CLIFFORD CHANCE

LABOUR'S PROPOSED UK FINANCIAL TRANSACTION TAX

WHAT IT MEANS FOR INVESTORS, INSTITUTIONS AND BUSINESSES

The Labour Party has announced a plan to expand the existing UK stamp duty into a broader financial transaction tax.

Stamp duty currently applies in practice only to UK equities. Labour's proposed tax would cover all equities and debt securities, if there is either a UK issuer or a UK party to a trade. It would also apply to credit and equity derivatives with a UK counterparty.

Many elements of the proposal are currently unclear, however there are in our view significant flaws in its design. In particular, it suffers from "cascade" effects which will greatly increase the effective rate, and these costs will inevitably be borne by pension funds, investment funds and other end users. It will also, despite the claims of its designer, create a strong incentive for funds, investors and traders to migrate from the UK.

What is the proposal?

Labour has announced a proposal to expand the existing UK stamp duty and stamp duty reserve tax into a new broader financial transaction tax (**FTT**).

The proposal has some commonalities with the proposed (but currently stalled) EU FTT, but is unconnected and stands on its own.

Stamp duty generally applies only to UK equities. The proposed FTT would apply to all debt and equity security trades where there is either a UK issuer, or a foreign issuer but one of the parties to the trade is a UK person. The FTT would also apply to derivatives where one of the parties is a UK person.

There are two critical problems with the tax.

- The first is that the proposed FT has no intermediary exemption. However, in the modern world, securities and derivatives transactions are settled and cleared through multiple layers of intermediaries. There would, therefore, be a "cascade" of multiple FTT charges, with a very high effective rate. The resultant cost would be borne in part by the end-investor, principally pension funds and other fund and institutional investors, and in part by corporate issuers (through increased cost of capital).
- The second is that the tax only applies to derivatives and foreign debt/equity securities where a party to the trade is a UK person. The obvious result will be the relocation of funds, investors and market infrastructure from the UK.

Current Parliamentary arithmetic means that this proposal has no chance of becoming law as things stand. However, given the possibility of an early general election, in our view it should be taken seriously by those potentially affected, particularly pension funds, institutional investors and corporates.

What is the stated purpose of the FTT?

The proposal is based on a paper published earlier this year by Professor Avinash Persaud.

The stated objectives are to:

- raise an additional £4.7bn of annual tax revenue, and disrupt the supposed capturing of profits by the financial sector,
- reduce systemic risk, particularly that caused by high frequency traders,
- deter "excessive churning of the investments of ordinary savers by their asset managers", and
- increase transparency in markets.

We would say at the outset that – even if one accepts these objectives – they would be better achieved through other measures.

- The most obvious and least distortive way to raise tax from the financial sector is by taxing its profits: as achieved by the existing bank surcharge (which could be modified or extended if thought insufficient).
- The most obvious and least distortive way to raise tax from high earners is to increase income tax.
- Concerns around systemic risk, churning, high frequency trading and transparency are best dealt with through financial services regulation.
- If one wishes to stop high frequency trading then the most obvious approach is to ban high frequency trading, not to introduce a tax which may or may not stop high frequency trading, but which will have adverse affects on other products.
- Achieving a regulatory outcome through a tax measure is a curiously indirect approach, and leads to odd design decisions and distortive outcomes (as will be seen below).

How does stamp duty currently apply?

In most cases, stamp duty only applies to shares issued by a UK incorporated companies. It does not ordinarily apply to debt securities or derivatives.

Stamp duty is an old tax – dating from 1694 - and only applies to written instruments of transfer, and so is of little relevance in the modern world of electronic trading. When people say "stamp duty" they are usually actually referring to stamp duty reserve tax (**SDRT**), a tax created in 1986 when floor trading was replaced by electronic trading.

Most UK equities are traded through CREST, which deducts SDRT automatically. The rate is 0.5%. Intermediaries are generally exempt, which means that, whilst any one purchase of shares may have any number of intermediary transactions behind it, there is only one charge.

The technicalities of how SDRT applies to a CREST transaction are complicated, but in practice the economic cost is always borne by the end-purchaser – the "incidence" of the tax falls with them.

To give an example: if a UK pension fund buys £1m of Marks & Spencer plc shares, the "spread" will be around £300. This represents the total cost of the fees of all the intermediaries, as well as the (very small) market inefficiencies associated with the purchase. The stamp duty cost will be £5,000 (0.5% of £1m). The intermediaries cannot economically absorb more than a fraction of this.

