FESE position on the Enhanced Cooperation FTT

1. Introduction

FESE does not support the introduction of an FTT on the grounds that it will not deliver the objectives intended to be achieved by the European Commission, namely to: raise revenues in the long-term, curb speculation, make markets safer and make those responsible for the crisis contribute to the post-crisis costs.

Moreover, FESE considers that a financial transaction tax as outlined in the Commission proposal will have a **negative impact on the real economy**. This will be both at the level of corporate access to finance, in addition to the negative impacts already acknowledged by the Commission in respect of growth and employment, as well as in respect of a direct impact on citizens accessing financial services products such as mortgages and pensions.

In addition, we are concerned that implementation of the FTT as currently proposed will have serious negative implications for the **relative attractiveness of transparent, regulated and multilateral trading venues, such as Regulated Markets**. This appears to be in complete contradiction with the overall objectives set by the G20 and the regulatory reform embarked upon by the EU in the shape of the EMIR and draft MiFID II / MiFIR proposals.

This paper is therefore structured in two parts:

- Assessment of the impact of an FTT on the real economy;
- Assessment of the impact of an FTT on the relative attractiveness of transparent, regulated and multilateral trading venues in Europe.

2. Assessment of the impact of an FTT on the real economy

FESE believes that the introduction of the financial transaction tax will have negative effects on the real economy of the Member States as follows:

- Negative impact on growth & employment
- Increasing citizens' cost of access to retail financial products such as mortgages
- Increasing the cost of corporate access to finance

Below we detail these areas and expand on our concerns on the impact of the FTT:

- **Negative impact on growth & employment** – The Commission's own impact assessment[1] acknowledges that, under certain scenarios, an FTT will have negative macro-economic effects, as it is expected to have a negative impact of 0.3% on the European GDP as of 2050. This would account for around 33% of the budget of the European Union[2]. In addition, the Commission has acknowledged that at 0.1%, a transaction tax on securities could, without the application of mitigating effects, reduce future GDP growth in the long run by 1.76% of GDP. Turning to the impact on employment, again the Commission estimates that in some of the originally modeled scenarios for an FTT, securities transaction taxes at rates of 0.01% (financial transactions related

[1] See page 10 of European Commission Executive Summary of the Impact Assessment of an FTT http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/summ_impact_assesmt_en.pdf

[2] http://ec.europa.eu/budget/index_en.cfm

to derivatives contracts) and 0.1% (financial transactions other than those related to derivatives contracts) would impact employment negatively by -0.03% and -0.20% respectively. At the current level of employment in the EU, this would mean a reduction in employment between 64,000 and 426,000 people.

- **Increasing citizens' cost of access to retail financial products such as mortgages -** The Commission contends that the FTT will have no impact on citizens' access to finance in the real economy. This is palpably not the case. To take but one of a long list of potential examples, **Annex 1** examines the impact of the FTT on the costs of taking out a fixed rate mortgage. The bottom line is that while borrowing from a mortgage lender is not, in and of itself subject to the FTT, the tax would be applied to futures' contracts which guarantee the fixed rate nature of such products. The cost would naturally be passed on by the mortgage lender to the client requesting the mortgage.
  More generally, it is clear that the tax burden will be borne by parties uninvolved in the financial crisis: pensioners and savers. According to a survey carried out by the CFA Institute between April and May 2011[3], many of whom work for financial intermediaries, most of the burden of the tax is likely to be passed on to end investors. Investment vehicles with strategies that require frequent trading will probably suffer the most tax drag. Intermediaries will pass the tax on to the final consumers, as they do with other indirect taxes which results in pensioners and savers suffering greater financial losses as the tax will directly hit their retirement provision and savings products. The tax will actually promote non-transparent banking activities which will not be in the best interest of consumers as the fairness of the transaction would be put into question.
- **Increasing the cost of corporate access to finance** – Anything that damages access to capital formation makes access to capital for companies more expensive. The FTT will severely damage issuers' access to capital and investors' access to quality investment opportunities by increasing the cost of trading in participating Member States. Although primary market transactions are **exempted,** a deep and liquid secondary market is vital for the success and growth of issuers' products to enable economic growth and the resulting job creation. A reduction of liquidity on the secondary market will make primary issuance less appealing in the first place, turning less efficient sources of financing into feasible alternative solutions. Furthermore, at a rate of 0.1% for transactions on equities, the tax effectively doubles the end-to-end cost for investors trading equities. According to a study prepared by Oxera for the Commission in 2011[4], the average trading cost borne by investors on each transaction in equities is equivalent to 0.0925% of the value of the transaction at stake. It follows that if a tax rate of 0.1% were applied on each transaction, investors would face a cost increase of 100%. Increased transaction costs and lower liquidity volumes in secondary trading will make it less attractive for investors to subscribe to new primary equity issuance. These new costs will be factored into primary market offerings and lead to higher financing costs for companies, thus hurting the real economy and its potential for growth.

