

## Trade Strategy

### Europe's Dalliance with FTTs

Market Commentary

17 April 2012

#### Key Points

- It is highly unlikely that the EU FTT will be adopted by all 27 EU member countries.
- It is much more likely in our opinion that either a smaller set of countries implement a modified version of the EU FTT or individual countries will follow France's lead with unilateral FTTs.
- France's FTT (FFTT) on equity trading, HFT and naked exposure to EU sovereign debt through CDS is aimed at the financial sector but most studies suggest that FTT costs will be passed on to end investors.
- HFT turnover is unlikely to be impacted by the "tax on HFTs" since it only applies to HFTs operating in France and is easily circumvented. The "tax on shares" element will also not impact HFTs since it applies to *net* buys only.
- Investors could change the way they gain exposure to French equities by making greater use of derivatives (e.g. CFDs or futures).
- Currently, France is one of the cheapest equity markets to trade in Europe. After the imposition of the FFTT – expected to go live in August 2012 – it will become the 4<sup>th</sup> most expensive.
- Most studies conclude that the real economy effect of an FTT would be negative and that it would do nothing to prevent future financial crises.
- Strong political momentum dictates that other countries are likely to follow France's lead and implement an FTT ahead of the 2014 proposed implementation date for the EU FTT.

## Transaction Tax Debate Heats Up

### French FTT Proposal Gains Traction in EU Capitals

Opinion is divided on the merits of introducing a form of financial transaction tax (FTT) in Europe. Those in favour argue that it will raise a significant amount of revenue from banks, reduce the risk of future crises and discourage short-term trading. Opponents argue that it will be borne by ordinary investors, have a negative impact on GDP and do nothing to stop speculative bubbles forming.

On 28 September 2011, the European Commission published its proposal and impact assessment for an EU wide FTT covering virtually all financial instruments, asset classes and transaction types. Technical discussions on this proposal have reached political gridlock, and alternatives – including an EU wide stamp duty tax and Financial Activities Tax<sup>1</sup> – are being considered.

Meanwhile, France's FTT (FFTT) proposal covering equity transactions, HFT and naked exposure to EU sovereign debt through CDS is expected to go live in August 2012. The situation remains highly fluid, with François Hollande proposing even tougher measures if he is elected president of France this May, but the current French approach, loosely modeled on UK stamp duty, has gained traction in EU capitals and other countries may be tempted to follow suit.

### How Does the FFTT Proposal Measure Up?

While much has been written on the potential impact of the EU FTT – see [Financial Transaction Tax – Review of Impact Assessments](#) [1] by the International Regulatory Strategy Group for an excellent critique – significantly less has been published on the FFTT.

In this report we summarise the main features of the FFTT and compare them with UK stamp duty and the EU FTT proposal. We also investigate the following key topics of debate:

- 1) Who will actually pay the tax and what impact might it have on HFTs?
- 2) If the cost is passed on to end investors, what impact might it have on portfolio returns?
- 3) What will be the impact on overall trading costs in France and could it become more like the UK or India?
- 4) How might the real economy be impacted?

<sup>1</sup> A Financial Activities Tax is a tax on profits and remuneration at banks and other financial services companies.

## FTTs in a Nutshell

The FTT is being presented as similar to UK stamp duty, but there are some notable differences. The EU FTT should also not be confused with the FTT or UK stamp duty since it is much broader in scope.

### UK Stamp Duty / SDRT

- 0.5% (buys only) on UK shares.
- All companies incorporated in the UK.
- Only applies upon agreement to transfer beneficial ownership (i.e. CFDs, swaps, single stock futures and synthetic ETFs are exempt).
- Market makers and LSE member firms exempt.
- Generally collected via CREST.
- 1.5% on issue of depository receipts and transfer of shares into clearance services.

