

DRAFT NOTE FOR DISCUSSION PURPOSES ONLY

OECD Base Erosion and Profit Shifting (BEPS) project

Hybrid instruments – Draft discussion paper on the impact of a hybrid mismatch rule on intercompany stock lending and repo transactions

Meeting between HMRC/HMT and the trade associations on 9 September 2014

1. Purpose of note

This note is provided to facilitate a discussion between HMRC/HMT and interested parties on the potential impact of a hybrid mismatch rule on intercompany repo and stock lending transactions and to raise industry concerns as well around the definition of tax structured transactions. The aim of the meeting is to explain to HMRC/HMT how repo and stock lending transactions work and to outline our concerns regarding the application of action item 2 (neutralising the effects of hybrid mismatch arrangements) of the July 2013 OECD action plan on BEPS to the operation of the capital markets.

This note represents the preliminary thoughts of some members of AFME, ABI, BBA, CBI, ICMA and ISLA. This note has been put together in a short time frame and with the benefit of more time members may have further or different thoughts in due course.

This note assumes that the OECD's recommendations regarding action item 2 will suggest a "bottom up" approach and a connected party test threshold of 25%. The focus of a hybrid mismatch rule will therefore be on tax structured transactions and all intercompany transactions.

2. Summary of Conclusions

- The repo and stock lending markets are at the core of the financial system, are pivotal to the functioning of financial markets and to financial stability. Intra group repo and stock lending transactions form an integral and significant part of those markets.
- Members are concerned with the vast range of ordinary course repo and stock lending transactions which are not intentionally being used in the ways outlined in the OECD discussion draft on action item 2 published on 19 March 2014.
- Whilst members assume that the OECD's approach will not impact stock lending and repo transactions with external parties, there is likely to be a significant indirect impact on those transactions as they are often facilitated by transactions between related parties. In addition, the definition of "structured transactions" will require care and require consultation with interested parties in order to ensure that the OECD action plan recommendations are effective, consistent with the OECD's design principles, and do not inadvertently impact ordinary commercial activity.

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- Regulatory, customer and practical commercial requirements will dictate which entities enter into external transactions. A key benefit of being part of a group is the efficiency which can be achieved through the centralisation of risk management e.g., a centrally managed treasury function. As a result, many external transactions will require prerequisite internal transactions undertaken on a cross-border basis.
- The identification of information on an individual trade basis may be unmanageable due to:-
 - the large volumes involved and the fragmental nature of transactions undertaken either domestically or on a cross-border basis.
 - the complexity of normal intercompany arrangements and relationships (e.g. global trading) and the prescribed accounting treatment for different categories of transaction.
 - post-trade settlement matching – impacts physical flows.
 - impact of contractual arrangements e.g. master agreements.
- Tax authorities trying to risk assess and audit such transactions would face similar difficulties in seeking to use any information produced.
- Given the minimal level of risk attached to daily transactions, a possible solution would be for an exemption for transactions undertaken by banks in “the ordinary course of business”.
- Alternatively, it might be possible to identify other, more specific exemptions, such as in relation to intragroup transactions which facilitate a flow to or from the market (i.e., with an external counterparty). Such exemptions could impose a burden on businesses and tax authorities, depending upon how they are implemented, but appear to be required to sustain the operation of the market as a whole.
- Other possible solutions, such as reviewing based on a counterparty basis rather than on a per transaction basis - or based on a tax return review - would likely still impose a significant burden on businesses and tax authorities, but these options would be preferable to the general approach of reviewing all possible tax deductions on intragroup repos and stock loans.

3. Role and importance of stock lending and repos

- Both stock lending and repo transactions have a vital role in the operation of financial markets, including intra group transactions.

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- Transactions are regularly undertaken in high volume and are high value.
- Functions include:-
 - Secured lending and borrowing
 - Lending fees represent a valuable source of income for institutional clients
 - Trading i.e. fulfilling client orders
 - Settlement – providing a mechanism to minimise or rectify failed trades.
 - Collateral management providing for either a pledge or full title transfer
 - For central banks, repos are a monetary policy instrument.
- Repo and stock loan transactions are frequently undertaken under market standard master agreements, ensuring consistency of treatment and effect.
- Annex A provides links to some materials published by ICMA which are intended to provide HMRC/HMT with more detail regarding the importance of the repo market to the financial sector.

