Over-the-Counter Derivative Markets in the Light of EMIR Clearing Obligations and the Financial Transaction Tax

The European Financial Market is and will be subject to significant legal changes. At its current stage, the European Union has issued Regulations for the over-the-counter derivative market; under the European Market Infrastructure Regulation, these contracts must be cleared through central counterparties. Beyond that, several EU Member States are attempting to implement a common financial transaction tax that should increase financial market stability. The authors conclude that these two instruments are not sufficiently coordinated and thus, further amendments to the current financial transaction tax proposal are necessary in order to provide a coherent European regulatory approach for the financial market.

1. Introduction

Over-the-counter derivatives have played a major role in causing the global financial crisis that started originally in the US housing market. Since then, the market volume has increased and the need for regulations in that field has widely been acknowledged by policymakers. On a European Union level, the two most important mechanisms are the European Market Infrastructure Regulation (EMIR) and the financial transaction tax (FTT). This article will examine whether these two European instruments are coordinated with each other. However, the article will deal only with over-the-counter derivatives contracts.

First, the authors will discuss the scope of the EMIR. Next, the discussion turns to the FTT, outlining the European Commission’s latest Proposal and analysing the application of the FTT to the clearing process, which is mandatory under the EMIR. The current inconsistencies between the EMIR and the FTT Proposal are illustrated, and finally, the authors provide suggestions for amending the FTT Proposal.

2. Over-the-Counter Derivative Markets and the European Market Infrastructure Regulation

Derivatives are bilateral financial contracts the value of which is dependent on the value of an underlying. Any type or value of an asset may underlie derivatives contracts, for example securities, interest rates, currencies, commodities or even other derivatives. Derivatives may be traded on exchange markets or over the counter. Three types of derivatives can be distinguished at the outset, although more complex products may combine aspects of different types. Through forwards, concluded over the counter, and futures, concluded on exchange markets, parties trade the future value of an underlying asset and promise the delivery of a certain future value for consideration. An option allows a buyer or seller to decide in the future to buy or sell an underlying asset at conditions defined today. Swaps are bilateral exchanges of future cash flows. Thus, shifting risks between the parties is the focal point of a derivatives contract.

In the case of over-the-counter trading, both counterparties negotiate the contract privately without interposing a trading venue. Derivatives traded over the counter are non-highly standardized contracts; only highly standardized derivatives contracts are suitable for trading on exchange markets. As no trading venue is involved, over-the-counter derivatives contracts involve significant counterparty risk, which is the risk of default of the counterparty. This is why they are of particular importance for market (in)stability, especially during financial crises, as they increase the interconnection of the financial sector in a non-transparent manner.


In light of the role of over-the-counter derivative markets during the last financial crisis, the European Union has started initiatives resulting in more extensive regulation of these markets, and leading to the adoption of the EMIR. This regulation imposes far-reaching obligations on financial institutions that are party to over-the-counter derivatives contracts. The parties must clear certain derivatives contracts through a central counterparty under article 4(1) of the EMIR. This obligation will apply to derivatives contracts that are considered suitable for clearing. The list of the class of over-the-counter derivatives contracts that should be subject to the clearing obligations and will be developed under article 5(2) of the EMIR, has not been drafted yet. Despite this, under article 9(1) of the EMIR, the details of all over-the-counter derivatives contracts must be reported to a trade repository. If certain derivatives contracts are not suitable for clearing, the parties will have to mitigate the risk involved. The regulation further sets out certain minimum requirements to fulfill this obligation, which is also due to non-financial institutions’ being party to an over-the-counter derivatives contract. However, this article will address only the obligation to clear certain over-the-counter derivatives contracts through a central counterparty.

If an over-the-counter derivatives contract is suitable for clearing and the parties are subject to the clearing obligation of article 4(1) of the EMIR, a central counterparty must be interposed between the original parties – resulting in economically the same derivatives contract and trade of market risk had they concluded over the counter.

Example 1

Two banks, A and B, located in Germany and France, respectively, agree over the counter on a forward. Under this contract, A must deliver 5,000 shares of company X, located in the United Kingdom, at a price of EUR 20 per share in six months. The derivative concluded is supposed to fall under the clearing obligation. Both A and B are clearing members of the same central counterparty located in France.