### French FTT [due to go live August 2012]

#### Tax on Shares:

- 0.1% (buys only) on shares in companies headquartered in France with market cap > €1bn.
- Intermediary exemption is available for defined market making activities.
- Only applies upon transfer of beneficial ownership (i.e. CFDs, swaps, single stock futures and synthetic ETFs are exempt).
- Only applies to *net* purchases upon settlement.
- To be collected via Euroclear.

#### Tax on HFT:

- Only applies when order cancels or modifications exceed a certain threshold of orders submitted – TBD, but not likely to be below two-thirds.
- 0.01% on excess of cancelled or modified transactions above threshold.
- Applies to all equity securities (not just French)
- HFT firms operating in France.

#### Tax on CDS:

- 0.01% on naked exposure to EU sovereign debt via CDS by French based entity.

See [AMAFI Financial Transaction Tax](#) for further details.

### EU FTT [2014 target]

- 0.1% (buys & sells) on non-derivatives, 0.01% (buys & sells) on derivatives.
- Applies to tradable securities; repos and securities lending borrowing agreements; derivatives (OTC and exchange traded); intra-group transactions; (re)-delivery of collateral, including margin calls.
- At least one party to the transaction must be based in EU through incorporation, residence, location of branch or Member State authorization.
- See [Public Policy Note - EU FTT Proposal](#) for further details.

## How Do The Major FTTs Compare?

### “Tax on Shares” Element of FTT Similar-ish to UK Stamp

“...it is difficult for the UK to criticise this tax as madness, since stamp duty served as its inspiration”.

François Baroin, French Finance Minister, FT.com, 13 February 2012.

UK stamp duty or SDRT is applied at 0.5% on agreement to purchase shares of UK incorporated companies, raising around £3.0bn a year [2]. It is chargeable whether the transaction takes place in the UK or overseas, and whether or not either party is resident in the UK.<sup>2</sup> There is relief for intermediaries – e.g. market makers and LSE member firms – to facilitate their obligation to provide liquidity.

**Similarities:** The “tax on shares” element of the FTT is similar to UK stamp duty – it is charged whether the transaction takes place in France or overseas, only applies to share purchases of companies with headquarters in France and exempts market makers and other intermediaries, although the scope of the intermediary exemption is not as wide as in the UK – e.g. unlike UK stamp duty principal trading by brokers is not exempt.

**Differences:** It differs with respect to UK stamp duty in that it is *only* 0.1%, excludes companies with market caps less than €1bn on 1 January each year<sup>3</sup> and is to be applied at the point of settlement, as opposed to the transaction level. In other words, if intra-day buys and sells in the same stock lead to the delivery of a net balance, the tax applies only to the net balance delivered to the buyer.

This is unlike UK stamp duty where 0.5% is applied to all eligible buy trades, independent of any offsetting sells. The FTT also goes further than UK stamp duty in that it taxes HFTs operating in France and naked exposure to EU sovereign debt through CDS (see side box).

### EU FTT Much Broader in Scope vs. FTT and UK Stamp

“We just can't get it [the EU FTT] done”

Wolfgang Schaeuble, Germany Finance Minister, Reuters, 26 March 2012.

The EU FTT proposal is much broader in scope than both UK stamp duty and the FTT. As well as equities transactions (sells and buys), it also covers buy and sell transactions in bonds, structured products, units in unit trusts, derivatives (OTC and exchange traded), intra-group transfers and delivery / re-delivery of collateral, including margin calls.

The rate applied for non-derivatives transactions is 0.1% and the rate on derivatives is 0.01%. While this may not sound like much, the cumulative effect of charging each agent (i.e. the buyer and the seller) 0.1% or 0.01% in a multi-step execution process can be substantial, particularly if the fund's turnover is high and the full end cost is passed on to the end investor.<sup>4</sup>

Political wrangling within the EU, and even between Eurozone countries, means that it is highly unlikely that the EU FTT will be adopted by all 27 EU countries. It is much more likely in our opinion that a smaller set of countries either implement a modified version of the EU FTT or follow France's lead by introducing an individual tax on equity trading (with some kind of accompanying anti-HFT policy).

