The financial transaction tax: an update

On 18 April 2013 the UK government issued a legal challenge to the decision of the EU Council of 22 January 2013 which authorised a subset of the EU (not including the UK) to introduce a financial transaction tax under a little used procedure known as enhanced cooperation. The decision was subject to qualified majority voting but the UK, Luxembourg, the Czech Republic and Malta abstained from voting, seemingly for legal and practical reasons. This note explains why the UK may have taken this step and what is likely to happen next. It also recommends that all those who will be potentially affected by the tax both continue their efforts to influence the decision-takers and consider their own positions, legal and operational.

Background

On 28 September 2011 the European Commission adopted a proposal for a Directive on an EU-wide financial transaction tax ("FTT"). It became clear throughout 2012 that there was not unanimous support for the FTT and, as unanimity is required for the introduction of fiscal measures in the EU, it was not possible for an EU-wide FTT to be introduced. A subset of Member States still wished to proceed, however. The Council gave permission for them to do so under enhanced cooperation on 22 January 2013 and that decision was published in the Official Journal of the EU on 25 January 2013. This is the decision that the UK has challenged.

On 14 February 2013 the European Commission published a proposal for a FTT to be introduced in a subset of the EU: Germany, France, Spain, Italy, Belgium, Austria, Estonia, Slovenia, Slovakia, Portugal and Greece. That proposal is currently being negotiated and these negotiations will continue despite the UK challenge. The proposed FTT was considered in detail in our client alert "A global financial transaction tax by any other name?" which is available on our website.

Enhanced cooperation

Essentially, enhanced cooperation allows a subset of Member States to proceed with a measure that does not have enough support to be adopted by all 27 Member States in the EU. It requires nine or more Member States to participate in the measure. Other Member States retain the right to join subsequently, should they so desire, but acts adopted under the framework of enhanced co-operation only bind the participating Member States.

The Council must grant permission to proceed to enhanced cooperation (which it did on 22 January 2013) and once it has done so, the Commission has to adopt a proposal defining the substance of the enhanced cooperation. Once the Commission has adopted a proposal (which it did on 14 February 2013), deliberations take place. All Member States may participate in those deliberations but only the Member States taking part in enhanced cooperation vote. The voting mechanism depends on the underlying Treaty provision: the original legislative measure for the FTT was proposed under a legal base that required unanimity, so unanimity remains necessary for the measure proposed under enhanced cooperation to be adopted by the 11 Member States ("the FTT-zone") who currently want to go ahead.

The Treaties of the European Union lay down the conditions under which enhanced cooperation can proceed. They are as follows:

i. Enhanced cooperation must not undermine the internal market or economic, social and territorial cohesion.

ii. It shall not constitute a barrier to or discrimination in trade between Member States, nor shall it distort competition between them.

iii. It must respect the competences, rights and obligations of those Member States that do not participate in it.

On 22 January 2013 Bloomberg reported that the UK explained its abstention from the vote on whether enhanced cooperation should be authorised in the area of a FTT as follows, "It is not possible to take the view, expressed in the authorising decision, that the conditions set out in the Treaties are fulfilled." The UK has now requested that the European Court of Justice ("ECJ") consider its concerns.

The UK challenge

The UK challenge pre-empts any adoption of a FTT directive by the participating Member States but it is protective. There is ECJ case law which states that if a person has standing to challenge a decision, knows about it and of its being of concern to him but does not challenge within the initial time-limit, that decision becomes definitive against him and he cannot later challenge its legality. As the enhanced cooperation procedure has only been used twice before – in 2010 in the case of cross-border divorces and more recently in 2012 in respect of the unitary patent – there is little precedent. Spain and Italy, the only two Member States not participating in the unitary patent, challenged the use of enhanced cooperation in this context, requesting annulment of the Council decision of 10 March 2011 which authorised the enhanced cooperation. The ECJ heard the challenge in September 2012: the only time that it has considered enhanced cooperation. Advocate General Bot's opinion seemed to suggest that any challenge should be made not to the Council's decision authorising enhanced cooperation but to the legislation which implements that decision but the ECJ decision, handed down on 16 April 2013, did not make this criticism explictly. On this basis, the UK acted to preserve its ability to challenge any FTT directive that may be adopted by the FTT-zone. It may be assumed that if the FTT directive that is eventually adopted is amended so as to address the UK's concerns, the UK would withdraw its challenge. Accordingly, the challenge will give an interesting focus to the continuing negotiations of the participating Member States.

The details of the UK's challenge are not in the public domain but it appears to focus on whether the extraterritorial provisions of the proposed FTT are compatible with the enhanced cooperation procedure (as set out above) rather than on the ability of a subset of the EU to adopt a FTT.

Concerns

The UK's concerns appear to coalesce around the extraterritorial provisions of the proposed FTT. The issuance principle, which brings within scope financial instruments issued in the FTT-zone regardless of where they are traded or where the parties to the transaction are established so long as a financial institution is party to the transaction (acting as principal or agent), is an obvious, but not the only, example of the extraterritorial effect. The residence principle also has extraterritorial effect as it brings within scope branches in the FTT-zone and financial institutions authorised outside the FTT-zone which are either EEA-authorised institutions using a "passport" to trade in the FTT-zone or third country institutions permitted to trade in the FTT-zone.