3. Assessment of the impact of an FTT on the relative attractiveness of transparent, regulated and multilateral trading venues in Europe

As outlined above, FESE believes that the proposed FTT will harm the European economy as it will have a serious and negative effect on growth, employment, access to capital and will ultimately be paid by citizens. In addition, FESE notes the lack of sufficient impact assessment, not only in general terms but also regarding the impact of the FTT for the non-participating member states and the cost to build up the tax collection mechanisms.

[3] http://www.cfainstitute.org/Survey/cfainstitute_eu_member_survey_results.pdf
[4] To access the Oxera report, please see: http://ec.europa.eu/internal_market/financial-markets/docs/clearing/2011_oxera_study_en.pdf

Given the current proposals tabled by the Commission, FESE strongly believes that significant changes are needed to ensure that the likely negative impacts on regulated, transparent and multilateral trading venues are mitigated to the greatest degree possible and that the tax does not merely incentivise a shift in trading activity away from such venues to the over-the-counter ("OTC") space.

Our proposed changes are detailed below.

3.1. Need to assess the full implications of the FTT for transparent, regulated and multilateral trading venues

There are several aspects of the Commission proposal that have the potential of increasing the cost of on-exchange trading and clearing, thereby incentivising OTC transactions. This appears to be in complete contradiction with the G20 policy objectives of increasing the levels of trading on transparent, regulated and multilateral trading venues as a key element of measures to increase financial stability. In turn, it is contrary to the regulatory objectives laid out in EMIR and MiFID II/MiFIR**:**

i. **Effect of the tax on the post-trade clearing chain.** Given that in the Commission proposal each leg of the transaction chain would be taxed, back to back or intermediated trades, necessary to perform the clearing function, will all be liable for the tax. The Commission has exempted agency trades in Article 10.2. However, the great majority of transactions done throughout the clearing chain are carried out on a principal to principal basis. This means that the FTT could exponentially raise the cost of clearing, in a clear contradiction with EMIR and the G20 objectives.

ii. **Effect of the tax on anonymous order books.** For instruments not caught by the issuance principle, any non-resident market participant trading in an anonymous order book would have to factor in the potential cost of being matched with a resident counterparty, and hence being taxed. The consequence of this is that the additional costs would be factored into the cost of a trade at the outset as certainty at the point of execution cannot be guaranteed. This will result in additional costs being borne by the counterparties, even if they are non resident counterparties and not subject to the issuance principle. These will become *de facto* higher transaction costs when trading on an organised trading venue which would not be present when trading OTC (where they can choose their counterparty and thereby ensure there is no tax liability). Such an outcome would have serious consequences for on-exchange trading and provide a greater incentive to trade OTC.

iii. **Collection challenges in respect of OTC trading** - Despite the Commission's intention to include OTC trading (see section below), practical difficulties for collection, especially for non-cleared trades, may keep some of these markets untaxed, thereby creating an incentive to trade financial instruments this space.

iv. **Exemption for OTC derivatives from the issuance principle.** This exemption means that OTC derivatives would only be covered by the residence principle, thereby creating a potential loophole for financial institutions to avoid the tax on all kind of asset classes covered by the issuance principle by simply creating equivalent OTC swaps. As explained by Morrison and Foerster LLP: this "means that for two parties to a financial transaction, who have no connection to the FTT zone, payment of the FTT in respect of a transaction linked to an FTT zone-issued share can (subject to the final anti-abuse provisions) be avoided altogether by entering into an OTC derivative on that share, rather than by transacting in the share itself."[56]