<sup>2</sup> A charge of 1.5% is applied on conversion of ordinary shares into depository receipts (e.g. ADRs). Thereafter, trades in depository receipts can take place without the 0.5% charge being applied since the registered owner of the underlying share is unchanged.

<sup>3</sup> There are approximately 107 stocks in the 349 member CAC All-Tradable index with market caps > €1bn accounting for 97.7% of the weighting.

<sup>4</sup> Illustration B from ALMA's note [3] is a good demonstration of the potential *cascade* effect of the EU FTT.

## What the Impact Assessments Say

Most of the EU FTT impact assessments published so far seem to support the view that the tax would be passed on to end investors, including individual investors and pension funds.

**Oxera** [4]: "...for most transactions, it would seem sensible to assume that the pass-through of the tax from traders to investors or companies is close to 100%, including any intermediate transactions...".

The **IMF** [5] notes that any transaction is likely to be passed on to clients "which not only include wealthy individuals and corporatism but charities and pension and mutual funds".

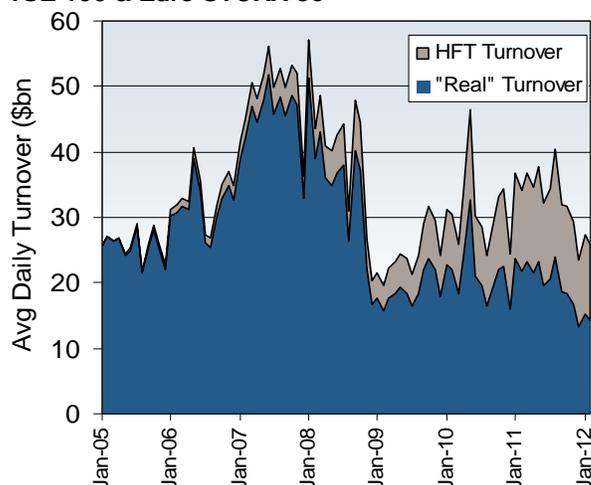
The **Netherlands Bureau for Economic Policy Analysis** [6] highlights the potential for a negative impact on prices in the short-term with the burden of this drop "...falling most heavily on those holding the largest fraction of such investments, pension funds and wealthy individuals" and longer term adjustments in prices and wages to reflect the increased cost of capital.

**Oliver Wyman** [7] adds further weight by suggesting that the EU FTT would "Predominantly hit the real economy (pension funds, asset managers, insurance companies and corporates) as both direct and indirect costs will largely be passed on to the end users; these end users will be the least able to move transactions to jurisdictions not subject to the tax".

The **Institute of Development Studies** [8] suggests that "a significant proportion of the tax could end up being passed onto consumers".

The **EC** [9] itself concludes that costs will "also fall on the users of financial services".

### Exhibit 1: HFT vs. "Real" Money Turnover in the FTSE 100 & Euro STOXX 50\*



Source: Credit Suisse Trading Strategy, January, 2005 – February, 2012

<sup>5</sup> Grant, Jeremy. "European MP calls for holding period in HFT". The Financial Times, 23 March 2012

<sup>6</sup> "Price list for trading services". Borsa Italiana, London Stock Exchange Group, 23 February 2012, page 18.

<sup>7</sup> The EC's impact assessment [11] states that HFTs would "probably" disappear from European markets as a result of the EU FTT.

## Aimed at the Financial Sector But Who Will Really Pay?

### Cost of Client Facilitation Likely to Be Passed on to End Investors, But Broker's Principal Trading Caught by FTT

"It's a question of fairness ... it is time for the financial sector to make a contribution back to society."

José Manuel Barroso, President European Commission, FT.com, 28 September 2011.