The UK's concerns coincide with the concerns that are being expressed by individual financial institutions, industry bodies and third countries over the scope and enforceability of the proposed tax. Luxembourg's abstention from the vote on 22 January 2013 was, according to Bloomberg, explained by its concern that enhanced cooperation should not be "used as a tool to impose" taxes on non-participating Member States[1]. On 13 February 2013 various US industry groups wrote to the Commission to warn that the FTT would hurt the US and other economies, harm consumers and damage international relations. They stated that "The extraterritorial application of this tax in the United States by other jurisdictions would further fray the bonds that bind our global economy." On 16 April 2013 a number of industry bodies from other third country jurisdictions wrote to G20 leaders to protest at the extraterritorial effect of the proposed FTT.

1 On 22 April 2013 Luc Frieden, Luxembourg's Minister of Finance was reported by Reuters to have said that "We are very sympathetic to the stance of the UK ... We will certainly bring our support to the case that has been started in the European Court of Justice." Shortly after making these comments he was asked whether Luxembourg was now considering formally adding its signature to the UK's challenge, rather than just voicing support. He replied "This is something that I have to examine. We are now in a political process and then I have to look into the details."

Whilst those jurisdictions outside the FTT-zone are protesting about the extraterritorial reach of the FTT proposal, the countries within the zone have their own concerns. On 16 April 2013 the 11 participating countries sent a memo to the Commission asking for clarification of a number of issues, including the impact of the FTT on the cost of sovereign and corporate debt[2]. Although the raising of capital through, for example, the issuance of shares and bonds on the primary market is excluded from the scope of the FTT, the trading of debt instruments, including sovereign debt, on the secondary market is not exempt. In addition, there is concern that the application of the FTT to repurchase agreements will make such agreements, especially overnight repos, economically unviable. The possibility of the extinction of the repo market plus the application of the tax to secondary market trading has raised concerns of a negative effect on bonds market and a consequent increase in the the cost of funding for governments and corporates alike. The FTT-zone and the non-participating Member States are now questioning the Commission's impact assessment of 14 February 2013.

Other areas of concern are the inclusion of pension funds as financial institutions liable for the tax, the lack of exemptions for derivatives, structured products, hedging and market-making and the likelihood that the posting of collateral is within scope of the tax. One general criticism that can be levied against the FTT is that it is inconsistent with the general direction of travel of the EU, particularly at a time when there is a need to encourage EU economic growth and competitiveness. More specifically, bringing the posting of collateral within scope appears inconsistent with both EMIR[3] which requires the exchange of collateral as a risk-mitigation technique for uncleared OTC derivative trades and the fact that interbank lending is moving from an unsecured to a secured basis. Other risk mitigation techniques mandated by EMIR, such as portfolio compression and reconciliation, could be regarded as material modifications and equally attract the FTT.

Enforcement also remains a concern, particularly where financial institutions are outside the FTT-zone. One apparent means of addressing this concern seems to be the suggestion that there be joint and several liability for the payment of the tax amongst the parties to the transaction, extending to entities which would not otherwise be liable for the tax such as CCPs, CSDs and entities which are not financial institutions. In this case, the apparent solution raises its own legal and practical concerns.

What next?

The UK's challenge will not cause the 11 Member States who want to adopt the FTT to suspend their negotiations nor the coming into force of what is ultimately agreed. It is unlikely that the ECJ will hear the challenge before 2014. It appears, however, equally unlikely that the envisaged timetable for the introduction of the FTT will be met. The ambitious plan was for the national legislation implementing the tax to be in place by 30 September 2013 and to apply from 1 January 2014 but political agreement before the German elections in September 2013 is looking unfeasible.

It is important, therefore, that all those who are interested in the shape of the FTT continue their lobbying efforts. Points of concern can be raised with all EU Member States, both participating and non-participating, the Commission (the Internal Market and Services Directorate General and the Taxation and Customs Union Directorate General) and the European Parliament.

The UK challenge reveals that the legal concerns that we have previously identified are being taken seriously. Accordingly, all those who will be affected by the FTT should consider their own legal options. Whereas natural and legal persons do not have the same privileged status as Member States and need to show standing, it is possible for persons *directly and individually concerned* by a directive to challenge it once it has been adopted. The grounds for challenge

2 See "Implementing enhanced cooperation in the area of Financial Transaction Tax - Questions to the Commission from the working level."

3 Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

are set out in the Treaty: lack of competence, infringement of an essential procedural requirement, infringement of Treaty provisions or misuse of powers. It is also possible for trade associations to bring a challenge if, for example, they represent persons who themselves have standing.

The case law about challenging a decision at the earliest opportunity or risking being time-barred from later challenge applies equally to natural and legal persons. There is an extremely tight timescale for challenge to the ECJ which cannot be extended (2 months from the publication of the directive in the Official Journal plus 24 days for procedural reasons) so consideration of legal options, particularly as to whether standing can be shown, must be given early in order that a fully informed decision regarding available options can be taken once the FTT directive is adopted.

In addition, consideration ought to be given to the operational issues, such as systems and business models, that the FTT will raise. Although some amendment to the proposal for a FTT directive and some delay appear probable, adoption of some form of tax on some types of financial instruments within a reasonably short timeframe remains likely.

If you have any questions about any of the issues raised in this update, please contact one of the lawyers listed below or your usual point of contact:

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