MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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Via Electronic Mail: TAXUD-FINTAX-NON-REG-ORG-NON-FIN@ec.europa.eu

European Commission
Directorate-General for Taxation and Customs Union
Rue de Spa 3, Office 06/31
B-1049 Brussels

Re: Managed Funds Association Response to Consultation on Taxation of the Financial Sector

To whom it may concern:

Managed Funds Association ("MFA")[1] appreciates the opportunity to comment on the European Commission's (the "Commission") consultation paper on taxation of the financial sector (the "Consultation Paper"). MFA and its members are committed to working with policy makers and regulators in a constructive manner. We believe that, in considering the taxation of the financial sector, policy makers should establish clear policy objectives and avoid discriminatory and overly broad measures that could unfairly penalize financial institutions.

In the Consultation Paper, the Commission provides two primary policy reasons to consider additional taxation on the financial sector: (1) because the financial sector has benefitted from substantial public support during the crisis that sector should make a substantial contribution to fiscal consolidation efforts; and (2) to use tax measures as a complement to regulation to address shortcomings in the governance or behavior of financial markets or financial institutions. The Consultation Paper contemplates a financial transaction tax and a financial activities tax as two possible means to achieve these policy goals. For the reasons discussed below, we are concerned that each of these proposals is likely to result in adverse consequences for European markets, investors and businesses and is likely to generate significantly less revenue than contemplated.

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

Policy Rationale

We understand the Commission's reasons for considering a tax on certain financial institutions, however, we are concerned about the broad nature of the contemplated taxes, which do not distinguish between different types of financial institutions. With respect to the first policy reason, not all financial institutions received public support during the crisis. Hedge funds do not have government guarantees or expose tax payers to potential liability and did not receive direct government support during the crisis. To the extent that European policy makers consider changes to tax policy to address this policy goal, hedge funds should be distinguished from those financial institutions that did receive direct government support or that create exposure for tax payers. Using tax policy to complement regulatory requirements also requires policy makers to consider important differences among different types of financial institutions (as regulatory policy does) and avoid a "one-size-fits-all" approach, which would likely result in unfair treatment for certain types of institutions. In addition to these overall concerns about the tax policies contemplated by the Consultation Paper, set out below are some specific concerns about the financial transaction tax and financial activities tax considered in the Consultation Paper.

Financial Transaction Tax

The Consultation Paper notes that a transaction tax could be narrow or broad-based and could be implemented at the EU or global level. While each method of implementation creates different risks, we believe that imposing any of the contemplated versions of a financial transaction tax ("FTT") would create adverse consequences for European investors, European businesses, and European markets. These adverse consequences would outweigh any perceived benefits from imposing an FTT.

Narrow-based FTT

One of the options discussed in the Consultation Paper is an FTT only on stocks and bonds. Such a narrow-based FTT is unlikely to produce significant revenue because market participants would restructure their transactions to trade financial instruments not subject to the FTT in order to avoid incurring the tax. An example of this market restructuring took place in the United Kingdom, when market participants began trading more debt instruments that imitate stocks—like exchange-traded notes—to avoid the U.K.'s Stamp Duty Reserve Tax. Providing an incentive for market participants to enter into such structured transactions can also lead to significant amounts of assets being put onto the balance sheets of large financial institutions, which are most likely to be counterparties for these transactions. Moving more assets onto the balance sheets of the largest financial institutions could increase systemic risks.

Broad-based FTT

A broad-based FTT that includes derivatives and currency carries its own set of difficulties. As noted in the Consultation Paper, taxing currency could impede the free flow of capital across borders. Taxing derivatives transactions would be difficult to implement because many derivatives products will have a value of zero at the time of the transaction and there is no

uniform method to determine future value, meaning there is no clear value on which to base a tax. The Consultation Paper states that the tax base for a derivative transaction is in principle the value of the underlying asset. At the time of the derivative transaction, however, the value of the underlying asset and the value of the derivative contract are unlikely to be the same, meaning this approach is unlikely to provide a fair method of assigning tax liability.

Moreover, while a broad-based FTT could include a wide variety of financial instruments currently used by financial market participants, it is likely that new products will be created that would not be subject to the FTT. Because financial innovation moves more quickly than regulation or legislation, the likelihood is that an FTT that is broad-based when adopted will become a narrow-based FTT after implementation.

EU-level FTT

An FTT at the EU level (whether narrow-based or broad-based) would put EU investors and businesses at a competitive disadvantage in relation to non-EU investors and businesses. As noted by European Central Bank President Jean-Claude Trichet, an EU level tax would deter foreign persons and companies from transacting in EU instruments or with EU persons, and ultimately may incite businesses and financial markets to relocate to geographic areas not subject to an FTT.[2] These unintended consequences have been observed in other countries, which have imposed a similar tax. For example, after Sweden instituted a transaction tax, half of trading in Swedish equities migrated to other countries.[3]

Global FTT

The final option discussed in the Consultation Paper is an FTT at the global level. While a global FTT (particularly a broad-based FTT) would seem to address many of the above concerns, the adverse consequences that would result from such a tax demonstrate why an FTT in any form results in bad policy outcomes.

An FTT on financial transactions would increase the costs for investors seeking to invest in or provide financing to companies. These costs would be passed onto businesses raising the cost of capital and reducing the availability of credit to businesses in the EU and around the

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[2] http://euobserver.com/9/30943.