[5] http://www.lexology.com/library/detail.aspx?g=445d3d08-64d4-40c3-9242-003a5d718ab0&utm_source=lexology+daily+newsfeed&utm_medium=html+email+-+body+-+general+section&utm_campaign=lexology+subscriber+daily+feed&utm_content=lexology+daily+newsfeed+2013-03-20&utm_term

3.2. Ensuring that OTC trading is properly caught by the FTT

While we urge policymakers to consider the above comments on the impact of the FTT on the attractiveness of regulated, transparent and multilateral trading venues in Europe, it is also critical to ensure that the FTT proposal does not work against other policy objectives designed to ensure that all secondary markets equities trading is conducted on appropriately regulated organized trading venues. In this regard, FESE welcomes the proposal of the EU Commission that the financial transaction tax should also cover OTC trading. However, this raises a crucial question that has not been definitively answered by European lawmakers to date: what exactly does OTC trading comprise, what is the definition?

These points are currently being debated in the negotiations on the adoption of the MiFID II / MiFIR proposals. We doubt strongly whether the proposed creation of the Organised Trading Facility (OTF) by the Commission in the MiFID Review will actually produce the desired effect in terms of incentivizing a shift of activity onto regulated trading venues. What is clear is that without an equivalent clear definition of what should be permissible to be traded on an OTC basis, Europe runs the risk of simply repeating the MiFID 1 experience, that is to say a multiplication of trading categories matched by a parallel increase in trading volumes executed on an OTC basis. Therefore, we welcome both proposals in the Parliament to define OTC trading or the alternative approach currently under consideration in the Council to provide a clear equities trading mandate, to complement the trading mandate in respect of OTC derivatives

In our opinion, **a pre-requisite for the introduction of an FTT is a guarantee that OTC trading will be properly caught.** In the absence of such a guarantee, the introduction of an FTT would simply incentivize a shift of trading to the OTC space, in complete contradiction with the policy objectives being pursued in MiFID II / MiFIR & EMIR and would lead to unfair competition between transparent and non-transparent environments.

3.3. Ensuring exemptions for market makers – critical to the functioning of transparent & multilateral trading venues

Market makers play a key role in the effective functioning of markets in financial instruments and specifically in the provision of liquidity. This is even more important in regional capital markets where domestic liquidity is key to ensuring investor confidence. They help to keep volatility low and provide liquidity by continuously placing buy and sell quotes at all times. For this reason, FESE believes that **market makers should be excluded from the scope of the FTT proposal.**

If market making were no longer available there would be serious implications for the smooth functioning of secondary market in a number of venues. This would particularly be the case on small regional stock exchanges. Were all market makers to withdraw from providing their market making functions, due to significant cost increases, it would have a significantly damaging effect on investor confidence and reduce the attractiveness of some products in some markets. As a result of the market models stipulated by some competent authorities in certain jurisdictions, it would even make it impossible for certain exchanges to maintain continuous trading in securities affected by the lack of a market maker.

3.4. Lack of consistent tax rates will distort competition

The Commission's proposal contains only minimum tax rates for the FTT and allows every participating Member State to fix its own tax rates. In our view, this could encourage a race to the bottom and unfair arbitrage between high and low rate jurisdictions. Accordingly, it would cause

[6] A similar situation was experienced in the UK and triggered the creation of the CFD markets

further fragmentation of the internal market and create market distortions among the participating member states. This should be avoided at all costs as it could give rise to arbitrage opportunities for the effected products to be de-listed from the incumbent state and listed in a jurisdiction with low tax rates.

Furthermore, the Commission proposal gives participating Member States the power to specify the obligations with regard to registration, accounting and reporting amongst others. In this case as well, it is very likely that different rules would apply across Member States which, in turn, would consequently cause distortions to competition and produce a complex and un-harmonised tax collection system.