First, A and B concluded the derivative over the counter. Accordingly, the contractual relationship exists directly between A and B, as follows:

Second, A and B are obliged to clear the forward agreement under article 4(1) of the EMIR. Thus, a central counterparty is interposed between A and B. As a result, the central counterparty is obliged to deliver the shares to B and pay the price agreed upon to A. A must deliver the shares to the central counterparty, whereas B must pay the price agreed upon to the central counterparty.

3. Over-the-Counter Derivative Markets and the Financial Transaction Tax


The FTT is another mechanism proposed by the European Commission that should ensure the proper functioning of the internal market for transactions in financial instruments, as well as create appropriate disincentives for transactions that do not enhance the efficiency of the financial market. At the current stage, the European Commission has issued the second Proposed Directive for a Common

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8. Art. 11(1) EMIR. 
9. T. Gstädtner, supra n. 3, at 145, 149. 
10. Art. 2(1) EMIR. 
14. Regarding whether the FTT is an appropriate mechanism to stabilize the financial market, see W. Schön, Die Finanztransaktionssteuer – ein ”fairer Beitrag“ des Finanzsektors?, Zeitschrift für das gesamte Handels- und Wirtschaftsrecht (2012), at 261, 265 et seq.
FTT\(^{22}\) (Proposed FTT Directive). The discussion here focuses on the implications of the clearing process under the EMIR on the FTT.

Under the Proposed FTT Directive, the FTT would apply to all financial transactions where at least one party to the transaction is established in the territory of a participating Member State.\(^{16,17}\) The Proposed FTT Directive defines the term ‘financial transaction’ in its broadest possible sense, so as to include the sale or purchase of financial instruments, which are defined by reference to the Markets in Financial Instruments Directive (MiFID),\(^{18}\) certain internal transactions in financial instruments; and the conclusion of derivatives.\(^{19}\) Unsurprisingly, the definition of financial institutions is also extremely broad and under the Explanatory Memorandum so as to include ‘investment firms, organised markets, credit institutions, insurance and reinsurance undertakings, collective investment undertakings and their managers, pension funds and their managers, holding companies, financial leasing companies, special purpose entities’.\(^{20}\) However, FTT would not apply to central counterparties where they are exercising the function as a central counterparty.\(^{21}\) Despite this, clearing members, which are the only entities authorized to act directly with the central counterparty, are not covered by the exemption provision.

Under the Explanatory Memorandum, it is the financial transaction that would be subject to tax;\(^{22}\) however for FTT to apply, it is irrelevant whether the contract forming the legal basis for the financial transaction infringes other parts of the states’ law or whether the financial transaction can be performed. Form the authors’ perspective, the FTT is designed in a way in which it will be sufficient for FTT to apply if the contract underlying the financial transaction is established. Thus, the nature of the FTT is more of a stamp duty than of a transaction tax. In accordance with this, the cancellation of financial transactions cannot be considered as a reason for not imposing FTT. The chargeability of the tax should be excluded only in cases where errors have occurred.\(^{23}\)

It is not only the broad definitions implemented in the Proposed FTT Directive that characterizes the broad scope of the FTT, but also the residence principle of the Proposed FTT Directive. Under article 4(1)(f), a financial institution that is established in a non-participating Member State is deemed to be established in the participating Member State in which the counterparty to the financial transaction is established. Therefore, a financial institution is liable to FTT as soon as one party to the financial transaction is established in a participating Member State. If the financial institution is established in a participating Member State, it is subject to FTT under the jurisdiction of its country of residence. If, however, the financial institution is deemed to be established in the participating Member State of the counterparty, that country exercises jurisdiction over an entity located outside the geographical area in circumstances in which a sufficient linkage between the financial institution and the participating Member State exercising jurisdiction might not be established as required by customary international law.\(^{24}\)

### 3.2. Interposition of central counterparties and its impact on the financial transaction tax

As has been shown above, parties to over the counter derivatives contracts that are suitable for clearing are obliged to interpose a central counterparty between them.\(^{25}\) However, from an FTT perspective, the original over the counter derivatives contract between the original parties, not including the central counterparty, is a financial transaction within the meaning of article 2(1)(2)(c) of the Proposed FTT Directive. If one of the original parties is established in a participating Member State, the transaction will be subject to FTT.\(^{26}\)

With regard to Example 1, where two financial institutions (both established in a participating Member State) agree over the counter on a forward, both banks, A and B, would be liable to FTT in their state of residence. The over the counter derivatives contract is established between A and B, first without interposing a central counterparty. FTT will be imposed on this transaction, although its underlying contract will be subject to a novation, as the original parties to the over the counter derivatives contract are obliged to clear the financial transaction.

