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REF: THE ITALIAN FINANCIAL TRANSACTION TAX (*Sections 491 to 500 of Italian Law No. 228 of 24 December 2012, published in the Official Gazette No. 302 of 29 December 2012 (the Law)*

Dear Sirs,

The International Swaps and Derivatives Association's (ISDA[1]) European Tax Committee would like to send you some brief comments with reference to the Financial Transactions Tax (**FTT**) introduced by the Italian Parliament in the Stability Law 2013, which was approved at the end of December 2012.

We understand that a number of other industry bodies operating in the financial markets and in other sectors, as well as professional bodies and advisers and other interested parties, may also be submitting comments before the secondary legislation is approved in order to determine the application rules.

The following comments are made to Sections 491 to 500 of Article 1 of the Law. References to the Decree are made to the Decree to be adopted by the Ministry of Economy and Finance pursuant to Section 500 of the Law.

1. Definition of market making activity – Section 494 (a)

The Law cross-references the definition of market making activities set out in Article 2(1)(k) of EU Regulation No. 236/2012 of 14 March 2012 on short selling (the **Short Selling Regulation**) for the purposes of exempting such activities from the scope of the FTT (the **Exemption**).

ISDA agrees with the definition provided in the Short Selling Regulation. Regarding the interpretation of this Exemption we understand it on the basis of the arguments set out below and support the activity of the Ministry of Economy and Finance and the Italian Revenue Agency related to the issue of both the Decree and the implementing regulations, respectively, pursuant to Section 500 of the Law. We are however concerned with certain elements of the interpretation of the Article 2(1) k of the Short Selling Regulation that

[1] Since its founding in 1985, ISDA has worked to make over-the-counter (OTC) derivatives markets safe and efficient. ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. ISDA has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool. Today, ISDA has more than 800 members from 55 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on OTC derivatives to efficiently manage the financial market risks inherent in their core economic activities. ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of ISDA toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework.

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is currently under consideration by the European Securities and Markets Authority (ESMA) and we hope that market participant's views will be taken into account in ESMA final guidelines on market making, expected to be published end January or early February 2013.[2]

From an operational perspective, market making is at its heart the provision of liquidity and, as such, directly contributes to the promotion of long-term growth in the capital markets. This activity is vital to the efficient and effective running of the markets and, more importantly, contributes to a reduction in transaction and funding costs for end-user investors and corporates, provides enhanced risk management options, and allows improved access to finance.

An inaccurate or incomplete interpretation of the definition of market making activity for the purposes of FTT will create an obstacle for legitimate market making activities that meet the tests of client servicing and hedging, and will therefore have a damaging effect on liquidity and efficiency in the equity, securities and derivatives markets – this would also affect markets where market makers are reliant on these instruments to hedge their risk positions.

If this would be the case, the ultimate consequence would be a reduced liquidity in the derivative market that would result in higher issuing or funding costs for Italian companies, in particular smaller companies. Indeed, if markets become more costly or uncertain then companies will have to compensate investors for the increased risk, leading to higher funding costs for their debt.

We would thus recommend an interpretation of the Exemption that is practical to implement in accordance with the text and the intent of the Short Selling Regulation, supports the efficient functioning of EU markets, and reflects the needs of market participants who look to market makers to provide liquidity across a range of financial instruments at a reasonable cost affordable for corporates.

Based on the definition of the market making activity under the Short Selling Regulation, the Exemption would apply to trading in any financial instrument where an investment firm is performing any of the quoting, client servicing and hedging activities listed in Article 2(1)(k) of Short Selling Regulation.

This approach is consistent with existing practice and the CESR Report on Technical Details of the Pan-European Short Selling Disclosure Regime (Report CESR/10-453) and the CESR Report on a Model for a Pan-European Short Selling Regime (Report CESR/10-088).

Therefore, most firms have scoped their implementation plans related to the Short Selling Regulation in keeping with CESR interpretation.

Furthermore, equity derivatives are used by institutional clients to hedge their portfolios and manage their risk. The fact that the instrument can be acquired over the counter (**OTC**) allows it to be customised according to the specific needs and requirements of the client. For example, an institutional investor may have issued a product to its client base; in order to hedge this offering effectively, the institutional investor may wish to enter into a customised derivative.

For market makers in 'related' equity derivatives, it is essential that they can hedge their positions (that are created as a result of their market making activity) using the underlying instrument (which would be cash equities in relation to this example).

Overall, we understand that the Exemption seeks to enable market makers to continue offering liquidity in derivative products and clients using these instruments, to address customised funding and hedging needs, to effectively mitigate other business-related risks and ensure meaningful transparency by avoiding double counting with the clients' orders.

