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Dear Sirs,

RE: CITY OF LONDON LAW SOCIETY'S RESPONSE TO REFORM OF TAXATION OF SECURITISATION COMPANIES CONSULTATION

Please find below The City of London Law Society's ("**CLLS**") response to the HM Revenue & Customs ("**HMRC**") consultation document entitled "Reform of Taxation of Securitisation Companies" (the "**Consultation**").

INTRODUCTION

The CLLS represents approximately 17,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response to the Consultation has been prepared by the CLLS Revenue Law Committee. The current members of the committee are herewith:-

http://www.citysolicitors.org.uk/clls/committees/revenue-law/revenue-law-committee-members/

1. **Question 1: What are respondents' views on the commercial importance of retained securitisations, the drivers for such securitisations, and the impact of being able to carry out such securitisations in the UK on the competitiveness of the UK as a financial services centre?**

1.1 Members of the CLLS regularly see securitisations where there is at least the possibility of the originator's group retaining 50% or more of the notes, commonly in order to use them as collateral for loans for the Bank of England but also for other reasons for example regulatory capital management within financial services groups.

1.2 Due to the complexity of the UK securitisation rules, clients will often set up securitisations, even where the receivables originate in the UK, in other jurisdictions such as Ireland or Luxembourg, not because it achieves a better overall tax outcome but just to save costs. The commercial reality often experienced by some CLLS members is that the UK is not even in the conversation when clients are deciding where to locate a securitisation issuer (despite a concentration of sophisticated advisors and clients in the UK that would likely prefer the UK as a jurisdiction for their securitisations if the UK regime were comparable to international alternatives). The complexity of the connection test in s.1122 CTA 2010 impacts the competitiveness of the UK as a venue for securitisation not just in retained securitisations but on every occasion where clients face the decision of where to incorporate a securitisation issuer. The complexity of the connection test in the context of the provision of the funds to capitalise the issuer by the originator is a particular point of difficulty. We therefore welcome HMRC's engagement with reforming and simplifying the taxation of securitisation companies and consider that the interests of HMRC and CLLS member firms are aligned in making the UK more competitive for these transactions.

2. **Question 2: What changes by way of clarifying and/or reforming the Regulations in relation to retained securitisations would be helpful, and what form should they take? What would be the benefits and any potential difficulties of making any such changes?**

2.1 Typically the receivables sold to the issuer will remain "on balance sheet" for the originator with the originator retaining what is referred to as the "first loss piece" of the transaction. Generally at least two classes of notes will be issued and the originator tends to hold the junior notes as well as the final item in the waterfall of payments set out in the transaction documents, which is usually characterised as deferred consideration for the sale of receivables. An area of complexity in verifying that the originator is not connected with an "orphan" issuer is that this "first loss piece", however structured, has an equity character. This gives rise to concern that the originator, by virtue of its entitlement to deferred consideration (or equivalent) is a "participator" in the issuer as defined in s.454 CTA 2010, and could potentially therefore control the issuer for the purposes of s.450 CTA 2010.

2.2 Private correspondence between HMRC and five CLLS members in 2008 is helpful in that it has enabled the legal market work around this issue and nevertheless issue legal opinions to the satisfaction of rating agencies and other market participants. However it is clearly not ideal that such an important legal conclusion can only comfortably be reached based on some unpublished and now somewhat vintage guidance.

2.3 The least disruptive change to clarify the rules would be publication of the 2008 guidance in a clarified form. However that would essentially achieve little more than retaining the status quo.

2.4 A more satisfactory although somewhat more radical solution would be simply to delete the independent persons test. That could give rise to securitisation company status applying unintentionally. Perhaps a solution would be for securitisation company tax status to apply either if the independent persons test is met or where the issuer has elected into the regime. That would simplify the regime whilst also avoiding an increased administrative burden for the majority of structures which easily meet the independent persons test. Any concern that these structures could be more easily used for tax avoidance in the absence of the independent persons test ought to be met by the width of the unallowable purposes test at regulation 12.

3. **Question 3: Should the scope of assets which can be securitised within the Regulations be expanded beyond financial assets as defined in Regulation 9A? What would be the benefits and potential difficulties for the UK in doing so?**

3.1 Globally, some CLLS members are seeing a movement towards a broadening of asset classes (which seems likely to continue). We understand that Ireland's regime, for example, allows "Qualifying Assets" to be securitised, which includes exchange traded commodities and plant and machinery. CLLS members expect to see continued growth in demand to securitise real estate, exchange traded commodities, inventory, intangible assets such as carbon credits and hard assets (such as ships or aircraft). If a less restrictive definition of assets were adopted, this would contribute to the attractiveness of the UK securitisation regime generally and would also make the UK a more attractive place to do business for actors in certain sectors, such as commodities.