Those in favour of FTTs in Europe often present them as a tax on banks, but it is highly likely that the full cost of the tax would be passed on to end investors, including pension funds and individual investors. At the very least, broker commissions would be increased to reflect the cost of the FTT, as is common practice in some emerging markets where FTTs are in use. Most of the impact assessments published so far appear to agree with this view (see side box).

Brokers would need to pay the FTT on principal trading activities however, so it is true that some of the tax burden may fall on banks.

### HFTs Largely Unscathed... For Now

In order to avoid paying the 0.01% charge, HFT firms operating in France would need to register as market makers (something which is already being encouraged through draft MiFID II legislation) or relocate outside France. The very nature of the HFT business model – i.e. holding positions for very short periods of time and *always being flat by the end of the day* – also means that the 0.1% "tax on shares" does not apply to them, since the tax is levied on *net buys only* (see p. 2).

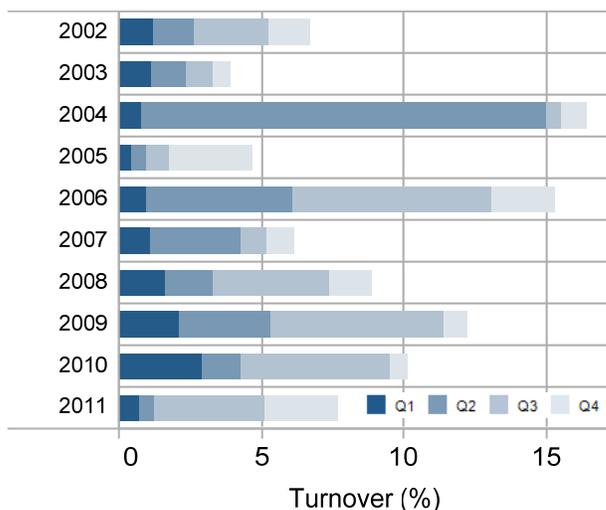
We therefore do not expect the FTT to impact HFT turnover levels.

However, it is possible that more stringent rules could be introduced due to strong anti-HFT sentiment in Europe. For example, minimum holding periods have recently been advocated by Marcus Ferber<sup>5</sup> – German member of the European Parliament – and Borsa Italiana recently introduced a more costly pricing scheme<sup>6</sup> for HFTs at the request of Italian regulator Consob.

In [Who Let The Bots Out? Market Quality in a High Frequency World](#) we highlight the broadly neutral impact of HFTs on trading in the US. While HFTs account for a smaller percentage of turnover in European markets it is hard to dispute their growing importance in terms of market volumes, particularly in light of weak "real money" turnover (see Exhibit 1). If HFTs were to be eliminated<sup>7</sup> from European markets we would expect a 40% – 45% reduction in turnover, consistent with the EC's view [10] that HFT accounts for "up to 40% of the total [turnover] on some market segments".

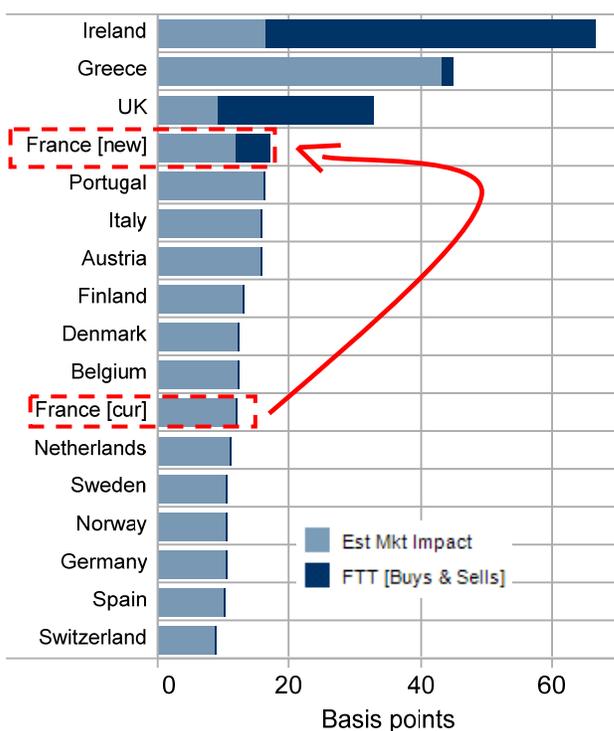
\*Our analysis uses the FTSE 100 and Euro STOXX 50 turnover indices. We adjust for the growth of MTFs, which we now estimate at 40% market share, as well as HFT, which has been estimated at 45% of turnover (consistent with the EC working paper estimate).