[2] ISDA/AFME 31 Oct 2012 letter to ESMA on market making (SSR) (https://isda.securevdr.com/default.aspx?cmd=d&id=s93f5eba99ec4911a)
Responses to ESMA consultation on market making and primary dealing exemption for short selling (http://www.esma.europa.eu/consultation/Exemption-market-making-activities-and-primary-market-operations-under-Regulation-EU-23#responses)

Similarly to the exemption under the Short Selling Regulation, the Exemption is crucial to the efficient and orderly functioning of markets. Market makers provide liquidity which involves taking some amount of direct risk for short periods. They must manage the inventories of positions they take as principal in order to mitigate those risks. If this is done effectively, it allows them to accommodate clients' orders quickly and at favourable prices. Restrictions on the ability of market makers to manage risk discourages them from taking on intermediation risk, reducing the ability of investors to manage their own risk in a timely and cost-effective manner.

In order to facilitate a customer who wants to sell a financial instrument the market maker must acquire the financial instrument as principal for short periods of time. In order to hedge the risk associated with the acquisition of the financial instrument, the market maker may elect to sell the financial instrument. Such hedging can take place before or after the trade with the client (called "anticipatory market making").

Gradually accumulating a short position in anticipation of a large sale by a client (rather than selling after the fact) is often the best strategy for maintaining an orderly market and providing the best prices to clients as well as reducing potential impact on the volatility of the market.

If the market maker cannot properly hedge its positions or hedging becomes too expensive, the market maker is compelled to reduce its activity, with a consequent deterioration or reduction of the positive effect that such activity brings to the market.

In other words, limitation to the possibility of the market maker to hedge its positions has a negative impact on the market, which is reflected on the final client in terms of increased costs and reductions in markets' efficiency.

In summary, taking into account that:

(i) the European financial institutions conduct market making activity in a wide range of financial instruments;

(ii) those institutions may want to rely on the Exemption even when they trade on illiquid products in order to execute client's orders in the best efficient way;

(iii) the scope of the Exemption should be determined on the basis of the trading activity itself and not on the type of products that are traded; and

(iv) there are lots of financial instruments that would fall under the scope of the Law that do not trade on any venue,

<u>we believe that the interpretation of the Exemption under the Law should comprise, and/or rely on, the market making activity that is effectively and efficiently performed for the benefit of the financial markets as described above, and result in an interpretation that (1) refers to the market making activity identified on a issuer/reference entity basis (rather than on a product basis), (2) includes all necessary and reasonable hedging activities that arise from market making and/or client facilitation activities; and (3) is construed irrespective of the liquidity of a financial product or the admittance to trading of the relevant financial product in a regulated venue.</u>

<u>The suggested interpretation of the Exemption would be in line with the rationale of the Law, which does not intend to create obstacles or affect the liquidity of the markets, and is shared by intermediaries that are already familiar with it</u>.

2. Derivatives in scope of FTT – Section 492

2.1 FTT applies to derivative transactions (including, but not limited to, warrants, covered warrants and certificates) linked to, providing for the right to transfer, or having as their underlying instruments, "mainly"

Italian shares or other in-scope securities (please refer to Section 491 of the Law). Although it is clear that the Italian securities should somehow "prevail" over the other underlying instruments in order for a derivative to be in scope, no criteria have been identified for the assessment of this "prevalence".

It can be reasonably held though that this "prevalence" should be verified on the basis of the economic value of the underlying instruments, which can be gathered from either available market quotations or alternative assessment methods where no market quotations are available (e.g. recent transactions on the same or similar products; the consideration paid by the client net of any transaction fee; expert opinions; etc)

In this respect, the Decree should indicate (i) what parameters/method shall be taken into account/applied in order to verify said "prevalence"; (ii) the moment in time in which such "prevalence" test shall be performed; (iii) whether such "prevalence" tests shall be conducted only once with respect to a derivative transaction or on the occasion of amendments to the derivatives transaction agreed between the parties; (iv) the method to calculate the economic value of a derivative transaction, if relevant; and (v) if applicable, whether the relevant economic value shall be determined on single-day trading values before execution or on the average of the values registered in a certain period of time preceding the execution (e.g. the average of trading values registered during the last calendar month, etc.)

In this respect, it is our view that since the FTT applies to both parties as at the date in which the derivative transaction is entered into, the information necessary to perform the "prevalence" test shall be available to the parties on or prior to that date. Subsequent fluctuations in the value of the underlying instruments should therefore not affect the application of the FTT, i.e. changes in value should not result in new taxable events.

Moreover, amendments to the terms of a derivative transaction should not trigger further taxable events, unless the amended transaction is so materially different from the original transaction that the latter shall be deemed to be terminated and replaced by the new transaction in accordance with the parties' will[3].