3.2 We believe it would also be advantageous for securitisation companies to be able to hold portfolio type investments in shares, as this would help simplify structures by avoiding the need to bifurcate debt and equity investments. This could increase the attractiveness of the UK securitisation regime, particularly as compared to other similar regimes. In order to ensure that securitisation companies were not used for unintended purposes such as being group holding companies, we would suggest introducing relatively straightforward restrictions based on familiar concepts – for example, a restriction on the percentage of the securitisation vehicle's assets that could comprise shares (akin to the bond fund rules), or on the maximum percentage interest that a securitisation vehicle could hold in an investee company (e.g. no controlling interests).

3.3 We note that HMRC is consulting separately in relation to real estate, but note that there may be some utility in allowing for a permissive regime in respect of securitisation companies holding non-UK real estate.

3.4 As a separate point, there are a small handful of *de facto* restrictions contained elsewhere in the tax legislation that prevent the use of the securitisation regime in certain circumstances. For example, a regulated non-bank Home Purchase Plan provider is able to provide Islamically-compliant mortgages for the purposes of the alternative property finance rules in FA 2003. However, because such an institution would not be a "financial institution" for the purposes of section 502 CTA 2009, it would effectively be unable to securitise the portfolio (as the issuer would not then also be treated as a financial institution in turn and the conveyance of the relevant property to the home owner at the maturity of the Islamic-compliant mortgage would require the home owner to make a second payment of stamp duty land tax for the purchase of the property). This is not an issue with the securitisation regime per se, but illustrates the need to consider restrictions contained in other areas of the tax legislation when assessing what it may or may not be possible to securitise.

4. **Question 4: If the scope of assets were expanded, what assets should be included, and should that only be under specified circumstances? For instance, should shares be included but only as part of restructuring/ bailout of an existing securitisation?**

4.1 An issue we have come across resulting from the financial asset restriction is incidental holdings of non-financial assets in transactions where all or at least the vast majority of receivables are intended to be financial assets.

4.2 We would suggest that "incidental" holdings of non-financial assets would be better dealt with through a legislative definition of "incidental activities".

4.3 One example would be residential mortgage backed securitisations where a bundle of "ancillary rights" are transferred, by way of security, along with the loan receivables, which might include shares in freehold or management companies.

4.4 An example of a situation which CLLS members have experience of HMRC giving private clearances confirming it to be an "incidental activity" is an issuer which has purchased automotive receivables taking title to vehicles in order to enforce its security and recover the receivable where the underlying customer has defaulted. If incidental activities could be defined to include something like obtaining title to non-financial assets where having the right to do so is economically equivalent to security in order to protect financial assets it would be helpful.

4.5 Similarly, if the definition of "financial assets" was not broadened to allow securitisation companies to hold shares more generally (as discussed in response to question 3), we believe it would be beneficial to allow securitisation companies to hold shares as a result of a financial restructuring. This would simplify existing restructurings involving for example, debt for equity swaps, where it is currently necessary to move the debt out of the securitisation company prior to such restructuring to ensure that the securitisation company is not left holding shares. This could also be included through a definition of "incidental activities", as the vehicle would have been established with the intention to manage "financial assets" but, due to the relevant circumstances, those financial assets would have been replaced with shares in the debtor.

5. **Question 5: If the scope of assets were expanded, what would be the implications for interaction with other parts of the UK tax code? What consequential changes, if any, would be appropriate?**

As suggested in the consultation document, if non-debt assets were to be included the approach to the corporate interest restriction would need to be looked at again. We are aware that the equivalent interest restriction rules cause issues for securitisation companies with non-debt assets in other jurisdictions so if an acceptable solution could be found to this it could be a competitive advantage for the UK regime.

6. **Question 6: Should the threshold limit per capital market arrangement be changed and if so, to what sum and why? Should the threshold be subject to any other amendment: for instance, should it be possible to take into**

account an issue made earlier in an accounting period in assessing whether the threshold is met for a second issue later in the period? If so, how and why?

We think that the £10m threshold works well for securitisations based on an originate to distribute model (as most securitisations were envisaged to be when the UK regime was created). This relatively high threshold does have drawbacks, however. The £10m threshold discriminates against SMEs and fintechs and makes it harder for high growth entities to enter the securitisation market (these entities would often be able to engage in deals above the £10m threshold if they could successfully close earlier and smaller deals as the financing such entities obtain through such deals are crucial for their growth). Whilst SMEs and fintechs may currently look to take the warehouse (rather than the note-issuing company) route, this also has drawbacks. Accordingly, a lower threshold (at around the £1m mark) or a cumulative test, that could apply across a number of issuances, may level the playing field for new entrants.

