Communication of the Association of Global Custodians'
European Focus Committee and Tax Committee
Subject to Supplemental Commentary

13th May 2015

European Commission
Via online questionnaire:
http://ec.europa.eu/finance/consultations/2015/capital-markets-union/index_en.htm

Re: European Commission Green Paper, Building a Capital Markets Union (the "Green Paper")

The Association of Global Custodians' European Focus Committee (the "European Committee") and Tax Committee (the "Tax Committee")[1] are grateful for the opportunity to comment on the European Commission's Green Paper.

Because the Association of Global of Global Custodians is an association of participants in the custody industry, our comments below will focus on post-trade aspects impacting or influencing EU capital markets.

<u>Introduction</u>

In order to provide for better integration of EU capital markets, the European Committee envisions a post-trade "end-state" by which an investor is assured that if any intermediaries in a chain of custody become insolvent, the shares that the investor has bought and holds are recognised as the property of the investor and not of the insolvent intermediary, or of any other intermediary, whichever national system of law applies. Moreover, if one intermediary is insolvent, shares should – if necessary - be capable of being rapidly transferred to another, operating, intermediary. In the meantime, the investor should be recognised by the issuer of the shares as a shareholder and be able to exercise its voting rights in common with other shareholders.

Following the events of 2008, a number of initiatives were undertaken at the EU and member state levels relating to ensuring protection of customer assets and improving the certainty and speed of return of these assets. Many of these reform measures sensibly improved confidence in the way customer assets are maintained and transferred. This generally is consistent with furthering the goal of achieving a more integrated and successful EU capital markets union. The European Committee worked with authorities in support of these measures.

However, not all measures in support of this goal were taken to completion and, in some cases, those that were contained post-trade aspects that unfortunately have undermined the goals of improving consistency, market efficiency or other investor interests in the operation of capital markets.

[1] The members of the Association of Global Custodians are: BNY Mellon; Brown Brothers Harriman & Co; Citibank, N.A.; Deutsche Bank; HSBC Securities Services; JP Morgan; Northern Trust; RBC Investor & Treasury Services; Skandinaviska Enskilda Banken; Standard Chartered Bank; and State Street Bank and Trust Company.

In summary, the European Committee recommends as key priorities in support of better integrated and more efficient EU capital markets:

- The successful adoption and implementation of T2S;
- Adoption of a new securities law legislation to clarify ownership of collateral, among other things;
- Removal of barriers to cross-border collateral use; and
- Consistent adoption of market and technical standards by market infrastructures.

The Tax Committee recommends as key priorities to facilitate better integrated and more efficient EU capital markets by eliminating existing and preventing new tax barriers:

- Removal of withholding tax relief procedural barriers through the adoption of a harmonised, streamlined, relief-at-source system in conjunction with the current initiative on automatic exchange of information;
- Removal of obstacles to tax treaty benefits for cross-border investment funds by encouraging adoption of the OECD's treaty recommendations on collective investment vehicles;
- Encouraging publication of guidance on issues relevant to claims of withholding tax relief; and
- Ensuring that the OECD's work relating to tax treaty abuse in its Base Erosion and Profit Sharing (BEPS) Project does not create new barriers to legitimate claims for treaty relief.

These priorities will be further elaborated on in our responses to the European Commission's questions identified below.

Questions Identified to be Answered by the European Committee and the Tax Committee:

18) How can the ESAs (European Supervisory Authorities) further contribute to ensuring consumer and investor protection?

In 2014 and in previous years, there were a number of initiatives relating to client assets segregation rules as they relate to transferable securities.[2] We emphasise the importance of these initiatives in support of creating confidence in EU capital markets by ensuring the protection of *property rights* of investors once transferable securities have been purchased by them. One aspect of these initiatives that has been under debate is what kind of segregation would meaningfully protect investors without imposing undue costs and inefficiencies which might operate to preclude access to capital markets.

We understand "segregation" to refer to arrangements an intermediary can make to avoid customers' book-entry securities from being treated as the property of the intermediary and used to meet the claims of creditors of the intermediary, which is often achieved by requiring the intermediary to keep records to identify book-entry securities as belonging to each of its customers.

The initiatives mentioned above focused in part on whether segregation concepts should reach through the custody chain in some way, so that customers' interests in book-entry securities can be identified not only

[2] The Committee's proposed approach to transferable securities is set out in our response to Question 26, *infra*.

at the level of each customer's immediate proximate custodian but also by other intermediaries (e.g., sub-custodians) further up the chain of custody.