2.2 FTT seems to be applicable to the "notional amount" of any derivative transaction. However no definition of "notional amount" is given throughout the Law. We believe that Decree shall specify what shall constitute the "notional amount" that is the basis on which the FTT shall be applied, as derivative transactions may include complex terms and often the economic value of the cashflows exchanged between the parties is not equivalent to the amount that is indicated as parameter to such cashflows (eg. short term out-of-the money options).

3. FTT mechanics for derivative transactions

3.1 Transaction chains

As a matter of fact, listed derivatives can be entered into either by entities authorised to trade on the relevant market directly (authorised brokers), or by unauthorised entities acting through an authorised broker.

A private client of a financial institution may enter into a listed derivative transaction by executing an equivalent OTC derivative transaction with an authorised broker.

Alternatively such a client may deal with a non-authorised broker, who enters into a second OTC transaction on client's behalf with the first broker, who in turn takes an equivalent position on the regulated market. Thus, the client's order generates a number of transactions equal to the number of parties intermediating such order.

Nonetheless, the Law explicitly excludes the application of FTT to intermediaries acting on behalf of a client (Section 494 of the Law, first sentence). Therefore, it is our view that when more than one broker intervenes in the same transaction, FTT should be only applied once, by the broker who directly receives the order from

[3] The Italian Civil Code defines this concept as an objective novation (*novazione oggettiva*). Article 1230 of the Italian Civil Code provides that "*The obligation is extinguished when the parties substitute a new obligation having a different subject or title from the previous obligation. The intent to extinguish the original obligation must appear in an unequivocal manner*".

the client and that, consequently the Decree shall specify such circumstance.

Any different interpretation not considering transaction chains as transparent would trigger a number of distortive and detrimental effects for the markets, such as:

(i) double taxation of the same economic transaction;
(ii) consequent increase of transaction costs for the final client and reduction of the market liquidity;
(iii) distortive impact on investment decisions, e.g. choice of the trading market and the relevant intermediary, purely driven by tax-related considerations.

On the contrary, under a correct interpretation of the Law, we believe that transaction chains should be taxed as a single transaction.

3.2 Definition of listed transactions

As already pointed out, the rationale of the Law is to prevent speculation and unregulated forms of trading. In order to accomplish this, the Law provides for the application of reduced tax rates to listed derivatives.

When the order refers to a listed transaction, the intermediary receiving the order should apply the tax rate set out in the chart attached to the Law, reduced by a fifth. This should also be the case when the client and its broker enter into an OTC derivative with the aim to facilitate the client's ultimate investment in a listed derivative, ie a client requests an authorised broker to enter into a listed derivative and the broker transfers the economic result of either (i) the listed derivative or (ii) a combination of listed and OTC derivatives to the client through a single OTC derivative.

Indeed, if the rationale of the FTT is to promote the conclusions of derivatives on regulated markets, it is our view that the rate to be applied to complex transactions aimed at transferring the result of a listed derivative to a client is the rate provided for listed transactions. Any different conclusion would prevent clients' access to the lower rate of taxation on listed transactions, transforming such favourable regime into a privilege for banks and financial entities trading for their own account on the relevant market.

Analogously, we believe that reduced tax rates shall be applicable to derivative transactions that are cleared through central counterparties in accordance with the provisions of the European Markets Infrastructure Regulation (**EMIR**), as this approach would be in line with the rationale of such legislation and all other related European legislation (such as the incoming MiFID II and MiFIR) aimed at increasing the number of derivative transactions traded through centralised platforms and, thus, improving market transparency.

The foregoing issues, similarly to those discussed under the previous paragraph 3.1 on transaction chains, should be clarified in the Decree.

4. Tax treatment of collateral – Section 491

The scope of the FTT on shares is very wide and in principle includes any transfer of ownership rights on in-scope securities, with certain exemptions. Among these exemptions there is one in particular dealing with temporary acquisition of securities liquidity transactions as set out in Article 2 (10) of the EU Regulation No. 1287/2006 of 10 August 2006.

This exemption does not seem to explicitly contemplate temporary acquisition of securities for no consideration, e.g. collateral. However, there are many collateral structures in the market that trigger the transfer of ownership rights (eg irregular pledge, charges under ISDA CSA, etc.). These structures are crucial for the liquidity of a market, as they mitigate credit and market risks.

Moreover, collateral structures pertain to other transactions which are autonomously taxed, so that the taxation of collateral would result in a double taxation of the same transaction. In addition, if collateral structures triggering transfer of ownership are taxed, these structures would be unreasonably differentiated from other collateral structures not triggering such a transfer, with a consequent distortive effect on the market.