**Exhibit 2: Impact of Quarterly Reviews on CAC 40 Passive Fund Turnover (Two-way)\***



Source: Credit Suisse Trading Strategy, Bloomberg  
 \*Quarterly reviews reflect adds, deletes, shares in issue updates and free float changes.

**Exhibit 3: Total Trading Costs by Country\***



Source: Credit Suisse Trading Strategy, March 23<sup>rd</sup>, 2012

\*Market impact estimates are based on the Credit Suisse EDGE pre-trade model and assume a trade size of 1% ADV in each market, executed at 25% participation.

## What Difference Does 0.1% Make?

### FFTT Will Increase Cost, Particularly for Active Funds

*"It is not a tax on bankers, it's a tax on people's pensions"*

George Osborne, Chancellor of the Exchequer of the UK, guardian.co.uk, 29 November 2011.

The rate at which the FFTT is imposed is only one-fifth of UK stamp duty (i.e. 0.1% versus 0.5%). This has led to the view in some quarters that it will be easily absorbed and have a negligible impact on investor returns. Our analysis suggests this may indeed be true with respect to passive funds. Analysis of CAC 40 quarterly review rebalancing from 2002 – 2011 (see Exhibit 2) suggests that the FFTT would only cost (on average) an additional 0.5bps per year as compared to a current total expense ratio of 25bps for a typical CAC 40 ETF tracker.

However, funds which rebalance more often would incur much higher costs. Assuming turnover of 20% per quarter an active fund would face additional costs of 4bps per year. As with the passive analysis this excludes the 0.1% charge which would be applied to cash injections and ad hoc rebalancing so should be treated as a lower bound.

### France Will Become Europe's 4<sup>th</sup> Most Expensive Market

Currently, our [EDGE](#) pre-trade model shows France as one of the cheapest markets to trade in Europe. After the imposition of the FFTT we estimate it will become the 4<sup>th</sup> most expensive (see Exhibit 3), which could lead to reduced value traded. It will also add ~1.1bps to the cost of an MSCI Europe buy basket (see Exhibit 4).

**Exhibit 4: Current Taxes & Fees by Region (based on MSCI indices)**



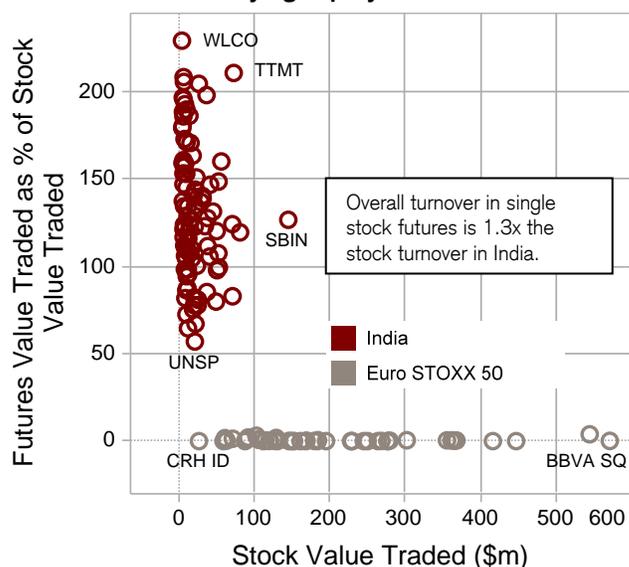
Source: Credit Suisse Trading Strategy, June 17<sup>th</sup>, 2011

