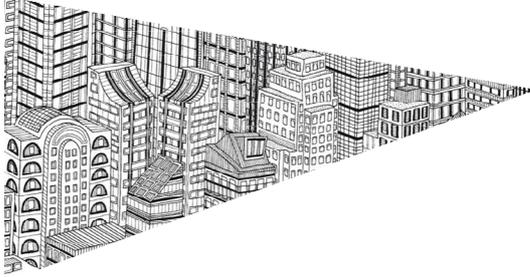


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FTT Alert



EU Financial Transaction Tax and the market infrastructure industry

The draft Directive on a European Union Financial Transaction Tax (EU FTT) that is proposed to be introduced in 11 Member States (the 'FTT zone') has generated a lot of interest among those who are likely to be paying it. Admittedly, this is a wide category: financial institutions established outside the EU can be subject to the tax on certain transactions, as can investment funds, market makers and even corporates' group treasury companies. However, there has been much less focus on the EU FTT among stock exchanges, central counterparties, securities depositories and others in the market infrastructure industry.

We feel that the draft Directive leaves a number of key questions unanswered and has the potential to result in market infrastructure participants established within the FTT zone being at a competitive disadvantage compared to participants established outside it. The EU FTT could also drive behavioral change among market infrastructure parties' own clients. In this Alert, we examine some of the key points and seek to dispel some prevalent EU FTT myths.

Some common EU FTT myths dispelled

Myth 1: The EU FTT is just a tax on EU residents

This is certainly not true. The draft Directive contains an "issuance principle" that could make two US banks dealing in French equities on a US stock exchange fully subject to the tax. The concept of 'deemed establishment' means that any financial institution that transacts with a financial institution in the FTT zone is potentially subject to the tax. So, a market infrastructure party cannot ignore the proposal simply because it is established outside the FTT zone.

Myth 2: Central Counterparties (CCPs), Central Securities Depositories (CSDs) and International Central Securities Depositories (ICSDs) are unaffected by EU FTT

It is true that CCPs, CSDs and ICSDs, when exercising those functions, are not themselves subject to the EU FTT. However, they can be jointly and severally liable for the EU FTT of their customers, might still be obliged to collect and administer the tax and, given the wide range of activities they perform, there is much doubt as to the breadth of the exemption in any event. Finally, there is the question, referred to below, of whether a financial institution established outside the FTT zone could be 'pulled into' the scope of the tax if it chooses to transact with a CCP/CSD that is based in the FTT zone.

Myth 3: The provision of securities collateral will be unaffected as it is just a security transaction, rather than a financial transaction in itself

This does not seem to be correct. A person who gives securities collateral, especially if the securities are given with a right of rehypothecation, may well be entering into a financial transaction.

Myth 4: There is a 'market makers' exemption

There is no such exemption in the draft Directive. There is a limited exemption where one financial institution "acts in the name of or for the account of" another financial institution. It seems reasonably clear that the purpose of this exemption is simply to make the second financial institution liable for the tax rather than the first; however its precise scope is not yet certain. Further, it is nothing like the 'market maker' exemption that applies to French FTT (or UK stamp duty reserve tax).

Why should market infrastructure participants focus on FTT given the regulatory change agenda is already stretching resources?

The implications of the EU FTT for the whole market may drive significant business change in this sector, both in response to changing customer behavior and to potential risks and costs to market infrastructure participants.

Clarity is needed on the scope of the 'acting as CCP' exemption

The draft Directive does not make clear how wide this exemption is, but it will be of central importance, not just to market infrastructure parties, but also to their customers. For example, a CCP/CSD that enters into transactions with securities collateral deposited by its customers will want to know whether an exemption applies. A US financial institution who happens to transact via a CCP established in the FTT zone will want to know whether that causes it to be deemed to be established in the FTT zone so as to become subject to the tax. The answer to the latter point could in turn affect the question of whether a CCP/CSD established in the FTT zone is at a disadvantage as compared with its competitors outside the FTT zone.

The market infrastructure segment might have to collect and administer the tax

The draft Directive makes it clear that the EU FTT is due at the very moment an 'electronic' financial transaction is entered into. It is difficult to see how this could be achieved without some involvement from the relevant exchange or central counterparty. The draft Directive also makes it clear that CCPs, CSDs and ICSDs can be jointly and severally liable for their customers' EU FTT and gives Member States wide discretion on how to collect the tax. Taken together, these factors may point toward a conclusion that market infrastructure participants could have some collection responsibility and/or a requirement to share information on transactions with government or regulatory authorities. If that is right, then a relevant question for the industry will be whether those obligations bite only on

participants established in the FTT zone or whether governments will exercise their wide discretion on how to collect and administer the tax in order to impose the same requirements on all participants.

Customers will also ask for more information. For example, the concept of “deemed establishment” means that non-EU participants will be very interested to know where its counterparty is established under any one of a number of criteria. Market infrastructure participants will need to find a way of capturing that information from their users.

The EU FTT will almost certainly drive behavioral change among users of market infrastructure services

Some examples may illustrate this point. Currently financial institutions use short-term repos of securities as a means of providing, or obtaining, finance. There is no exemption in the draft Directive for short-term repos and an EU FTT cost of 10 basis points per transaction would make this kind of finance uneconomic. So, unless the draft Directive is amended, repos in the financial sector will disappear overnight and be replaced by other types of liquidity management. This may be just one of the countless examples of change driven by the EU FTT and a market infrastructure party that fails to take into account the behavioral change of its customers will be in danger of offering the wrong products and facilities.

There is a difference between the treatment of OTC derivatives and market-traded derivatives

OTC derivatives are not within the scope of the ‘issuance principle’, whereas market traded derivatives are. So, just as CCPs have been gearing up to deal with the anticipated explosion in central clearing of derivatives, they have to deal with a change that may make OTC derivatives more attractive in some cases. Clearly, the EU FTT will not reverse the move toward central clearing, but it will introduce additional considerations to be dealt with.

Joint and several liability means more risk

A CCP will be jointly and severally liable for the EU FTT liabilities of their clients. How do they protect themselves against this risk? Do they need to hold additional capital against it?

Conclusion

The EU FTT may affect market infrastructure participants from macro issues to micro issues and front office to finance.

There is some doubt whether the tax will, as proposed, come into force on 1 January 2014 (not least since the 11 participating Member States continue to discuss the proposals and unanimity among them is required). However, while acknowledging the uncertainty on timing, there is a real possibility that market infrastructure participants within the FTT zone will face at the very least, higher compliance costs, and possibly higher cash tax costs, than participants established outside the FTT zone. For all of those reasons, participants should act now to understand the impact, assess their lobbying position and plan for change.

More information

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