If we look at the experience of the French FTT, in order to solve this issue the French lawmaker and authorities have limited the taxation to "transfers for value", i.e. in the absence of a consideration a transaction is out of scope of the FTT.

The current Italian legislation seems in line with this approach, e.g. when it calculates the value of the transaction on the basis of the consideration paid by the purchaser (see Section 491). In fact, if the value of the transaction depends on the consideration, a transfer that is not "for value" should not be taxed.

Nonetheless, in order to avoid uncertainties this aspect should be addressed in the Decree taking also into account the significant impact of the mandatory margin obligations related to the entering into derivatives transactions under the EMIR. In particular, derivative transactions that will be centrally cleared will be subject to the margin obligations set out by the relevant central counterparty whereas derivative transactions that would not be centrally cleared would be subject to the obligation to provide adequate collateral as prescribed in the EMIR and further specified by the implementing regulation issued by ESMA.

Finally it would be appropriate that the Decree specifies that the exemption in question also applies with respect to Section 492 of the Law as the cross-referenced transactions in question are also commonly documented as derivative transactions.

5. High frequency trading – Section 495

5.1 Section 495 provides that high frequency transactions executed on the Italian financial market are subject to a special form of FTT which is aimed to penalise high order to cancel or order to amend ratios. The Decree will set a threshold based on orders cancelled or modified on a certain trading date divided by the overall size of orders registered on the same trading date. The amount of orders cancelled or modified which exceeds this threshold is subject to FTT at a rate of 0.02%.

It is not clear though whether this tax only applies to entities operating on the Italian financial markets on a proprietary basis or also includes transactions executed by intermediaries upon clients' instruction (e.g. through smart order routing or similar technology).

In our view, the later transactions should not be taxed autonomously in order to avoid a double taxation of the same transaction, considering that the broker would only be an intermediary for transactions between its client and the market. We understand that the latter transactions would be covered by existing exemptions but confirmation on this point would be welcomed as soon as possible to give clarity to market participants and to avoid unnecessary market disruption.

5.2 It is important that the Italian tax authorities specify which is the objective of the HFT Tax, e.g. in France the objective is to discourage High Frequency Trading operations from French based entities rather than raising money (the objective is thus different from FTT on equities).

As FTT on HFT has been already implemented in France and operators invested heavily in order to comply with this legislation, it would be important that the Italian tax authorities could use the French model and implement it without major changes.

Please find below a short description of how the French High Frequency Trading Tax works.

Basically, the French tax on HFT applies if the desk is considered as high frequency trading on a given stock and, in this case, is calculated on cancelled orders.

A first test confirms whether the tax applies to a certain desk on a certain stock and consists in checking that the median of the time between the creation and the cancellation or modification of an order is below 500 ms, for an entire month. This check is done on a stock by stock basis., i.e. a desk could be considered as HFT on one Stock and not on the others if the latencies on this stock were too low.

This test must be made the month before the application of the tax (e.g. in August for a tax to be levied in September). If the test is made the same month as the calculation of the tax, the tax cannot be predicted and the tax does not work as a deterrent for cancellations of orders.

On the contrary a two-step process (1) eligibility based on the latency and (2) taxation based on cancellations or modifications allows for a better monitoring of latencies and cancellations.

Putting it otherwise, it is important to have certainty in advance, ie before a transaction is executed, as to whether the operations of a certain desk on a certain stock or derivative are going to be considered as High Frequency Trading operations.

This can be made if the eligibility test based on the latency is run in month N-1 and the tax is levied in month N, so that the high frequency trading desk is able to price its transactions accordingly during the month N, rather than discovering the last day of the month that a tax was due. This will also allow intermediaries to timely reduce their cancellation ratios, which will in turn minimize the volatility on the relevant market.

6. Exempt pension funds – Section 494 (b)

Section 494(b) of the Law exempts certain pension funds and pension entities from FTT. The Law refers to pension funds and entities set up within the context of the first pillar and the second pillar of the Italian pension system, which include mandatory and complementary contributions, but exclude private pension schemes.

Literally, the Law does not include equivalent EU pension entities or funds. Hopefully the Decree will clarify that equivalent pension entities and funds set up in other EU Member States also share the same exempt treatment, in order to prevent infringement procedures and to comply with the free movement of capital and, in general, the fundamental freedoms on which the EU Treaty is based.

Moreover, in consideration of the important role played by pension entities in the management of future pensions for employees and self-employed, it is worth considering whether the same treatment should be considered applicable to pension entities set up in white-listed countries (as set out in Ministerial Decree 4 September 1996, as amended), i.e. not only EU countries.

We remain fully at your disposal for further engagement and correspondence.

Yours faithfully,

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