In addition, FESE notes that the Italian legislation for a financial transaction tax[7] introduces a higher tax for OTC trading to encourage market transparency and investor protection and that the European Parliament in its 19 March 2013 draft report on FTT under enhanced cooperation is proposing a similar approach[8]. Proponents of this view argue that a higher tax for OTC would reflect the fact that those activities are riskier and non-transparent. They believe that this is completely in line with the aims of the proposal which is in part to make markets safer. As outlined above, FESE considers that policymakers should ensure that the FTT does not put in place disincentives to trading on regulated, transparent and multilateral trading venues with the consequence of increasing OTC trading. This runs contrary to the G20 objectives and the EMIR & MiFID II / MiFIR reforms in Europe. We consider that the most appropriate policy response would be to ensure that the proposals are modified to mitigate those disincentives to trading on organised trading venues and guarantee that all OTC trading will be subject to the tax (at the same rate). However, in the absence of such measures we note the potential for alternatives such as higher rates for OTC to ensure a level playing field between organised trading venues and OTC trading.

3.5. Extraterritoriality

Because of the way in which the tax is designed and in particular because of the effects of the very nature of the enhanced cooperation procedure, the FTT has the potential of impacting the activity that occurs outside of the participating Member States. The FTT could have effects both outside the EU jurisdictions and within the EU. This would likely be contested by the non-participating Member States.

The extraterritorial effects will mean a real problem for the implemen**tation of the FTT, in particular when the issuance princip**le is applied.

3.6. Tax collection

FESE believes that Regulated Markets should not be the infrastructure required to perform the collection duties for the following reasons:

- Regulated Markets do not have oversight of all trading activity as outlined above. This is particularly the case for OTC transactions. These transactions lack full transparency and are not part of the surveillance regime currently operated by Regulated Markets. Furthermore, due to fragmentation activity is also conducted in MTFs and SI, hence activity is no longer centralised at the trading venue layer of the value chain. The potential introduction of OTFs through MiFID II would further aggravate this.

[7] http://www.rgs.mef.gov.it/_Documenti/VERSIONE-I/Finanza-Pu/Legge-di-s/2013/Legge_di_Stabilitx_2013_Testo.pdf
[8] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+PE-507.928+01+DOC+PDF+V0//EN&language=EN

- Tax-related activities are usually out of the scope of Regulated Market's business model, as we are not party to the physical transfer process of instruments so do not have an efficient mechanism to extract the tax from the cash flows of the transactions. We therefore lack the required system functionalities, making an eventual collection obligation potentially inefficient.
- The result of this fragmentation is that Regulated Markets are not an effective mechanism on which to build a collection process. Using Regulated Markets as a collection institution would increase the already existing un-level playing field towards other trading venues.
- MiFID I included obligations for investment firms and banks to report their on-exchange and OTC transactions in securities admitted to trading on regulated markets of the EU to the local market authorities ('transaction reporting'). Market authorities regularly exchange data for the purpose of the EU-wide recording of transactions. FESE proposes recording OTC transactions based on the 'transaction reporting' regime in order to facilitate the collection of the tax on OTC transactions.

4. Conclusion

FESE believes that the proposed FTT will harm the European economy as it will have a serious and negative effect on growth, employment, access to capital and will ultimately be paid by citizens.

Given the current proposals tabled by the Commission, FESE strongly believes that significant changes are needed to ensure that the likely negative impacts on regulated, transparent and multilateral trading venues are mitigated to the greatest degree possible and that the tax does not merely incentivise a shift in trading activity away from such venues to the OTC space.

Annex I – Impact of the Proposal for Enhanced Cooperation on a common system for an FTT on the real economy

Despite the Commission's intention to exclude "real economy" financial transactions from the scope of the proposed tax, the below example shows that a tax designed as per the Commission proposal of 14 February 2013 would have a direct negative effect on the "real economy". In this example, we look at the impact of the proposed FTT on an ordinary citizen getting a mortgage. The aim is to contribute to the ongoing debate on the introduction of a Financial Transaction Tax in the European Union and help promote informed, evidence-based decision making.