![Diagram showing interposition of central counterparties and its impact on the financial transaction tax](https://via.placeholder.com/150)

- **Germany**
- **France**

**A**

FTT

**B**

FTT


\(^{25}\) Art. 4(1) EMIR.

\(^{26}\) Art. 3(1) Proposed FTT Directive.
3.2.1. The process of novation in light of the European Commission’s proposal

The novation has different legal consequences depending on its meaning in each jurisdiction. From an FTT perspective, it is necessary to examine whether the novation of the over-the-counter derivatives contract is subject to tax. Whereas the first Proposal of the European Commission on a common FTT explicitly characterized any modification of derivatives in article 2(1)(1)(c) as a separate financial transaction that is subject to tax, the revised proposal considers only a material modification of a taxable financial transaction to be subject to FTT by deeming the material modification to be a new taxable financial transaction of the same type as the original transaction. This should prevent tax avoidance. However, material modifications will not only be subject to FTT where derivatives contracts are involved, but any material modification to any type of financial transaction will give rise to a charge.

Under the Proposed FTT Directive, a modification to a financial transaction is considered to be material in particular where it involves a substitution of at least one party, or a change of the time period or the consideration of the transaction. Notably, this is not an exclusive list; the scenarios stated in the Proposed Directive are of a generic nature.

As has been shown, the novation of the original contract is generally characterized as the conclusion of a new derivatives contract with the central counterparty by each party to the original financial transaction. The original over-the-counter derivatives contract could either remain unaffected or become void. In either case, the original parties would be liable to FTT under the original over-the-counter derivatives contract. Despite this, the two new derivatives contracts, which consist of (i) one between one of the original parties to the over-the-counter derivatives contract and the central counterparty, and (ii) the second between the other party to the original contract and the central counterparty, are separate financial transactions where each of them is subject to FTT.

These new derivatives contracts should not be considered as a material modification of the original contract, as these contracts are separate contracts to the original contract. The trading of risks between different parties. As the counterparties for both parties to the original over-the-counter derivatives contract have changed, the two new derivatives contracts result in a different risk traded as the counterparty risk changes. The trading of risks is the reason for imposing the FTT liability. Thus, such an understanding corresponds to the aim of the FTT. Besides the conclusion of the new derivatives contracts, the original contract could either become void or remain unaffected. If, however, the original contract remains in force, it stands under the condition that the contract may give rise to legal claims only insofar as the new contracts do not enter into force properly. Thus, the question could be raised as to whether the cancelation or – if not cancelled – the condition imposed on the original contract by the new derivatives contracts, can be regarded as a material modification of the original derivatives contract that would be subject to FTT.

With regard to Example 1, it has been determined that A and B are liable to FTT on the original over-the-counter derivatives contract under the jurisdiction of their state of residence. However, A and B are obliged to clear the over-the-counter derivatives contract under article 4(1) of the EMIR. To interpose the central counterparty, each party to the original contract, A and B, concludes a new derivatives contract with the central counterparty. These contracts are subject to FTT under articles 2(1)(2)(c) and 3(1) of the Proposed FTT Directive. Assuming that the original contract becomes void, under the current Proposed FTT Directive it is questionable whether the cancelation of the contract is a material modification of the original contract so as to be subject to FTT.

3.2.2. The process of novation in light of European Parliament’s proposed amendment

The European Parliament has given a report on the European Commission’s Proposed FTT Directive. Among other things, the European Parliament proposes amending article 2(1)(2) of the Proposed FTT Directive. The newly added sentence 5 would state that “any novation of transactions carried out for the purposes of clearing or settlement by a central counterparty or by another clearing house or settlement system operator or interoperable systems [...] shall not constitute a material modification under this paragraph.” According to the European Parliament, this provision will be a mere clarification and will be in line with the treatment of the clearing procedure in the European Commission’s proposal. The European Parliament states that the novation of transactions for purposes of clearing by a central counterparty as described in this contribution should not be considered as a material modification, and thus should not be characterized as a transaction within the meaning of article 2(1)(2) of the Proposed FTT Directive. However, in the authors’ opinion, the amendment to article 2(1)(2) of the Proposed FTT Dire-
The novation generally takes the form of substituting the original over-the-counter derivatives contract with two newly concluded derivatives contracts. The old contract may remain in force upon the proper fulfilment of the new derivatives contracts, or may be discharged by the conclusion of the new derivatives contracts. As stated, this might be considered a material modification of the old derivatives contract. In such circumstances, the amended provision will ensure that this material modification remains untaxed, not constituting a mere clarification.