It is important to define what is meant with reference to "segregation" when looking at accounts maintained by custodians with sub-custodians. Alternative approaches include:

a) Individually segregated accounts;
b) Pooled ("omnibus") segregated accounts (i.e., containing the book-entry securities of multiple clients of a particular class (e.g., "AIFs", "pensions", etc.) in one account); and
c) Omnibus accounts (i.e., containing the book-entry securities of all of the clients of the Intermediary in one account and other types of assets).

We emphasise that ***all of these options*** envision segregation of assets of an intermediary ("proprietary assets") from assets of clients held with the intermediary ("customer assets") as well as segregation of customer assets from lower-tier intermediaries: ***these are the most important elements of customer asset protection***. While maintaining individually segregated accounts throughout the chain of custody (option "a" above) may have intuitive appeal, it would come at high cost, especially if extended comprehensively to all customers of custodians. Furthermore, such an approach would not be operationally possible for activities where there are frequent changes of beneficial ownership at the investor level (for example, tri-party collateral management). Applying such an approach across all custody clients would generate significant operational complexities (especially in view of cash settlement practices) and much higher likelihood of error.

Option "b", whilst providing some efficiencies through omnibus accounts, effectively does the same thing: segregating "classes" of customers through the chain provides no discernible benefit and instead only increases operational risk by requiring reconciliation of artificial group-sets (e.g., "AIF Omnibus") between intermediaries.

Omnibus accounts (Option "c" above) are more efficient operationally, more cost-effective, less prone to error (because there are fewer opportunities for data errors to arise) and do not detract from customer asset identification. The simplicity of the omnibus account structure in an insolvency situation means that the reduced volume and complexity of reconciliation should facilitate a more expedient return of a client's assets.

As a rule, neither "a" nor "b" provides more protection in the event of the insolvency of upper-tier intermediary, because a customer (as account holder) could not independently instruct an upper-tier intermediary (such as a sub-custodian) or a competent official in the insolvency of that intermediary with respect to the book-entry securities: the upper-tier intermediary would only be accountable to the proximate lower-tier intermediary.

Moreover, "a" or "b" would inevitably trigger a reshaping of custodial holding structures, and custody business in general. Such measures would only bring greater costs to market participants without bringing greater protection to client assets.

The European Committee believes that a consistent definition of segregation and a single standard of segregation should be implemented at the EU level and should not be left to national interpretation or an interpretation that "cherry-picks" certain classes of investors (e.g. "AIFs", "collective investment schemes", "clearing members", etc.) without regard to others: no single class of investor should be made subject to better or worse protections in the context of the protection of their property interest in transferable securities.[3]

Our recommendation for adoption of segregation requirements in relevant EU securities legislation is set out in our response to Question 26, *infra*.

23) Are there mechanisms to improve the functioning and efficiency of markets not covered in this paper, particularly in the areas of equity and bond market functioning and liquidity?

A key requirement for a Capital Markets Union is the consistent and widespread use of market standards by market infrastructure entities, by intermediaries, and by entities accessing capital markets.

The non-use of market standards by a party imposes costs and risks on other parties. In a cross-border environment in which investors in one country invest in securities issued in other countries, non-use of market standards by, for example, issuers or issuer agents in one country means that investors from other countries may suffer from a loss of rights (as they may in practice be unable to exercise some rights) due to increased costs (as they, or their intermediaries, would need to put in place special processes in order to exercise their rights) and increased risk (as they or their intermediaries would need to manage multiple, divergent operational processes).

Such non-use of market standards represents a barrier to investment in securities.

The T2S project has recognized the importance of market standards in its list of harmonisation activities. T2S has made significant progress in achieving compliance with standards; however, the scope of the T2S effort is focused on core settlement activities, so that there is room for additional work to achieve compliance with standards.

Among the market standards that should be fully implemented by all parties in a European Capital Markets Union are the Market Standards for Corporate Actions Processing and the Market Standards for General Meetings.

The European Committee believes that the European Commission should consider two possible courses of action:

[3] We believe a commonly understood and accepted baseline of investor protection in respect of property interests in transferable securities is essential; however, this should not preclude investors from conceding aspects of this protection subject to contractual arrangements with counterparties or others providing certain services, such as financing, to them. Financial markets rely on many of these arrangements to provide needed liquidity in transferable securities.