It has been suggested that stamp duty is economically inefficient and it would be preferable from a policy perspective to abolish it, and replace its revenues with an increase in corporation tax. This is an essentially political question on which we take no position: however we would say that stamp duty is a successful tax in that it is efficient to collect, minimally distortive of economic behaviour, and not easily evaded or avoided.

How does the proposed FTT work?

The Persaud paper is long on arguments in principle as to why an FTT is required, and short on implementational detail. However it is reasonably clear that the proposed FTT has four separate elements, all of which would be introduced at the same time.

Proposal 1: abolish the intermediary exemption

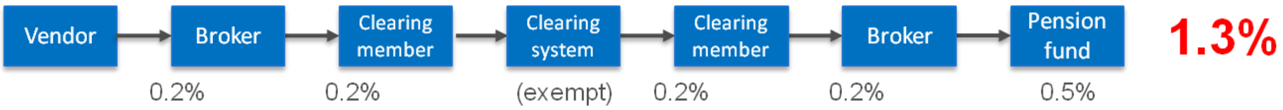
Intermediaries such as market-makers are currently exempt from stamp duty. The original purpose was to facilitate market liquidity. However, over time, market practices and the regulation around them have made the intermediary exemption of critical importance.

The reason is simple. An ordinary trade passes through multiple parties: brokers, clearing members and the clearing system. Each party is acting as principal and therefore would be subject to stamp duty on its acquisition were it not exempt.

Labour are proposing to abolish the intermediary exemption, and replace it with a lower rate of 0.2%. That means each of those multiple parties would be subject to a separate FTT charge, creating a "cascade" of charges and a very high effective rate.

Take, for example, a simple purchase of equities by a pension fund. The pension fund will acquire the equities from its broker, the broker from a clearing member, the clearing member from the clearing system. Those equities will have originated with a vendor, who sold to a broker, who sold to the clearing system. Six separate sales, each of which is prima facie subject to stamp duty at the moment, but five of which are exempted.

Labour's proposal removes these exemptions. Persaud's paper does not mention clearing, but let's assume the clearing system itself is exempt:



The effective rate is therefore 1.3% - and this is a simplified example, with no other intermediaries in the chain, and no other market-making activity taking place. In the real world the effective rate will in many cases be higher. And, for the reasons noted above, the economic cost will inevitably be passed to the pension fund. In the long term, some of these costs would be shared with corporate issuers through an increased cost of capital.

Persaud claims that pension funds and investment funds will be able to reduce the impact of the tax by changing strategies so they do not "churn" shares. This is simplistic. Most funds are required to rebalance their portfolios to reflect market movements, open-ended funds must sell/buy securities when investors leave/join the fund, and pension funds change their asset allocations in line with their actuarial projections.

The Investment Association estimates that the average passive fund tracking the UK All Companies index has a portfolio turnover of 11% - currently this results in a stamp duty cost of approximately 6 basis point each year; the proposed FTT would increase this cost to at least 14 basis points. It is unclear how this achieves Persaud's stated objectives.

If some fund managers are turning over their portfolios with unnecessary rapidity then we would suggest the solution should be greater transparency for investors and/or action by the regulator. Achieving a regulatory objective with a tax measure is inefficient at best, ineffective and damaging at worst.

Proposal 2: extend the FTT to foreign securities

At present, stamp duty usually only applies to UK equities, wherever in the world they are traded. Labour are proposing that the FTT also tax all worldwide equities, when acquired by a UK person.

Again, the cascade effect will magnify the charge. However this time there is an important difference: many market participants will be able to relocate to escape the tax. A UK resident individual will always be subject to the FTT when he or she buys a foreign security, as will their UK unit trust. But if the individual invests through an authorised Luxembourg fund (say) it will be outside the scope of this tax.

We could therefore expect widespread relocation of funds and trading desks from the UK to escape the tax.

Proposal 3: extend the FTT to debt securities

As well as applying to equities, the FTT would apply to debt securities. Debt securities with a UK issuer would be subject to the FTT worldwide (much like UK equities are subject to stamp duty at present). Foreign debt securities would be subject to the FTT when acquired by a UK person. Gilts would be excluded (but other government bonds would not be).

The rate would again be 0.5%, with a reduced 0.2% rate for financial intermediaries.