4. Role and importance of *intercompany* stock lending and repos

- In addition to the functions noted above, other factors generate repo and stock loan transactions between affiliated companies:-
 - Efficient risk control and management within groups - efficiencies can be achieved by centrally managing cash and collateral through a specific entity. In turn this requires internal transactions to transfer available cash and collateral to ensure that only net amounts need to be funded/invested externally. This saves paying away spread to the market or taking on the risk of loss in relation to any invested surplus. Furthermore, repo/stock lending activity may be channelled across the group to the entity which houses the trading function, or for an entity that is able to obtain an immediate source of securities intragroup or intercompany from an agency lending service provider.
 - Regulatory restrictions – regulatory regimes around the world will limit activities that may be undertaken by particular companies e.g. to require (or encourage) ownership of particular securities, conduct of certain activities or establishment of customer relationships to be undertaken or indeed not to be undertaken by particular legal entities. Accessing internal or external pools of funding or securities therefore requires intergroup transactions.
 - Customer requirements – customers may require or prefer to limit their contractual relationships with groups to specific companies, e.g. establishing contractual relationships, collateral management, credit risk, ability to enforce in

distress, applicable regulatory regime. Intercompany transactions are needed to facilitate this.

- Practical commercial requirements – market facing activity may be undertaken by specific entities within a banking group. There are various reasons for this. In relation to repo and stock loan transactions, the rationale for doing so includes that the market facing entity has the relationships with third parties, including the necessary legal agreements, connections to settlement systems etc., to enable the stock loan or repo transactions to be undertaken.
- Systems – complex and continually evolving control and support systems frequently support specific entities.
- Attached at Annex B are two examples of intercompany stock lending transactions which are frequently seen in the capital markets.
- Members report that within groups there can be thousands of intragroup trades outstanding on any given business day, with a substantial majority being of short duration. Calculations using figures reported on the Bank of England website suggest that intragroup repo trades are somewhere around 10% of the total amount of repos outstanding. It has been very roughly estimated that there are 30 million repo transactions per annum in Europe. This would suggest approximately 3 million intragroup transactions per annum which would equate to over 10,000 per day.

5. Key Concerns regarding the proposed hybrid mismatch rules for repo and stock loan activity

- The comments below are based on the proposals outlined in the OECD discussion draft on action item 2 published on 19 March 2014 though it is understood that the OECD is likely to propose a “bottom up” approach and a connected party threshold of 25%.
- Members are concerned with the vast range of ordinary course repo and stock lending transactions which are not intentionally being used in the manner outlined in the OECD discussion draft on action item 2 published on 19 March 2014.
- The key concerns are as follows:
 - It is understood that the OECD will adopt a “bottom up” approach and recommend a connected party transaction test of 25%. Whilst members believe that the OECD’s approach should appropriately eliminate most issues regarding capital market transactions with external parties, there is likely to be a significant indirect impact as those transactions are often facilitated by transactions

between related parties. In addition, the definition of “structured transactions” will also be a critical issue and consultation will be required.

- The large volume of non-hybrid intercompany stock loan and repo transactions means that the vast majority of transactions will not be subject to the final recommendations. There is therefore a significant risk that any requirements to prove non-hybridity could produce a disproportionate and ineffective compliance burden for both taxpayers and tax authorities and possibly would disrupt commercial activity.
- We understand that the OECD is likely to recommend that individual tracking (e.g. reporting) of all intercompany transactions will be required to identify “prescribed transactions”.
- The identification of information on an individual trade basis may be unmanageable due to:-
 - the large volumes involved and the fragmental nature of transactions undertaken either domestically or on a cross-border basis.
 - the complexity of normal intercompany arrangements and relationships (e.g. global trading) and the prescribed accounting treatment for different categories of transaction.
 - post-trade settlement matching – impacts physical flows.
 - impact of contractual arrangements e.g. master agreements.
- Tax authorities trying to risk assess and audit such transactions would face similar difficulties in seeking to use any information produced.