### EU FTT Even More Expensive & Impacts Bond Funds Too

Blackrock [12] and the European Fund and Asset Management Association (EFAMA) [13] have both published analysis on the potential cost of the EU FTT. Blackrock, based on actual turnover data from its funds, finds that the EU FTT would have a negligible impact on an equity UK passive fund, but would increase the annual cost of rebalancing a UK active fund by 6bps and a European active fund by 257bps. They also point to a 6bps increase in the cost of a fixed income passive Euro fund versus 25bps of additional cost for a Euro active fund. On top of this they estimate that wider bid-ask spreads, lower liquidity and increased volatility as a result of the EU FTT could add 10-15bps of additional cost per annum.

EFAMA reaches broadly similar conclusions, concluding that the EU FTT would increase annual costs for equity funds by 15bps, bond funds by 20bps and short-term money market funds by 130bps under its central portfolio turnover scenario. They also suggest that the tax would raise €15bn from direct trading in UCITS funds, based on 2011 sales and redemptions data.

**Exhibit 5: India - Single Stock Futures Value Traded vs. Underlying Equity Value Traded**



Source: Credit Suisse Trading Strategy, March 23<sup>rd</sup>, 2012

## Could France Morph into the UK or India? CFDs and Single Stock Futures Could Gain in Popularity

"...the brunt of the tax will not be paid by ordinary pensioners and savers but hedge fund managers and investors".

Griffith-Jones and Persaud, Financial Transaction Taxes, February 2012.

Investors (particularly hedge funds) could change the way they gain exposure to French equities in response to the "tax on shares" element of the FTT. One possibility is that France begins to mirror the UK where CFDs and spread betting (for retail clients) are a popular means of gaining synthetic exposure to the underlying share without incurring the stamp duty charge. For the same reason trading in synthetic ETFs may become more popular, reversing a recent trend towards less complex and opaque structures (see [European ETP Trends and Outlook](#) for further details).

A second possibility is that single stock futures become more popular. In India, a Securities Transaction Tax (STT) of 0.125% and a stamp tax of 0.01% (both on buys & sells) make direct equities trading expensive and have contributed to an unusually liquid market in single stock futures (see Exhibit 5). Currently there is virtually no volume in French single stock futures.

## Don't Believe Everything You Read in Press Most Studies Agree Net Effect on Real Economy Would be Negative, and HFT Did Not Cause the Financial Crisis

"The EU is proposing this tax to distract from the real culprits for Europe's troubles – spendthrift governments who cannot balance their books."

Sam Bowman, Head of Research, Adam Smith Institute, 4 November 2011.

"The gap between reality and rhetoric is bigger for this industry [HFT] than for any other I have seen" Remco Lenterman, Chairman of the European Principal Traders Association, The Economist, 25 February 2012.

Most studies, including the EC's own impact assessment, agree that an EU FTT would have a negative effect on GDP – due to relocation of business activities, higher financing costs (lower profits), lower investment levels and higher unemployment. Oxera [16] and the Swedish National Bank [17] additionally point out that a fall in GDP would prompt a reduction in revenues from other taxes, which could lead to the EU FTT actually reducing the total amount of tax generated.

However, there are dissenting voices. Griffith-Jones and Persaud have been prominent in the press by suggesting that the EU FTT would actually help increase GDP by reducing the risk of future crises (see side box). We find their argument disingenuous because they acknowledge elsewhere [15] that an FTT by itself would "clearly not" reduce the risk of future crises and would have to be accompanied by a raft of policies including "prudent macroeconomic policy, effective financial regulation as well as supervision...".

### Beyond the Headlines

Griffith-Jones and Persaud's headline argument that the EU FTT would have a positive impact on GDP is heavily qualified in their paper and attributes blame for the financial crises to short-term traders.