1. At a minimum, the European Commission should ensure that there are no existing national legal, regulatory or supervisory measures that prevent market participants from complying with the Standards.
2. A more far-reaching step would be for the European Commission to propose legislation that would mandate compliance with the Standards.

The European Committee believes that the principal underlying cause for non-compliance is national legal and regulatory obstacles. Accordingly, the European Committee believes that the first course of action deserves most attention.

Extensive documentation on these two sets of Market Standards and the causes of non-compliance is available at:

http://www.ebf-fbe.eu/european-industry-standards/

The European Committee also believes that further standardization work is needed in other areas. One specific area where there is a need for increased standardization is the area of securities issuance practices at the CSD level (including securities reference data maintained by CSDs). Existing national practices (such as inappropriate minimum settlement amounts) cause problems in securities holding chains. In a CMU with greater cross-border investment, such problems would be multiplied.

24) In your view, are there areas where the single rulebook remains insufficiently developed?

The European Committee notes that a commitment to effective adoption and implementation of a single rulebook inevitably requires sufficient resources, both at ESMA and the European Commission. Our response to Question 25 below highlights the need to ensure consistent supervision, which can only be accomplished if EU institutions have the bandwidth to facilitate this.

25) Do you think that the powers of the ESAs to ensure consistent supervision are sufficient? What additional measures relating to EU level supervision would materially contribute to developing a capital markets union?

The European Committee believes that financial market infrastructure in Europe is subject to some very different national regulatory requirements. We believe this to be unjustified. To the extent that intermediaries and infrastructure should apply best practice, national regulatory authorities should do the same. Differences in national regulatory practices create barriers, which contribute to continued nationally segregated capital markets.

We note that the single CSD business process that generates the largest number of restriction rules and Market Specific Attributes in T2S is regulatory compliance. Information on this point is available at:

http://www.ecb.europa.eu/paym/t2s/governance/ag/html/mtg27.en.html

A specific example of a national regulatory practice that is highly problematic for foreign market participants, and that represents a barrier to accessing a national securities market, is the set of obligations relating to the Post Trade Interface mandated by the current Spanish securities market reform.

26) Taking into account past experience, are there targeted changes to securities ownership rules that could contribute to more integrated capital markets within the EU?

As the European Commission has long noted, the legal barriers identified in the 2001 and 2003 Giovannini Reports should be eliminated in order to improve cross-border aspects of securities holdings and dispositions in the EU. Elimination of legal uncertainty contributing to inefficiencies and cost, particularly in the context of insolvency of intermediaries and cross-border financial collateral arrangements, would help to further integrate capital markets in the EU.

EU securities legislation is an initiative that should be undertaken in the context of the CMU. Whilst it is not practical to try to harmonise all relevant insolvency, property and company laws within the framework of the CMU, it would be manageable to take a first step to ensure that national rules are adjusted as necessary to ensure a consistent treatment of intermediated securities holdings in the event of the insolvency of an intermediary. Such rules can and should apply to transferable securities:

- As defined in directive 2014/65/EU, art. 4(44);
- That are dematerialised or immobilised in accordance with the CSDR; and
- That are capable of being credited to securities accounts maintained by EU account providers for account holders with a view to safe-keeping and administration (this would correspond to Article 1(a) of the Geneva Securities Convention).

The European Committee believes that such legislation could take a form that does not require full harmonisation of national laws, but can respect the different legal systems and traditions of member states.

Moreover, new securities legislation need not replace or revise the FCD or the Settlement Finality Directive (SFD), however, efforts should be undertaken to ensure that legislation at the EU level is compatible and mutually supportive of respective goals. Legislative coherence and consistency is crucial. The new legislation should be aligned with other legislation such as MiFID/MiFIR, AIFMD, UCITS, EMIR and the CSDR, not only in respect of regulatory respects but also in other respects where there may be an impact on outcomes under commercial, property or insolvency laws.

For example, EU securities legislation should clearly delineate whether it applies to market infrastructure providers (such as CCPs, CSDs and clearing houses) and their agents. To the extent that securities legislation does not apply to market infrastructure providers, it should provide that their actions in accordance with their own relevant legislative regimes (including non-EU regimes where relevant) shall not prejudice account providers operating under the European securities legislation. More specifically (and by way of example), EMIR provides at Art. 47(5) that a CCP must ensure that "the assets belonging to a clearing member are identifiable separately from the assets belonging to the CCP and from assets belonging to a third-party custodian." Where securities have been transferred to the CCP under a title transfer arrangement, it would, however, seem that the only way to comply with EMIR's requirements is if such a CCP treats these securities as nevertheless belonging to the relevant clearing member or clearing client (and therefore holds them in the "client" account with the relevant securities settlement system or custodian). This aspect of EMIR, therefore, would seem difficult to reconcile to the crediting and debiting of securities accounts as being dispositive incidents of transfer of ownership.

