06 August 2013

Mr Jonathan Faull
Director General, Internal Market and Services
Directorate-General, Internal Market and Services
European Commission
B-1049 Brussels
Belgium

Dear Mr Faull,

**Issue 178: Financial Transaction Tax**

As you know, the role of the Financial Markets Law Committee (the "**FMLC**" or the "**Committee**") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

The FMLC considers it important to comment on legal uncertainties arising from the draft Directive for a Financial Transaction Tax ("**FTT**") under "enhanced cooperation", as proposed by the European Commission on 14 February 2013. *Inter alia*, the FMLC is concerned about the impact of the FTT on pre-existing—and future—market transactions. This letter is addressed to you because the FMLC believes that these concerns are relevant to the functioning of the internal market.

A separate letter, which discusses uncertainties arising from more technical aspects of the draft Directive, has been sent to Heinz Zourek at DG Taxation and Customs Union ("**DG Taxud**"). A copy of that letter is enclosed. Copies of both letters have also been sent to Vaidotas Linkevicius (Attaché for Fiscal Affairs) at the Lithuanian Presidency and Sharon Bowles MEP (Chair of the ECON Committee) at the European Parliament.

<u>Impact of the introduction of the FTT on market transactions</u>

The proposed FTT would create legal uncertainty for market participants under pre-existing contracts. Uncertainty resulting from the FTT would be likely to result in advisory costs and disputes (and possibly litigation), which would be detrimental to the functioning of the internal market—particularly owing to the number of contracts which may be affected.

Existing contracts—particularly in the financial markets—typically allocate foreseen risks and costs on a basis agreed between sophisticated parties. In the context of a detailed written agreement between such parties, it may be presumed that the relevant contract should be capable of being construed in such a way as to allocate tax risks (*e.g.*, the FTT). However, as the FTT will in fact have been an unforeseen risk in most—if not all—cases, ascertaining how it should be treated under existing contractual provisions may be extremely difficult in practice.[1]

Equally, provisions in pre-existing contracts may be unsuited to allocate risks associated with joint and several liability of the kind imposed by the proposed FTT. In this regard, the concept of "pre-existing contracts" should be taken to include agreements which will be negotiated and concluded before implementation by the participating Member States. Parties to financial transactions—particularly parties located outside the EU—will typically want to allocate, or protect themselves against, any potential liability under the proposed FTT (which may be primary or secondary, depending on the circumstances). The FTT as proposed is technically complex and is also of broad territorial application—in many transactions, one or more of the parties may be expected to have little or no familiarity with the tax. Any legal uncertainties arising from the FTT may result in protracted negotiations and associated advisory costs in the context of market transactions.

Similar issues of uncertainty and lack of knowledge exist regarding the anti-avoidance provisions at Articles 13 and 14 of the draft Directive. Not only is it uncertain how those

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provisions will operate but—as a practical matter—a party acquiring or holding a security (for example) may not have any information regarding the "purpose" for which that security was issued. (The proposed anti-avoidance provisions are discussed at greater length in the letter addressed to Heinz Zourek.)

Although it is not within its remit to comment on matters of policy, the FMLC notes that the likelihood of such uncertainties resulting in material advisory and/or litigation costs for market participants may be exacerbated by (i) the absence of "grandfathering" provisions and (ii) the "material modification" provisions, under which modification of an instrument may constitute a separately chargeable "financial transaction" for the purposes of the FTT. This latter concept remains unclear, as Article 2(2) of the draft Directive includes only brief and non-exhaustive provisions regarding the concept of materiality. (As a minor drafting point, in the English text the phrase "in case the object or scope of the operation" is also unintelligible as it appears in Article 2(2).)

A very significant number of transactions in the financial markets will have been concluded on the basis of standard terms published by trade organisations. It is not feasible to identify uncertainties which may arise where contracts have been entered into on bespoke or transaction-specific terms. This letter therefore considers examples of specific uncertainties which the FMLC believes would arise from the FTT under the following three sets of model documentation:

i. master agreements for derivative transactions published by the International Swaps and Derivatives Association ("**ISDA**");

ii. the Global Master Repurchase Agreement ("**GMRA**") for repos and similar transactions published by the International Capital Markets Association; and

iii. syndicated loan documentation published by the Loan Market Association ("**LMA**").

<u>ISDA—derivatives</u>

The FTT would lead to uncertainties regarding the provisions of the ISDA Master Agreement dealing with "Stamp Tax".