[3] A report published in 1993 concluded that after Sweden increased its transaction tax from 1 percent to 2 percent in 1986, 60 percent of the volume of the 11 most actively traded Swedish stocks migrated to London. *See* "*Transaction taxes and the behavior of the Swedish stock market*," *Journal of Financial Economics*; p.33, 227-240; Steven R. Umlauf, (1993). The migrated volume represented over 30 percent of all trading volume in Swedish equities. *See id*. By 1990, that share increased to around 50 percent. According to another report published in 1995, only 27 percent of the trading volume in Ericsson, the most actively traded Swedish stock, took place in Stockholm in 1988. *See* "*Securities transaction taxes: What about international experiences and migrating markets, in Hammond,*" in Suzanne Hammond (editor) "*Securities Transaction Taxes: False Hopes and Unintended Consequences*," Catalyst Institute; John Y. Campbell and Kenneth A. Froot (1995). *See also* "*The Impact of Transaction Tax on Stock Markets: Evidence from an emerging market,*" Li Zhang, (2001) (concluding that an increase in the transaction tax on securities traded on the Shanghai and Shenzen stock exchanges increased volatility in the securities traded on those exchanges and failed to increase tax revenues as much as expected).

world, jeopardizing the global economic recovery and impeding economic growth going forward. By increasing the cost of capital, an FTT acts as a tax on all businesses seeking access to capital markets to create and grow their businesses. Increasing the cost of capital for companies will divert valuable resources away from being invested in their businesses, ultimately resulting in fewer jobs.

Moreover, the imposition of an FTT on financial instruments would lead to a reduction in the value of those instruments, to reflect the additional cost imposed by the tax. Consequently, investments held by all investors, including pension plans and individual investors, would lose significant value. This means that all investors, not just financial institutions, are the effective tax payers of an FTT. Indeed, because individual investors are less likely than financial institutions to engage in structured transactions that are not subject to an FTT, these investors may ultimately bear the highest burden, a result that is inconsistent with the stated policy goal in implementing an FTT. Further, the imposition of new taxes and reduced asset values on investors, such as including pension plans and individual investors, could require increased government support to the extent these investors have insufficient resources to fund their retirements. Such increased government burden would reduce, or even outweigh, the benefit of any revenue generated by an FTT.

Financial Activities Tax

The Consultation Paper contemplates three potential forms of a financial activities tax ("FAT"). As discussed above, to the extent that the policy rationale behind imposing an FAT is because of government contributions during the crisis, applying such a tax to all financial institutions is overly broad. Hedge funds did not cause the financial crisis and, unlike other types of financial institutions, they did not receive direct government support and they do not have the kind of government backstops that put taxpayers at risk. As such, hedge funds should not be subject to a tax that is predicated on being the beneficiary of government support. While some argue that it would be fair to subject hedge funds to such a tax because they were indirect beneficiaries of government support, this line of reasoning equally applies to all market participants, including individual investors and non-financial companies, which receive financing through capital markets.

The Consultation Paper also considers an FAT as a means of discouraging risky activities by financial institutions. The MFA strongly supports regulatory oversight of financial institutions to ensure there is appropriate oversight, monitoring and management of risks undertaken by financial institutions. We have engaged in a constructive manner with EU policy makers in order to reach this goal. We disagree, however, with imposing an extra tax on those activities deemed to carry above average risk. Capital markets require certain parties, whether financial institutions or entrepreneurs, to take risks and compensates those risk takers accordingly. Regulatory and tax policy should not discourage this necessary risk taking, they should focus on ensuring that tax payers are not subsidizing such activities, either through direct government guarantees or through government intervention to mitigate the consequences of systemic failures.

Imposing an FAT on hedge funds (or other investment funds) or their advisers also presents unique issues compared to a tax on other types of financial institutions. Hedge fund advisers typically do not have significant amounts of assets; like all advisers, they manage assets on behalf of clients and investors. Any tax on an adviser would need to be based on the actual assets of the adviser, not the adviser's assets under management. Because hedge fund advisers have limited assets, a tax on these advisers is unlikely to raise significant revenues.

A tax on an investment fund is in essence a tax on the investors in the fund, for example pension plans. Imposing a tax on these investors will either subject them to an additional tax or cause them not to invest in a fund that is subject to an FAT. Subjecting pension plans to the FAT would reduce their investment returns, negatively affecting their ability to meet obligations to pension plan beneficiaries. Pension plans that elect not to invest in hedge funds subject to an FAT would lose the benefits of investing in such funds, including diversification, risk management, and returns that are not correlated to traditional equity and fixed income markets. Either result is undesirable from a policy standpoint and could ultimately increase costs, to the extent that governments face increased burdens to support pension plans that are unable to generate sufficient investment returns to meet their obligations.

To the extent that policy makers choose to consider an FAT, we believe it should be part of a discussion on overall tax policy and not as a stand-alone debate that singles out the financial sector for new taxes. Should policy makers continue to focus on an FAT as a means to achieve the policy goals stated in the Consultation Paper, it is imperative that they tailor the tax to account for important differences among different types of financial institutions. For example, if the policy goal of an FAT is to collect payments from those who received government support, the tax should only be applied to those institutions that received such support.

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Conclusion

MFA appreciates the opportunity to comment on the Commission's Consultation Paper. We are concerned that the financial transaction tax and financial activities tax considered in the Consultation Paper will result in adverse consequences for European markets, investors and businesses, while generating significantly less revenue than expected. We encourage the Commission to consider these undesirable consequences as it continues its analysis of these taxes. MFA and its members look forward to continuing to work with the Commission during this process.

If you have any questions regarding any of these comments, or if we can provide further information with respect to these or other issues, please do not hesitate to contact Stuart J. Kaswell or me at (202) 730-2600.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
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