Impact of FTT on getting a mortgage

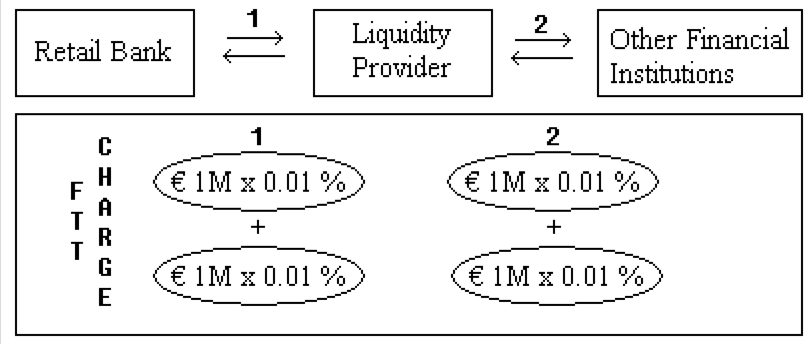
Whilst borrowing from a bank or other mortgage lenders is not in itself subject to a Financial Transaction Tax under the European Commission's proposal, the financial institutions providing these loans usually look to offset the resulting interest rate mismatches through the use of futures contracts, which would be subject to the tax. Moreover, not only would the FTT impact futures contracts directly, it would also run the risk of significantly increasing the **overall fixed rate on the mortgage or any associated arrangement fee as a result of the bank passing FTT costs onto its client** ('cascading effect[9]' of the tax').

Let us take the example of an individual wishing to take out a fixed rate mortgage on a € 200,000 loan with a bank which is deemed to be "established" in the FTT-11 area. A retail bank will typically pool mortgage requests and provide the customers with a fixed rate mortgage using derivatives contracts to hedge any interest mismatch incurred. Taking the scenario of the bank pooling **five loan applications**, (5 separate € 200,000 loans where the interest rate is fixed for an initial five year period), the bank will fund these loans using deposits on which the bank must pay a varying interest rate, which in this example we will say is re-set every 3 months. **The bank will therefore need to hedge against the rate mismatch between the fixed interest it receives on the loans and the varying interest it pays on the deposits.**

To do this, the bank will purchase three-month Euribor futures contracts with a nominal value of € 1,000,000 (i.e. 5 individuals x € 200,000) from a counterparty willing to assume this risk. As the interest rate on deposits is re-fixed every 3 months, the bank will need to buy a string/series of futures contracts to cover the duration of its fixed interest exposure, initially on a five year basis. The bank will therefore purchase 20 futures contracts, each with a nominal value of € 1 million: **5 years divided by 3 months = 20 contracts (1 for each 3 month period).**

The counterparty to this trade in the futures market will be a **liquidity provider** who builds in the potential cost of hedging its own flow imbalance with **another financial institution** in a second transaction, **which we assume is also deemed to be "established" in the FTT-11 area.** As illustrated below, because an FTT is chargeable to each financial institution which is party to a transaction, it follows that there are 2 transactions subject to an FTT, each involving two parties. Subsequently, the costs incurred will be factored into the final cost of the mortgage for the retail client.

[9] The 'cascading effect' refers to an unforeseen chain of events which result from an act affecting a series of other acts/events in a system.



In this case, it follows that the total FTT is:

4 (total number of transactions) x 20 (contracts required) x 0.01% (FTT) x €1,000,000 (nominal value) = **€8000.**

This additional cost will most likely be divided among the 5 clients. The extra cost could either be charged as an increase in the fixed rate of the mortgage or increased up-front arrangement fees, or both. If it is charged as an interest rate, it represents an increase of **0.16% per annum** for each client (or 320 euro per year for five years i.e. **1600 € per borrower**).

In addition, the current wording of the Commission proposal could mean that **the costs for customers would be considerably higher** as each derivatives transaction may trigger multiple charges through the conventional market structure whereby there is a back-to-back chain of contracts involving executing brokers, clearing members and the CCP itself as principals. This could make fixed rate mortgages several times more expensive for customers.

All these costs could be avoided if the retail bank were to choose not to hedge its interest rate mismatch exposure; but then the significant potential cost to the system is that there is **unmanaged interest rate risk.**