6. Potential approaches

- The following seeks to identify potential approaches - and associated difficulties – of allowing any OECD recommendations regarding hybrid instruments to be applied to selected intercompany transactions (“prescribed transactions”).
- The common objective should be to provide tax authorities with the information identified by action item 2 to identify “prescribed transactions”, while not constraining or disrupting international intercompany transactions that relate to the proper operation of the capital markets.
- It should be noted that any approach can only be fully discussed once the OECD’s recommendations regarding hybrid instruments have been published and its objectives and proposals are determined.

a) Financial services exemption

- “Ordinary course of business” exemption for intercompany transactions in regulated financial services from whatever measures are taken against intercompany hybrids. This appears the most straight forward approach, is expected to prevent a compliance burden arising when not needed, and clearly facilitates the operation of the capital markets.
- Tax structured intercompany transactions are perhaps in any event subject to the OECD hybrid action plan as tax structured transactions.

b) Narrower exemptions

- It might be possible to identify other, more specific, exemptions such as in relation to intragroup transactions which facilitate a flow to the market (i.e. with an external counterparty). Such exemptions appear to be required to sustain the operation of the market as a whole, given the links which can exist between intra-group transactions and market-facing transactions.
- However, this approach potentially leaves a range of benign transactions within the scope of the hybrid-mismatch rule, and also may still impose a compliance burden on businesses and tax authorities depending on how it is implemented.

c) High level tracking to exclude non “prescribed transactions”

- Can the difficulties of individually tracking all intercompany transactions be restricted by excluding non-hybrid intercompany transactions on a high level basis? For instance, no individual tracking would be required where the taxpayer certifies that the borrower has not claimed a tax benefit (as identified by the OECD hybrid action plan) e.g. the transaction concerned does not give rise to a tax benefit or no position is held at the relevant date on which a benefit could arise.
- However, this approach potentially leaves a range of benign transactions within the scope of the hybrid-mismatch rule, and also may still impose a compliance burden on businesses and tax authorities depending on how it is implemented.

d) Corporate tax return tracking to identify “prescribed transactions”

- Tax structured transactions with third parties are in any event countered by the OECD hybrid action plan.

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- Therefore only those intercompany repos and stock loans which give rise to a tax benefit within the OECD hybrid action plan for the company or group itself are potentially relevant.
- Rather than seeking to trace individual transactions, would it be possible to identify from tax returns, whether the company/group has any such income as the OECD hybrid action plan prescribes?
- However, this approach potentially leaves a range of benign transactions within the scope of the hybrid-mismatch rule, and also may still impose a compliance burden on businesses and tax authorities depending on how it is implemented.
- Possibly does not remove the risk of disrupting the operation of the markets if not accompanied by other measures, such as suitable exemptions.

7. Next steps

- HMRC/HMT to provide the trade associations and interested parties with further guidance on what further information is required and by when.
- Await the OECD's recommendations on hybrid instruments.
- Arrangements for a follow up meeting or call.