27) What measures could be taken to improve the cross-border flow of collateral? Should work be undertaken to improve the legal enforceability of collateral and close-out netting arrangements cross-border?

A key concern of the financial industry relates to the valid acquisition of collateral and to related aspects which flow from that concern, such as good faith acquisition and loss sharing.

From the collateral-taker's perspective, collateral over securities involves the acquisition of securities under a title transfer financial collateral arrangement or the acquisition of limited *in rem* rights in securities under a security financial collateral arrangement. Both the collateral-taker and the collateral-provider have a vital interest in the underlying legal framework being reliable and interpreted in a consistent manner across all member states:

- The collateral-taker's risk management depends on the enforceability of its financial collateral arrangement involving the collateral, alongside close-out netting arrangements.
- The collateral-provider expects that the re-delivery of collateral securities is legally clear and simple. Securities collateral must not be 'trapped' in another market participant's insolvency.

The entire wholesale financial market uses collateral and netting as risk mitigation mechanisms, as do central banks, and the amounts involved are very significant. Market participants that are unable to enforce security interests in collateral upon which they have relied, or to whom their collateral cannot be returned, might face important, unexpected losses due to their counterparty's insolvency. Depending on the scale and on the market context, such losses can threaten the continuing operation of the firm.

Therefore, the European Committee strongly supports measures at the EU level to improve predictability of outcome in connection with collateral arrangements – a key outcome stemming from improved legal certainty – in order to encourage cross-border collateral flows. We encourage a review and possible extension of important elements of the FCD, particularly those relating to the acquisition and enforcement of rights by collateral-takers in transferable securities.

A review of the extent to which EU member states have *fully* implemented the FCD should be undertaken: for example, the European Committee understands that some member states still require registration of financial collateral arrangements in the state in which relevant securities are issued. Such requirements would be inconsistent with the requirements and purpose of the FCD.

Second, certain enforceability aspects of the financial collateral arrangement should be reviewed in the context of insolvency. The question of if, when, what and how a collateral-taker acquires an interest in collateral is left unaddressed by the FCD in deference to member state national laws. These national laws sometimes are not consistent and contain different requirements, which may lead to problems in cross-border scenarios. Adoption of our recommendations in respect of securities legislation at the EU level, which can be found in our response to Question 26, would in our estimation help prevent these problems.

Third, we recommend the removal of existing and proposed regulatory, technological and operational barriers to the effective use of collateral. We address these below:

Regulatory barriers: some existing legislation, though intended to ensure transparency and reduce risk for end investors, also restricts the ability of users to manage their collateral, i.e.:

- EMIR: segregation of collateral requirements places restrictions on where collateral can be held;
- MIFID: restrictions are placed on retail users using title transfer collateral arrangements (TTCAs);
- AIFMD: the loss of collateral assets would be considered in-scope for restitution by depositaries, even though those assets may not sit with the depositary and be subject to bilateral arrangements between the AIF and the counterparty that are beyond the depositary's ability to influence or control;
- AIFMD/UCITS V: Obligations to segregate AIF/UCITS assets up the custody chain – if not imposed consistent with our recommended approach set out in our response to Question 18 – would be a material impediment to AIF/UCITS assets participating in securities lending, repo and other collateral management services;
- CSDR: settlement discipline requirements, in particular the mandatory buy-in requirements, may impose significant extra risk to repo and other OTC transactions;
- BASEL: There is a tension between mandating that market infrastructure (in particular CCPs) require high quality collateral (e.g. cash or certain government bonds) versus demand for collateral by an increasing number of market participants (e.g., investment managers) who do not have ready access to such collateral. The only way a balance can be achieved is by allowing intermediaries to provide transformation trades to market participants. Transformation trades will necessarily impact the balance sheets of intermediaries providing them under BASEL III: this in turn may operate to limit the number of providers in the market, concentrating risk, and limiting market options, in particular during stressed market conditions;
- National differences: there is a need for a review of the interplay of the different regulatory requirements around collateral management: coherence across different legislative regimes would facilitate market confidence;
- Importance to Buy-side: it is important that the obstacles faced by buy-side market participants be prioritised in this context. Buy-side market participants need access to collateral management services at different levels in the custody chain (and not just at the level of central infrastructure) and would be handicapped by regulatory requirements for excessive segregation up the custody chain and by regulatory measures that result in collateral management at the level of central infrastructure being privileged over collateral management at other levels; and
- Need for Calibration: taking all of the above into account, some kind of calibration should be factored in across various initiatives at Level 2, including MiFID, EMIR, BRRD, etc.