However, part of this process of novation is the conclusion of two new derivatives contracts. The conclusion of these contracts is within the scope of articles 2(1)(2)(c) and 3(1) of the Proposed FTT Directive. These provisions state that the conclusion of a derivatives contract before netting or settlement, as in this case, is a taxable financial transaction. Under the plain wording of the provision proposed by the European Parliament, it will not prevent these financial transactions from being subject to taxation. The provision explicitly refers only to the material modification, and thus will apply only to any material modification of the old derivatives contract, but not to the conclusion of the new derivatives contracts. The modification of a financial transaction gives rise to a new taxable event of the same type by deeming a new derivatives contract to be concluded. However, it does not hold the other way round; thus the conclusion of a new derivatives contract is not in every case a material modification in that sense. This is why the conclusion of two new derivatives contracts replacing the old derivatives contract – as in the case of a novation – does not constitute a material modification of this contract. As a result, the provision proposed by the European Parliament will not affect the taxation of the conclusion of the two derivatives contracts between the central counterparty and the original parties to the derivatives contract. Therefore, parts of the process of novation will remain taxed.

Amendment 1

From a systemic perspective, it would be necessary to amend article 2(1)(2) of the Proposed FTT Directive such that it would be clear that any material modification of any of the taxable events under article 2(1)(2)(a) to (e) would establish a separate and distinct taxable event, similar to the provision laid down in the first Proposal of the European Commission on a Common FTT for derivatives contracts; then, the material modification as such would be subject to FTT under a newly created article 2(1)(2)(f). The taxable events should be seen as being mutually exclusive. Thus, as soon as a case falls within the scope of one of the taxable events included in article 2(1)(2)(a) to (f), the other taxable events should not be applied. This should also be the case for any modification, even though it is not considered material.

Amendment 2

Article 2(1)(2)(f) should further clarify that the process of novation of derivatives contracts for the purpose of clearing must be characterized as a modification of the original derivatives contract. Such a modification would include not only the interposition of the central counterparty between the original parties to the derivatives contract, but also the interposition of clearing members if the original parties are not authorized to act directly with the central counterparty. If this were the case, the Directive would, at least for the novation of derivatives contracts for the purpose of clearing, determine that the contract law characterization of the novation is irrelevant for the purpose of FTT. If adaptations to the derivatives contract are needed for the purpose of clearing, like the possible modification of the original derivatives contract and the conclusion of two new derivatives contracts, all of them should be seen as modifications of the original contract, ignoring that, under contract law, new derivatives contracts within the meaning of article 2(1)(2)(c) of the Proposed FTT Directive are concluded. Therefore, the interposition of a central counterparty and clearing members must be characterized as a modification of the original derivatives contract. Only such an autonomous interpretation is capable of ensuring that the entire process of novation of derivatives contracts for the purpose of clearing is, in every participating Member State, treated equally from an FTT perspective, irrespective of the characterization under national contract law.

Amendment 3

The amendment proposed by the European Parliament, under which any modification to the original contract for the purpose of clearing should not be a material modification and thus should not be subject to FTT, should be incorporated into article 2(1)(2)(f) of the Proposed FTT Directive in the form proposed in this contribution. As a result of the amendments proposed in Amendments 1 and 2, above, this will ensure that the entire process of novation for the purpose of clearing is not subject to FTT, i.e. the possible modification of the original derivatives con-
3.3. Territorial scope of the financial transaction tax and the counterparty principle

The conclusion of the original over-the-counter derivatives contract is taxable financial transaction under articles 2(1)(2)(c) and 3(1) of the Proposed FTT Directive. Furthermore, the novation will generally be considered a taxable financial transaction. The over-the-counter trade and clearing will result in three to four taxable financial transactions – the conclusion of the original and two new replacement derivatives contracts, and possibly the conditioning or discharging of the original over-the-counter derivatives contract.

However, the territorial scope of the Proposed FTT Directive must be elaborated upon. Under article 3(1) of the Proposed FTT Directive, a financial transaction will be taxed if at least one of the parties to the transaction is established in a participating Member State. This requirement is further set out in article 4 of the Proposed FTT Directive, and its effect can be illustrated using the following example.