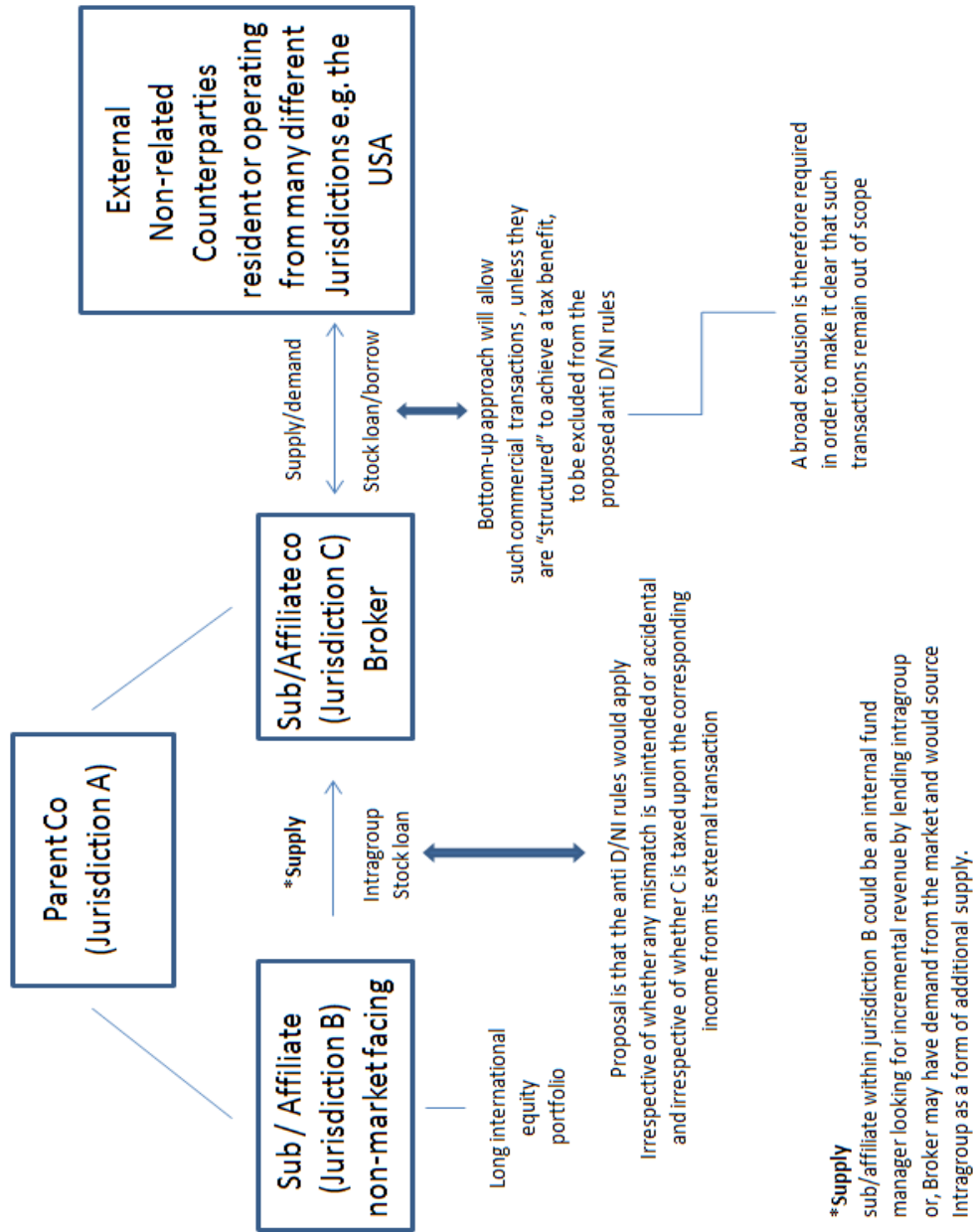
Annex A

Links are provided to the following documents:

- 1) A paper published by ICMA on 13 July 2010 entitled “A white paper on the operation of the European repo market, the role of short-selling, the problem of settlement failures and the need for reform of the market infrastructure” ([link](#)). Please note in particular section 2 of the white paper which sets out more detail regarding the importance and role of the repo market.
- 2) A paper published by ICMA on 29 October 2013 entitled “Avoiding counterproductive regulations in capital markets; a reality check” ([link](#)). Please note in particular the Annex to the paper which sets out in more detail the key functions of the repo market.
- 3) A paper published by ICMA on 3 April 2014 entitled “Collateral is the new cash: the systemic risks of inhibiting collateral fluidity” ([link](#)). The paper examines the importance of collateral to capital markets

Annex B

Stock loan and borrow trades – intragroup example I



Stock loan and borrow trades - intragroup example II

Stock loan and borrow trades – intragroup example II