Technical and operational barriers:

- Collateral eligibility: eligibility of collateral varies widely depending on the counterparty. The result is widely varying cost/funding impacts: the less fungible the collateral, the higher the cost/margin requirement. CCPs today have restrictive collateral approaches (cash or US Treasuries predominantly), which on the one hand is sensible due to the need to ensure the safety of the CCP but - on the other hand - will create issues and market distortions as the need for collateral increases and more business is routed via CCPs. It seems likely that a cash/US Treasuries shortage will result.
- Technology constraints: collateral management has moved from being a back office function to being a critical sophisticated Treasury/funding function in a very short period of time. The technology necessary to support this evolution is still catching up, both across the industry and within firms. Messaging standards and processes are emerging, but they are not wholly adopted as yet on an automated basis.[4] There is also significant utility competition in the market (e.g., Acadiasoft, Markit, SWIFT, etc.), which helps develop standardization but at the same time creates fragmentation through barriers as each tries to take market share (no interoperability is currently envisaged).
- Operational constraints: differing cut-off times exist on a global basis for the movement of collateral. Meanwhile, the need for real-time or intraday exposure management increases, which means the ability to mobilise collateral intraday becomes more important: without global standards, technology and operations intraday management will remain very challenging.
- Lack of market standards: how collateral should be held depends on the collateral arrangement.
- Lack of standardisation of new forms of collateral: e.g. out-of-network assets such as commodities or property.
- Fragmentation of collateral: collateral is too fragmented, and so, too, is the cash required to pay for it. Market participants are looking to overcome three issues driven by a fragmented market which has resulted in (1) no cash netting, (2) no collateral pooling and (3) no central tri-party collateral management. The introduction of T2S will somewhat address these challenges by providing cash pooling of credit lines and collateral, however, issues will remain. T2S will need to become a truly multi-currency system in order to provide real harmonisation that allows collateral givers/takers to bring together multi-currency assets of cash, debt and equities that can be drawn from a single asset pool across all markets.

28) What are the main obstacles to integrated capital markets arising from company law, including corporate governance? Are there targeted measures which could contribute to overcoming them?

As set out above in the Introductory Comments and in our response to Question 23, the European Committee believes that it is critical that at the level of core market infrastructure there be a very high degree of harmonisation of custody processes for all securities issued within the EU.

[4] It should be noted that significant industry progress has been made, such as automated matching, portfolio reconciliation, etc.

This is critical for three reasons:

1. to reduce cost, risk and complexity;
2. to ensure that all end investors can actually exercise the rights associated with securities that they have purchased; and
3. to ensure that end investors maintain trust in the process of holding securities through intermediaries; if end investors are faced with different processes to exercise rights, and see haphazard, and apparently incomprehensible, cases of non-exercise of their rights, trust will be damaged.

Differences in national company law do currently mean that end investors, and their intermediaries, are faced with very different practices, and with cases in which end investors are unable to exercise rights.

Even though each individual case of divergent practices may be viewed as relatively minor, and impacting only a limited number of issuers and investors, the cumulative impact of all the divergent practices is very large

The European Committee believes that the following requirements should set the minimum baseline in a Capital Markets Union:

1. Rights associated with a securities position become effective from the point of settlement of a securities transaction at the CSD. This means that no subsequent process, such as a registration process, should be required for an end investor to be able to exercise rights through the custody chain;
2. As set out in our response to Question 23, the European Committee believes that there should be full compliance with the Market Standards for Corporate Actions Processing and the Market Standards for General Meetings;
3. The record date determining entitlement to vote at a general meeting should be set so that all record date holders (including end investors domiciled in other countries and holding securities through one or more intermediaries) can vote. This means specifically that the record date must be set before the deadline of the last intermediary as specified in the Market Standards for General Meetings, so that all end investors can vote based on firm record date entitlements and do not have to issue voting instructions based on anticipated, future entitlements; and
4. The operational processing of any shareholder identification process should be harmonised to the greatest possible extent, so that end investors and intermediaries are faced with one process instead of up to 28 separate processes.