Example 2

Two banks, A and B, located in Austria and the United Kingdom, respectively, agree over the counter on the conclusion of a forward. Under this contract, A must deliver 5,000 shares of company Y, located in the United Kingdom, at a price of EUR 20 per share in six months. The concluded derivative is supposed to fall under the clearing obligation. Both A and B are clearing members of the same central counterparty. The central counterparty is located in the United States and is recognized by ESMA under article 25 of the EMIR; under articles 4(3) and 25 of the EMIR, the central counterparty is therefore allowed to provide clearing services, which fulfilling the clearing obligation of article 4(1) of the EMIR.

Before clearing:

<table>
<thead>
<tr>
<th>Austria</th>
<th>United Kingdom</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>B</td>
</tr>
</tbody>
</table>

After clearing:

<table>
<thead>
<tr>
<th>Austria</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>CCP</td>
</tr>
<tr>
<td></td>
<td>United States</td>
</tr>
<tr>
<td></td>
<td>B</td>
</tr>
<tr>
<td></td>
<td>United Kingdom</td>
</tr>
</tbody>
</table>

3.3.1. Taxation of the original derivatives contract

The original over-the-counter derivatives contract is directly agreed upon without interposition of a central counterparty. Thus, for purposes of the original over-the-counter derivatives contract, banks A and B will be established in a participating Member State. Bank A is established at least under article 4(1)(c) of the Proposed FTT Directive in Austria, a participating Member State, whereas Bank B is located in the United Kingdom, which will not participate in the FTT. Nevertheless, Bank B is the counterparty to Bank A in the original over-the-counter
derivatives contract. Under the counterparty principle in article 4(1)(f) of the Proposed FTT Directive, a party to a transaction will be deemed to be established in a participating Member State if another party to the transaction is established in a participating Member State under article 4(1)(a) to (e) of the Proposed FTT Directive. As this is the case for Bank A, Bank B will be deemed to be established in the participating Member State in which Bank A is established, namely Austria. This is why both banks, A and B, owe FTT for the conclusion of the original derivatives contract in line with article 10(1)(a) of the Proposed FTT Directive. The amount will be established under articles 7 and 9 of the Proposed FTT Directive, applying the national tax rate of at least 0.01% to the notional amount of the derivatives contract.

### 3.3.2. Taxation of the process of novation

Under the current Proposed FTT Directive, the process of novation gives rise to taxable financial transactions. The discharging or conditioning of the old over-the-counter derivatives contract may be considered a material modification of the original derivatives contract. The third sentence of article 2(2) of the Proposed FTT Directive states that, in such a case, the material modification will be seen as the conclusion of a new derivatives contract between the parties, which would be Bank A and B in Example 2. Correspondingly, the counterparty principle of article 4(1)(f) of the Proposed FTT Directive will apply again. If the European Parliament’s amendment were adopted, this material modification would not be subject to FTT.

In *Example 2*, the parties to the original contract interpose a central counterparty located in the United States by concluding two new derivatives contracts between Bank A and the central counterparty, and the central counterparty and Bank B. Correspondingly, the question as to whether Bank B is established within a participating Member State for purposes of the Directive depends on who the counterparty is. One could argue that the counterparty to Bank B is the Bank A for purposes of applying the Directive. This would disregard the central counterparty, establishing a look-through. If this were the case, Bank B would be deemed to be established in Austria under article 4(1)(f) of the Proposed FTT Directive. However, one could also argue that the central counterparty located in the United States is the counterparty to Bank B and that the transaction is between Bank B and the central counterparty. In this case, Bank B would not be deemed to be established in a participating Member State, as the central counterparty is not established in a participating Member State.

#### 3.3.2.1. Central counterparty as a party to a transaction

The question therefore arises as to whether the central counterparty is a party to the financial transactions for purposes of applying the Proposed FTT Directive. The term “financial transaction” is defined in article 2(1)(2)(c) of the Proposed FTT Directive as the conclusion of a derivatives contract. Although one may be tempted to argue that the conclusion of these new derivatives contracts takes place between Bank A and Bank B, such an argument leads to inconsistent results. The contracts necessary for interposing the central counterparty take their effects between Bank A and the central counterparty and between Bank B and the central counterparty, each being seen as a distinct derivatives contract. Thus, considering Bank A and Bank B to be parties to the financial transaction and being liable to FTT would result in discrepancies in the legal effects of the contracts that do not lie between Bank A and Bank B and give rise to the trading of risk as the reason for imposing FTT. Legal parties to these two distinct financial transactions are both Bank A and Bank B, and the central counterparty.