In the normal course, under the ISDA Master, each party agrees to pay any "Stamp Tax" levied upon it by a jurisdiction in which it is incorporated, organised, controlled or acting *etc.* Broadly, each party also agrees to indemnify the other against any such "Stamp Tax", but only where that other party itself has no such connection with the relevant taxing jurisdiction.

It is unclear whether the definition of "Stamp Tax" in the ISDA documents (*viz.*, "any stamp, registration, documentation or similar Tax") would include the FTT. Uncertainty and disputes may therefore arise regarding the applicability of the stamp taxes indemnity under the ISDA documentation, particularly in the case of transactions involving a party with no connection with one of the eleven participating Member States.

<u>GMRA—repos and similar transactions</u>

The FTT may result in disputes under the "Tax Event" provisions of the GMRA, in the context of repos and similar transactions.

Broadly, where a party reasonably believes that a change in tax law or administrative practice would have a material adverse effect on it, that party may serve notice terminating the relevant transaction(s), in which case it will indemnify the other party against legal and professional expenses but not against other losses or damages. That other party may elect to serve a counter-notice indemnifying its counterparty against the relevant adverse effect and treat the relevant transaction(s) as continuing.

In view of the impact the FTT would have on the repo markets, it is likely that disputes and possible litigation may arise as to whether its effect may be said to be "material", where a party seeks to terminate one or more transactions because of the impact of the FTT. The FMLC believes that such disputes would be most likely to arise in the context of long-dated repo or stock-lending arrangements pre-dating the introduction of the FTT. This issue is particularly material in view of the uncertain application of the FTT to this kind of transaction (and particularly the uncertainty regarding possible "cascades" of FTT charges in the case of daily movements or substitution of collateral pursuant to such arrangements). As stated in its letter to Heinz Zourek, the FMLC would welcome clarification in this regard.

<u>LMA—syndicated loans</u>

The FMLC has identified two key areas of the LMA model documents for use in the primary loan markets where the FTT may cause uncertainty: (i) "material adverse change" ("**MAC**") or "material adverse effect" ("**MAE**") provisions (particularly the "leveraged" loan markets); and (ii) provisions allowing the lenders to recover certain "increased costs".

A bank's commitment to arrange and underwrite a financing may be conditional upon there being no circumstances which *inter alia* could prejudice syndication of the relevant facility. Equally, circumstances giving rise to a MAE may be an event of default under the relevant loan agreement; a MAE would normally render any outstanding advances immediately due and payable and prevent utilisation of any undrawn commitments. The FTT should not apply to primary loan market activity; however, disputes may arise as to whether the adverse effect of the FTT on particular types of borrower may be said to be "material". In particular, a lender might claim that a borrower which is a financial institution or entity (including SPVs in structured financing transactions—*e.g.*, securitisations), pension funds or other entities that conduct a significant volume of hedging activity would be materially adversely affected by the FTT and seek to terminate—or amend the terms of—its agreement.

A lender may also be entitled to recover certain "increased costs" resulting from a change in law. As mentioned above, the FTT is not expected to apply to primary loan markets *per se*; however, uncertainties and disputes may arise where the effect of the FTT on a lender's method of funding its participation in the relevant loan (or a related hedging arrangement, if such arrangements are included in the "Finance Documents" covered by the "increased costs" provisions) results in increased costs—or a reduced rate of return—for the lender. The FMLC is aware that some borrowers are already entering into protracted and costly negotiations to try to exclude the FTT from the scope of the "increased costs" provisions (to avoid the possibility of their lenders passing-on any costs attributable to the FTT). This is one example of uncertainties arising from the FTT on pre-existing agreements or those which are currently under negotiation—as referred to above.

I and Members of the Committee would be delighted to meet with you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely

Joanna Perkins

Joanna Perkins
FMLC Director

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[1] In some cases, a court may be asked to imply a term in the commercial context. As Lord Hoffmann noted in *Attorney General of Belize v Belize Telecom* [2009] UKPC 10, debate over implication of terms "not infrequently arises when the draftsman of a complicated instrument has omitted to make express provision for some event". However, as Lord Hoffmann also cautioned, the court's power to go beyond the "express provisions" may be limited: "[t]he most usual inference in such a case is that nothing is to happen. If the parties had intended something to happen, the instrument would have said so."