**Pro-Tax Message for the Press:** "If we conservatively estimate that the probability of crisis would decrease by only 5% as a result of the FTT, which is very low, and we take into account that on average financial crises decrease gross domestic product (GDP) by around 7%, we would have a positive impact of +0.35% of GDP due to smaller likelihood of future crisis. The total net effect of an FTT would be an estimated boost of Europe's GDP by +0.25%, not a reduction." – "Why critics are wrong about a financial transaction tax" – [14] (European Voice, 12 March 2012).

**The fine print from their paper:** "We are clearly not arguing that on its own, the FTT would reduce the risk of crises, as prudent macroeconomic policies and effective financial regulation as well as supervision also have a major role to play in crisis prevention." – [15] (Financial Transaction Taxes, February 2012).

**If all else fails, blame HFTs:** "However, by significantly reducing the level of noise trading in general and reducing (or eliminating) high frequency trading in particular, the FTT would make some contribution to the reduction of severe misalignments and hence the probability of violent adjustments." – [15] (Financial Transaction Taxes, February 2012).

## Would FTT Prevent Future Crises?

Most impact assessments conclude that the EU FTT would not help prevent future financial crises.

The **IMF** study [18] states that a transaction tax is an *“inefficient instrument for regulating financial markets and preventing bubbles... [c]urrent economic thought attributes bubbles to excessive leverage, not excessive transactions per se”*.

The **World Bank** paper [19] agrees – *“a transactions tax would have little effect in discouraging the activities of the credit default swap market, the market in securitized sub-prime mortgages, or other derivatives based markets whose malfunction is thought to have contributed to the [credit] crisis”*.

The **Netherlands Bureau for Economic Policy Analysis** [20] notes that *“we should not conclude that this [the EU FTT] reduces systemic risk. Historically, financial crises are often associated with collapsing real-estate bubbles... real estate is not widely traded and any mispricing in this market will therefore not likely respond to a transactions tax.”*

However, **Griffith-Jones and Persaud** [21] provide an alternative view – *“To us and hundreds of other economists, the evidence is clear that an FTT adopted by all 27 EU states or by the 17 members of the eurozone would help strengthen Europe's finances and reduce the likelihood of crises”*.

Their view [15] that an FTT would nevertheless *“make some contribution to the reduction of severe misalignments and hence the probability of violent adjustments”* by *“significantly reducing the level of noise trading in general and reducing (or eliminating) HFT”* is also misleading, in our opinion. The conventional view is that rapid trading on equity markets had nothing to do with the real causes of the Global Financial Crisis or the Euro Debt Crisis (see side box).

## Conclusion

*“[Merkel can only rely on SPD support] if she finally takes the wind out of the speculators' sails with an FTT”*

Garreth Duin, Economic spokesman for the Social Democratic Party, FT.com, 5 March 2012.

Political wrangling within the EU, and even between Eurozone countries, means that it is highly unlikely that the EU FTT will be adopted by all 27 EU member countries. It is much more likely in our opinion that a smaller set of countries – in particular those with elections looming – either implement a modified version of the EU FTT or follow France's lead by introducing an individual tax on equity trading (with some kind of anti-HFT policy).

The FTT is partly aimed at banks but most studies conclude that in reality the cost will likely be passed on to end investors, including pension funds and individual investors – particularly affecting those in high turnover funds. HFTs are also targeted but since the tax on HFTs only applies to those operating in France it is easily circumvented and is unlikely to impact overall volumes. The “tax on shares” element will also not impact HFTs since it applies to *net* buys only. However it could lead to some market participants making greater use of derivatives – for example CFDs or futures – as a means of gaining synthetic exposure to the underlying share without incurring the FTT charge.

Almost all studies conclude that the EU FTT would have a negative impact on the real economy and do nothing to reduce the risk of future financial crises; however, strong political momentum dictates that other countries are likely to follow France's lead and implement an FTT ahead of the 2014 proposed implementation date for the EU FTT.

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