29) What specific aspects of insolvency laws would need to be harmonised in order to support the emergence of a pan-European capital market?

The European Committee recommends the following priorities in this respect:

- Harmonisation of the ***effects*** of insolvency rules among member states, so that there is clear and consistent recognition of the segregation of financial instruments held by an intermediary for its clients from assets belonging to intermediary. There should be a presumption that client assets are segregated from assets belonging to an intermediary; i.e., that they do not belong to such intermediary in the absence of evidence of title transfer.

- Harmonization of measures to be taken by CSDs after initiation of an insolvency proceeding, namely, not accepting new transfer orders, arrangements for the cancellation or recycling of instructions, etc.
- The procedures of CSDs need to be aligned to those of trading venues and CCPs.
- Implementation of rules requiring information exchange between T2S CSDs/NSBs in relation to insolvent participants and indirect CSD participants, e.g., introduction of a definition of indirect participants in the meaning of SFD across all T2S-Participating CSDs to avoid negative impact on cross-CSD settlement.
- Harmonization of steps to be taken for corporate actions processing in case of insolvency.

30) What barriers are there around taxation that should be looked at as a matter of priority to contribute to more integrated capital markets within the EU and a more robust funding structure at company level and through which instruments?

<u>Perspective of the Tax Committee</u>

In providing global custody services, AGC members routinely seek appropriate withholding tax relief on behalf of custody clients, and we experience on a daily basis the costs, inefficiencies, and excessive withholding that arises when the procedures for claiming lawful relief are unduly burdensome or complicated for the investors involved. Accordingly, the Tax Committee directs our comments to those problems and to the steps EU member states could take to alleviate them.

<u>Problems in obtaining withholding tax relief on cross-border investment flows</u>

The problems faced by cross-border investors in obtaining appropriate withholding tax relief are not new, and much thought and effort on the part of the Commission and others has gone into analysing ways to address them. The 2001 Giovannini Report identified national differences in granting withholding tax relief as a problem that should be resolved as a matter of priority. The Commission's 2004 Communication entitled "Clearing and Settlement in the European Union – The way forward" (ref: COM(2004) 312 final) set out broad policy guidelines for further Community action in the field of securities clearing and settlement. The First Report of the Fiscal Compliance Experts' (FISCO) group published in 2006 identified a number of issues which are still very common problems today, including the following:

- withholding tax collection and relief procedures vary considerably among member states and different procedures often even apply to different classes of securities within the same member state;
- tax rules may require foreign intermediaries to appoint a local agent or fiscal representative in order to be able to offer at source relief from withholding tax;
- relief procedures are not adapted to an environment where securities are held through multiple intermediaries -- problems systematically relate to the requirement that detailed information or paper-based certification on beneficial owners must be passed on through

one or more intermediaries to the withholding agent prior to the payment of the income, a requirement that makes it practically very difficult to apply for relief at source when securities are held in omnibus accounts through multiple intermediaries on behalf of a large number of beneficial owners;

- the administrative burden associated with such procedures is increased by the fact that each country of investment has its own formal documentation requirements, so basically similar information must be provided in a different format in each of the countries of investment;
- there may be insufficient time between the dividend announcement date and the income payment date to allow the beneficial owner to provide the required certificates through the intermediary chain;
- refund procedures are complicated because, for example, investors (or their authorized representatives) are required to file separate refund claims for each income payment, it is not always easy to identify the appropriate office to which the claim should be sent, and the cost of filing claims may exceed the tax benefits at issue.

<u>The Commission's Recommendation on withholding tax relief procedures</u>

The work of the FISCO Group led to the Commission's adoption of a Recommendation on withholding tax relief procedures (C(2009) 7924 final) in October 2009, which called upon member states to improve and simplify their procedures for granting withholding tax relief on cross-border securities income flows within the EU by, for example:

- granting withholding tax relief at source;
- allowing foreign financial intermediaries to verify investors' entitlement to relief and to pass pooled withholding rate information up the chain;
- allowing withholding agents to rely on the pooled information provided;
- replacing requirements for certificates of residence with self-certifications by the investors, coupled with the application of know-your-customer (KYC) rules by the financial intermediary;
- allowing for the transmission of information and documentation by electronic means;
- requiring the foreign intermediary with the investor information to report that investor-specific information to the source country tax authorities;
- developing common approaches to the above and working in coordination with the OECD on its parallel initiative; and
- ensuring a simplified refund procedure was available in cases where the appropriate relief was not provided at source.