This corresponds to the term of being a party to a transaction in article 3(1) of the Proposed FTT Directive. According to this, the systematic of article 3(2) and (3) of the Proposed FTT Directive does not allow any other interpretation; article 3(2) exempts certain parties to a transaction, whereas article 3(3) exempts transactions. If one were to interpret the Directive such that a central counterparty were not a party to a transaction, one would have to include such an exemption in article 3(3) instead of article 3(2). Although this exemption is limited to certain transactions of the central counterparty, this exemption is included in article 3(2) and thereby limits the exemption of the central counterparty as a party. These arguments show that a central counterparty will be a party to a transaction not being exempted if it does not act in its capacity as a central counterparty.

Furthermore, article 10(3) of the Proposed FTT Directive states that even non-financial institutions that are party to a transaction may be held liable for FTT. Under the technical explanation issued by the European Commission, this provision also applies to central counterparties. The European Commission explicitly states that central counterparties are parties to a transaction. It cannot be assumed that the interpretation of the term “party” differs within the Proposed FTT Directive in each provision. Furthermore, an interpretation under which the central counterparty would be seen as a party for purposes of establishing the financial transaction but not for further applications of the Directive, including determining the territorial scope of the Directive, will create an artificial distinction in the provisions establishing the tax liability. However, determining the territorial scope is a necessary step in prescribing a tax liability. Thus, characterizing a central counterparty as a party to a financial transaction corresponds to the wording, systematics and intention of the Proposed FTT Directive as expressed by the European Commission.

#### 3.3.2.2. The counterparty principle and out-of-scope central counterparties

The novation creates two distinct financial transactions between Bank A and the central counterparty, and between

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Bank B and the central counterparty. Applying article 4 of the Proposed FTT Directive in such a scenario shows that Bank A is established in the participating Member State of Austria. However, Bank B is located in the United Kingdom. In order to deem Bank B to be established in a participating Member State, a party established in a participating Member State must be party to the transaction. The central counterparty is party to this transaction, but not Bank A. The central counterparty is located in the United States and therefore will not trigger the presumption of article 4(1)(f) of the Proposed FTT Directive that Bank B is established in a participating Member State.\(^33\)

One may be tempted to argue that the term "transaction" in article 4(1)(f) of the Proposed FTT Directive should be interpreted rather broadly, establishing that the entire process of novation is seen as one single transaction. In such a case, not only the central counterparty would be party to the transaction, but Bank A as well as Bank B. As both banks were party to the same transaction, the counterparty principle of article 4(1)(f) of the Proposed FTT Directive would apply, and thus Bank B would be deemed to be established in Austria. However, such an interpretation would presume that the term "transaction" refers to something different than the term "financial transaction". The former would then have a different meaning and would not be defined in article 2 of the Proposed FTT Directive, although this provision is meant to define the key terms of the Directive. Thus, the term "transaction" should rather be seen as a shorter version of "financial transaction" in order to shorten the provisions and make them easier to read and understand. Therefore, these terms mean the same and an interpretation of article 4(1)(f) of the Proposed FTT Directive that would include Bank A as a party to the financial transaction between Bank B and the central counterparty, should be rejected.

In summary, Bank B will not be liable to FTT with regard to the new derivatives contract concluded with the central counterparty in Example 2.

If, however, the amendments proposed by the authors\(^34\) were implemented in the FTT Directive, all modifications necessary for the clearing obligations under the EMIR would be neutral for FTT purposes. Only the initial derivatives contract would be subject to FTT, although the modifications would remain untaxed.\(^35\)

Finally, the significance of the counterparty principle in the area of central counterparties is illustrated by the following variation of Example 2.

**Variation of Example 2**

Instead of a US central counterparty, assume that the central counterparty is registered in Germany. Furthermore, assume that Bank A is located in the United States (and not in Austria). It will also be assumed that Bank A, an entity not established in the European Union, would be subject to the clearing obligations if it were established in the European Union. Thus, Bank A and Bank B are subject to the clearing obligations.\(^39\)

![Diagram of clearing process](image)

Before clearing:

As before, the conclusion of the original derivatives contract over the counter gives rise to a financial transaction.\(^37\) However, both parties to this transaction, Bank A and Bank B, are not located in a participating Member State under article 4 of the Proposed FTT Directive. Therefore, the financial transaction is not within the scope of the FTT.\(^38\)