For the reasons noted above in relation to equities, the actual effective rate will be 1.3% in the simplified case above, and likely higher in a real-world case. The cost would be borne by the end investor in the first instance. Funds and traders investing/dealing in foreign debt securities would have every incentive to migrate from the UK. In the long term, some of the cost would be shared with corporate issuers, who would see an increased cost of capital.

No existing financial transaction tax, stamp duty or similar tax in the developed world applies to debt securities. This is for a good reason: many debt securities are highly liquid – particularly government bonds - and that is a key factor in their desirability for investors. The repo market, which relies on debt securities, is of systemic importance to the financial system, not least because of the ability of pension funds, institutional investors, and, increasingly, corporates to use surplus cash to enter into repo transactions with banks (i.e. rather than placing the cash on deposit, exposing them to the risk of bank failure). Most repos are very short term, commonly one day, and applying a 0.5% (or 1.3%) charge to each repo would likely force UK participants out of that market. It is unclear what the knock-on consequences would be, and Persaud does not consider them.

Proposal 4: extend the FTT to derivatives

Labour propose that the FTT apply to equity and credit derivatives where one of the parties is resident in the UK. Financial institutions writing derivatives, and derivative traders, would presumably react by migrating their business from the UK. UK pension funds and UK corporates, on the other hand, would be unable to do so and would inevitably bear the cost.

The EU FTT originally intended to tax derivatives at one basis point of the notional amount. This was quickly seen to be unworkable: the notional value of a derivative says nothing about the risks involved, or the value to the parties – it can also very easily be manipulated. Hence the European Commission more recently considered formulae that would tax a derivative in a fairer way, albeit reaching no firm conclusion before the EU FTT process stalled.

Post-financial crisis regulation has increasingly required derivatives to be cleared to reduce systemic risk. This means that many derivatives go through a similar series of principal-to-principal transactions to a securities trade. Hence an FTT that applies to derivatives will have the same problems with the cascade effect as when it applies to securities, with the effective rate being a multiple of the headline rate.

The Labour proposal clearly sees the difficulty of taxing the notional amount. Instead it proposes to levy the tax "on the value of the cash flows between holders of derivative instruments". There is no explanation of how this would work. When a derivative is written on normal market terms, the expected value of the cash flows will be small or even zero. Persaud's paper makes reference to the c£3 trillion "economic value" of derivatives held by UK firms; but this presumably represents the current mark-to-market of those derivatives, and is not remotely reflective of anything that could have been determined when each derivative was written.

Absent detail in the proposal, we assume an annual charge based upon the fluctuating fair value of derivative positions is envisaged. That tax already exists: the UK bank levy. Hence this part of the proposal amounts to little more than a complex and uncertain extension to the bank levy, which applies it to corporates and pension funds. That does not seem a very rational outcome.

How will market participants react?

The general principle with transfer taxes is that you should tax based upon the location of the asset being transferred, and not the location of the parties. Successful taxes work this way: UK stamp duty/SDRT in practice applies only to UK equities. UK stamp duty land tax applies only to UK land. The location of the parties is irrelevant. Relocation therefore does not avoid the tax.

Persaud appears to believe that his proposed FTT shares this feature. It does not. In proposing that foreign debt and equity securities are subject to the FTT when acquired by a UK person, anyone whose business includes buying foreign securities will have a powerful incentive to leave the UK. That includes funds and trading desks. But – critically – it includes brokers, clearing members and the market infrastructure that provides the plumbing for securities dealing.

Similarly, in taxing derivatives where a UK person is a party, a powerful incentive is created for derivatives end-users, and the derivatives business, to move offshore.

We would query whether it is good policy, from a UK perspective, to create incentives for business to leave the UK, particularly at a time when Brexit is already causing some corporates and financial institutions to reassess their UK presence.

Conclusion

The proposed FTT is sold as a "Robin Hood tax" redistributing the excess profits of the financial sector. Its actual effect would be very different.

This is a poorly thought through proposal that, if implemented in its current form, would prompt widespread market disruption and relocation. The ultimate cost would be borne by pensioners, savers and investors (magnified by the cascade effect) as well as business (through increased cost of capital).

It would, however, be complacent in the present political environment to assume that such a tax cannot be introduced. It is therefore incumbent on all those potentially affected – whether pension funds or businesses – to ensure their voice is heard.

Further information

If you would like further details on any aspect of this briefing, or how it applies to your business, please speak to your usual Clifford Chance contact or any of those listed below.

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