The Commission then formed the Tax Barriers Business Advisory Group (T-BAG) in June 2010, and the T-BAG's 2013 report endorsed solutions consistent with the Commission's Recommendation and the OECD's Treaty Relief and Compliance Enhancement (TRACE) proposals, described below.

<u>The OECD's recommendations on CIVs and on withholding tax relief procedures</u>

The OECD had begun parallel work on the problems of cross-border withholding tax relief in 2006. Its Informal Consultative Group (ICG) on the Taxation of Collective Investment Vehicles (CIVs) produced a report in 2009 which contained proposals for an "Authorised Intermediary" (AI) regime which was closely consistent with the EC's Recommendation. It also produced a series of recommendations on treaty provisions and withholding procedures countries should use to specifically clarify and streamline the issues surrounding the application of treaty benefits to income paid to CIVs. The latter recommendations were adopted through amendments to the OECD Model Tax Convention in 2010.

The OECD's Committee on Fiscal Affairs (CFA) continued the general work on improving withholding tax procedures in the form of the TRACE project, through which government representatives, working in close consultation with industry, developed an Implementation Package (TRACEIP) which could be used to implement the TRACE recommendations for the AI regime. The CFA approved the TRACEIP in January 2013, pledging further TRACE work to help countries adopt the AI system and to exploit synergies between the TRACE reporting rules and those being developed under FATCA and the more recent multilateral standard on automatic exchange of information (AEOI), the Common Reporting Standard (CRS). The latter standard was presented by the OECD to the G20 in February 2014 and has already achieved the endorsement of dozens of countries worldwide, with implementation expected to begin in 2017.

Developments in Automatic Exchange of Information

Both the OECD's 2013 TRACEIP and the Commission's 2009 Recommendation acknowledged the importance of well-functioning AEOI mechanisms to the appropriate application of withholding tax relief procedures, to ensure tax compliance in both source and residence countries. As noted above, the OECD has since moved forward with the CRS which will soon be implemented as a multilateral AEOI standard. The Commission has also moved forward with its December 2014 amendment to the 2011 Council Directive on Administrative Cooperation (DAC), which will extend the DAC's AEOI mechanism to include the same information covered by the OECD's CRS.

Our recommendations

Notwithstanding all the good effort that has gone into laying the theoretical groundwork for improved withholding tax relief procedures, little concrete progress has been made since these issues first became the subject of active intergovernmental discussion. Indeed, our experience is that the problems have become even more severe during the interim, as individual countries have introduced more and more diverging and onerous requirements for the processing of treaty relief claims. Urgent action is needed to remove these barriers in order to ensure both greater integration of the EU capital markets and enhanced international competitiveness of the EU as a destination for investment.

With the introduction of the DAC, member states are required to implement rules to require their financial institutions to implement reporting and due diligence procedures which are fully consistent with those included in the CRS and which document the tax residency of each customer. Specifically they align due diligence processes with AML/KYC rules. As a result, all banks and intermediaries will now be required under the DAC to collect and report residency information about all of their customers. Customers will be required to "self-certify" their tax status. The feature of self-certification coupled with AEOI is discussed in both the T-BAG and the TRACE reports.

With tackling tax evasion as a key policy objective in the EU and the new system for AEOI on the verge of implementation within and beyond the EU, it is clear that the political heart of these agreements reflects a notion of "no more borders" and that tax authorities will be working even more closely together to address cross-border tax matters. It would therefore appear that any pre-existing barriers to address collection of under-withholding are removed.

Without a harmonised, streamlined relief at source system, investors and intermediaries will continue to face the costly administrative burdens of diverging domestic procedures, excess tax will often be withheld, and source markets will be less attractive to investors. Residence countries will continue to face costs in the form of processing certificates of residence, under-reporting of income, and/or over-reporting of foreign tax credit claims. Source countries that continue to operate tax reclaim systems will continue to bear the costs associated with such systems, such as the stamping and certification of tax reclaim forms and processing refund payments.

We therefore have the following recommendations.

1. Encourage the adoption of a harmonised, streamlined, relief at source system in conjunction with the AEOI initiative

The most important step the EC could take to alleviate the withholding tax relief procedure problems would be to actively encourage the early and widespread adoption of a harmonised, streamlined, relief at source system by member states and other jurisdictions. The globalization of investment portfolios and financial service providers means that simplification and efficiency benefits from a coordinated regime can only be fully realized if the regime itself is globally applicable, so solutions to the European single market issues in this context must coincide with global solutions. As recommended by the T-BAG, such a system should be based on a common and standardised "Authorised Intermediary Agreement" (AIA) and should be in full alignment with the OECD's TRACEIP. Moreover, the EC should encourage the implementation of such a system in conjunction – and contemporaneously -- with the AEOI initiative.