Nevertheless, the process of novation gives rise to two new financial transactions under article 2(1)(2)(c) of the Proposed FTT Directive. The central counterparty is party to two distinct financial transactions. Article 4(1)(f) of the Proposed FTT Directive, implementing the counterparty principle, applies irrespective of whether the counterparty is a financial institution within the meaning of article 2(1)(8) of the Proposed FTT Directive. Explicitly, it even applies in cases where a party to the transaction is not a financial institution like a central counterparty and is established in a participating Member State. In this variation of Example 2, the central counterparty is registered in Germany and therefore established in Germany as a participating Member State.\(^39\) Correspondingly, both banks, A and B, will be deemed to be established in Germany. As a result, the process of novation is within the scope of the Proposed FTT Directive and the financial transactions occurring in the process of novation are taxable.\(^40\) Accord-

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\(^33\) Although FTT could also apply under article 4(1)(g) of the Proposed FTT Directive, a discussion of this topic is beyond the scope of this article.

\(^34\) See section 3.2.3.

\(^35\) The question as to whether a central counterparty is a party to the transactions remains a significant issue for derivatives traded on an exchange market, even if the amendments proposed by the authors were implemented, as in these cases a central counterparty is interposed between the trading parties from the beginning.

\(^36\) Art. 4(1)(a)(iv) EMIR

\(^37\) Art. 2(1)(2)(c) Proposed FTT Directive.

\(^38\) Art. 3(1) Proposed FTT Directive.


\(^40\) Arts. 3(1) and (4)(1)(f) and (2)(a) Proposed FTT Directive.
ingly, both the US bank and the UK bank will be liable to FTT in Germany.

If the amendments to article 2(2) of the Proposed FTT Directive proposed by the European Parliament were adopted, they would have an impact on the Variation of Example 2 only to the extent of the possibly occurring material modification of the original derivatives contract, which would be untaxed. Accordingly, the counterparty principle will still apply to the conclusion of the two new derivatives contracts and Banks A and B will remain liable to FTT in Germany.

With regard to the amendments proposed by the authors, they will ensure that the entire process of novation is characterized as neutral from an FTT perspective. In general, only the conclusion of the original derivatives contract would be subject to tax. However, in the Variation of Example 2, this financial transaction does not fall within the territorial scope of the FTT and is therefore not taxed.


Not every party to a financial transaction is authorized to directly act with a central counterparty. Therefore, they must interpose clearing members between them and the central counterparty in order to meet the clearing obligation of article 4(1) of the EMIR. However, the clearing members are not covered by the exemption provision of article 3(2)(a) of the Proposed FTT Directive exempting the central counterparties in circumstances in which they are exercising their function as a central counterparty. The FTT implications of interposing clearing members are illustrated by the following example.

Two banks, A and B, located in the United Kingdom and Germany, respectively, agree over the counter on the conclusion of a forward. Under this contract, A must deliver 5,000 shares of company Y, located in the United Kingdom, at a price of EUR 20 per share in 6 months. The concluded derivative is supposed to fall under the clearing obligation. Neither A nor B are authorized to act directly with the central counterparty; thus, A uses a clearing member located in the United Kingdom, while B uses a German clearing member. The central counterparty authorized under article 25 of the EMIR is located in the United States.

Before clearing:

After clearing:

Banks A and B agree over the counter on a forward, which is, from an FTT perspective, a financial transaction. As Bank B is established in a participating Member State and it is party to this financial transaction, A is deemed to be established in Germany and both banks, A and B, are liable to FTT. However, A and B are obliged to clear the forward agreement under article 4(1) of the EMIR. A and B are therefore required to interpose a central counterparty between them. As neither A nor B is authorized to act directly with the central counterparty, they also must interpose clearing members that act between them and the central counterparty. Notably, the clearing members are not covered by the exemption provision.

Based on the current Proposed FTT Directive, the novation of the original contract between A and B in the form of interposing the central counterparty and clearing members between them would be subject to FTT because new derivatives contracts are concluded, trading risks between the parties.

The new derivatives contracts are between the original parties, A and B, and the clearing members, and the clearing members and the central counterparty. B is established in a participating Member State, Germany, and is liable to FTT also under the new derivatives contract concluded with Clearing Member 2 in Germany. Clearing Member 2 is also established in a participating Member State, Germany, and as it is not covered by the exemption provision, Clearing Member 2 is also liable to FTT for the financial transaction with B. The central counterparty is established in a non-participating Member State and independently, FTT never applies to central counterparties in circumstances in which they are exercising their function as a central counterparty. However, as Clearing Member 2 is located in Germany, it remains liable to FTT for the transaction with the central counterparty, as its taxation is unaffected by the exemption of the central counterparty. Therefore, the German clearing member is liable to FTT twice. Clearing Member 1 is established in a non-participating Member State, the United Kingdom, and is party to

41. Art. 2(1)(2)(c) Proposed FTT Directive
42. Art. 3(2)(a) Proposed FTT Directive
43. Art. 2(1)(2)(c) Proposed FTT Directive
44. Art. 3(1)(2) Proposed FTT Directive
45. Id
46. Art. 3(3) Proposed FTT Directive
a financial transaction with the central counterparty that is located in the United States, a non-participating state.

As examined above, the central counterparty is a party in the financial transaction chain, and it is therefore impossible to look through this entity for the purpose of the counterparty principle. As neither the central counterparty nor Bank A are established in a participating Member State, Clearing Member 1 cannot be deemed to be established in a participating Member State and thus it is not liable to FTT. After interposing all entities necessary for clearing the forward, A’s counterparty in the financial transaction is Clearing Member 1, which is established in a non-participating Member State, the United Kingdom. Thus, A cannot be deemed to be established in a participating Member State and thus it is not liable to FTT.

Furthermore, the process of novation results in conditioning or discharging the original over-the-counter contract. This may give rise to a material modification and be considered a financial transaction, unless the amendment to article 2(2) of the Proposed FTT Directive proposed by the European Parliament were adopted. If a material modification of the original over-the-counter derivatives contract can be assumed, both banks, A and B, will be liable to FTT, as the counterparty principle will be applicable.

As this example shows, the necessary inclusion of clearing members in the transaction chain to fulfill the clearing obligation under article 4(1) of the EMIR is suitable for increasing the cascading effect of the FTT. Thus, from the authors’ perspective, it is necessary to include the clearing members in the exemption provision of the Proposed FTT Directive (article 3(2)(a)) in order to characterize the inclusion of a central counterparty and clearing members as a neutral element in the financial transaction chain. The exemption of clearing members in circumstances in which they are exercising their function as clearing members would be in line with characterizing clearing members as part of the market infrastructure that should not be taxed under the FTT.

If article 2(2) of the Proposed FTT Directive were to be amended in the way proposed by the authors, the process of novation necessary for clearing the original derivatives contract would not be subject to tax, irrespective of the inclusion of clearing members in the exemption provision. The conclusion of derivatives contracts with the clearing members by the parties to the initial derivatives contract is inevitable in order to fulfill the clearing obligation under article 4(1) of the EMIR in cases where the parties to the original derivatives contract are not clearing members. As the conclusion of derivatives contracts with the clearing members is a necessary modification for the clearing process, it would be covered by the amendments proposed by the authors and the new derivatives contracts would, in any case, remain untaxed.

However, if the amendments proposed by the authors were implemented, the exemption provision would have an impact on the derivatives contracts that are traded on an exchange market. In cases where a trading venue is involved, no further obligation to clear the transaction exists. The necessary counterparties (central counterparties and clearing members) are already party to the derivatives contract from the beginning. In these cases, the clearing process would be neutral from an FTT perspective only if the necessary counterparties (central counterparties and clearing members) were expressly exempt from the FTT regime.

5. Conclusion

The two main mechanisms for the financial market regulation, the EMIR and the FTT, are not coordinated in an efficient manner. Under the EMIR, market participants are forced to clear certain derivatives contracts concluded over the counter. This requires the interposition of central counterparties and, if necessary, clearing members between the original parties in the form of novation. Central counterparties and clearing members provide a key market infrastructure in mitigating financial market risks. From the authors’ perspective, it would be necessary to characterize the novation required for the entire clearing process as a neutral element within the financial transaction chain for the purpose of FTT. This could be achieved only by characterizing any modification, by way of concluding new derivatives contracts or amending the existing one, of the original over-the-counter derivatives contract necessary for meeting the clearing obligations under the EMIR, as a neutral act for the purpose of FTT. The authors have illustrated the necessary changes to the Proposal.

If derivatives are traded on the exchange market, no later novation of the original contract is necessary for clearing, as central counterparties and clearing members, where necessary, are parties from the beginning. Nevertheless, the transactions between the clearing members and the parties as well as the central counterparty are subject to FTT. Thus, it would be necessary to not only exempt central counterparties from the FTT regime but also clearing members acting as such should be included in the exemption provision in order to not attract FTT on the entire clearing process.