Pursuing these two goals simultaneously would provide several benefits. First, the simplification benefits from the TRACE-type approach would of course be realized for investors, intermediaries, and governments. Second, significant systems design efficiencies could be achieved for both business and governments by covering both AEOI and a TRACE-type approach simultaneously in the current initiative. Third, combining a TRACE-type approach with AEOI has the potential to contribute to the objectives of the AEOI initiative itself. For example, the simplification benefits of a TRACE-type approach would likely have the effect of attracting financial institutions that might not otherwise be subject to the reporting obligations relevant to the AEOI system (e.g., because of the jurisdiction in which they are located), thereby improving the chance that information about the customers of those institutions will be conveyed to their residence countries.

2. Encourage adoption of the OECD's CIV recommendations

As indicated above, the OECD in 2010 introduced into the OECD Model Tax Convention a number of optional approaches countries could adopt in their bilateral treaty relationships (e.g., through treaty amendments or competent authority agreements) to simplify and clarify the application of treaty benefits to investment income paid to CIVs. Model language for some of these proposals was further developed as part of the TRACEIP. These approaches allow countries to identify the criteria they will apply in granting benefits to CIVs established in their treaty partner countries and to agree upon reasonable procedural approaches to the actual application of those benefits. Unfortunately, there has been very little action on the part of governments to implement these proposals in their bilateral treaty relationships, with the result that investors are continuing to experience serious obstacles to the application of appropriate treaty benefits to the income they earn through CIVs (including, e.g., investment funds and pension funds).

3. Encourage publication of guidance on issues relevant to claims of withholding tax relief

One rather straightforward issue which arises in the context of claiming withholding tax relief is ensuring that the taxpayer has the appropriate information to determine whether relief is applicable and how it can be claimed. For example, an initial question is typically whether the taxpayer is a "resident" of a country to which relief has been granted by a treaty partner. Because residency criteria differ from country to country and because the residency determination requires familiarity with the legal standard, this determination can often be difficult for taxpayers to make. It would be very helpful if governments would publish guidance on this issue. Similarly, it would greatly lessen costs and difficulties for cross-border investors if governments made easily available necessary information on what withholding tax relief benefits are available and how those benefits can be claimed.

4. Ensure that the OECD's work on BEPS Action 6 (Preventing Treaty Abuse) does not create new barriers to legitimate claims for treaty relief

As part of its Base Erosion and Profit Shifting (BEPS) project, the OECD has proposed the addition of new provisions to bilateral tax treaties to prevent improper use of the treaties (i.e., "Limitation on Benefits (LOB)" and/or "principal purpose test (PPT)" provisions). As drafted, these provisions in our view create the risk of disproportionate outcomes, investor uncertainty, and a shift from the current trend of granting treaty benefits at source to the more burdensome, non-standard, and costly reclaim method of relief. In particular, they fail to take into account the nature of cross-border investment funds and the practical challenges such funds face in complying with complex documentation and other procedural requirements associated with establishing entitlement to relief under such provisions. The AGC wrote to the OECD in January 2015 to express our concerns about the proposals and to recommend adaptations that could be made to ensure practical access to treaty benefits for legitimate cross-border investors (letter available at http://www.theagc.com/Current%20Comment.Letters-Tax-Issues.htm). It would be very helpful if the EC and EU member states would take a strong position at the OECD in favour of the recommendations set out in that letter, including: (i) providing a waiver from any LOB, PPT or other anti-abuse provisions for institutional investors where the risk of treaty abuse is low, such as widely-held CIVs, life insurance companies, regulated pension funds, and sovereign wealth funds; (ii) ensuring that the final proposals reflect the approaches previously endorsed by the OECD for establishing CIVs' entitlement to treaty benefits; (iii) ensuring that the OECD develops comparable approaches for non-CIV funds, particularly pension funds; and (iv) ensuring that the final proposals include adequate guidance on how the PPT provision would be applied, if at all, to collective fund structures.

We are grateful for the opportunity to share our views on the Capital Markets Union Green Paper, particularly in relation to post-trade and tax aspects, and look forward to further engagement with the European Commission on this very important and timely project. Please do not hesitate to contact the undersigned should you wish to discuss any of the above.

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