7. **Question 7: If any such changes are proposed, what would be the best way of minimising the risk that arrangements are inadvertently caught by the amended rules?**

Issuers could elect into the UK securitisation regime for tax purposes (as they are required to do in Ireland where special tax treatment is sought).

8. **Question 8: How and to what extent does uncertainty related to the applicability of the loan capital exemption on the transfer of notes issued in securitisation arrangements increase cost and complexity? To what extent is this a factor in securitisation arrangements being implemented outside the UK?**

8.1 There are multiple technical issues surrounding the loan capital exemption. None of them are likely to lead to the raising of any tax revenues. Verifying to a rating agency standard that the loan capital exemption applies to transfers of notes issued by a UK securitisation company can be a costly exercise. On its own this stamp tax complexity probably doesn't lead to securitisations being implemented outside the UK but, together with a bundle of other complexities which are costly to obtain definitive advice on, it probably does.

8.2 Often notes are issued into clearing which should mitigate loan capital exemption problems. However there are difficulties getting clearing services to confirm that they have not made elections under s.97A Finance Act 1986. It would be more satisfactory if a public register of such elections were maintained.

8.3 Tax opinions on the loan capital exemption typically leave open some risk for noteholders as they will always assume, as is a factual matter, that the notes will not carry a right to interest the amount of which exceeds a reasonable commercial return on the nominal amount of capital. This gives rise to various issues, for example where revolving or variable funding notes are issued and market interest rates may vary throughout the life of the transaction whilst rates on the notes remain fixed.

9. **Question 9: What are the characteristics of notes issued in securitisation arrangements which create uncertainty as to whether the loan capital exemption applies to their transfer?**

9.1 Variable funding notes can cause issues as just mentioned.

9.2 Sometimes junior notes are issued which have terms that would mean they would be regarded as profit-participating and the loan capital exemption fairly clearly doesn't apply. More commonly the most junior piece of the transaction is structured as deferred consideration or certificates which are not debt instruments at all, although their status for stamp tax purposes is still complex. We understand the policy aim to ensure that securities that should properly be considered as equity are not exempt from stamp duties; however, in the context of an SPV financing such as a securitisation where the purpose of the SPV is to preserve the security of the lenders, there is no real "equity" in the arrangement and accordingly it should be within the policy aims to exempt from stamp duty all instruments issued by such a vehicle.

10. **Question 10: How could the government best address uncertainty about the applicability of the loan capital exemption to the transfer of notes issued in securitisation arrangements? Could updated HMRC guidance provide sufficient certainty?**

We would strongly suggest that there should simply be a separate stamp tax exemption for notes issued by a securitisation company within the securitisation tax regime. If HMRC are concerned about avoidance (which would be surprising in a market where stamp tax simply isn't paid on corporate debt) perhaps some sort of anti-avoidance rule could be added, but the existing patchwork of stamp tax exemptions is simply not practical.

11. **Question 11: How and to what extent does uncertainty related to the applicability of the loan capital exemption for transfer of pools of loan assets into and within securitisation arrangements increase cost and complexity? To what extent is this a factor in securitisation arrangements being implemented outside the UK?**

Where at least some loans comprised in a portfolio of assets are lent to corporate borrowers, it is likely that the loan capital exemption will apply to them but the exercise of examining the terms of each loan to ensure that none of the disqualifying conditions apply is an expensive exercise. Generally the stamp tax would be levied by reference to the borrower being a UK company so implementing the securitisation outside the UK would not be a solution.

12. **Question 12: How could the government best address uncertainty related to the applicability of the loan capital exemption to the transfer of pools of loan assets into and within securitisation arrangements? Could updated HMRC guidance provide sufficient certainty? If an exemption is required should there be a value cap on the individual assets and what should that cap be?**

Where the assets being securitised are bilateral loans it seems unlikely as a matter of fact that they could be sold in a stock market in the UK so as to be "marketable securities" within the definition in s.122 Stamp Act 1891. If that is right, they should be exempt from both stamp duty and SDRT by virtue of the spectacularly obscure "non-marketable debenture" exemption in paragraph 25(a) of Schedule 13 Finance Act 1999. Perhaps this could simply be confirmed in HMRC guidance, however it would still be open to risk as a result of changes to stock market practice. It would be better, and should not result in any loss in tax revenue, to have a new clear stamp tax exemption for loans (as opposed to notes). This could be limited to loans being acquired, transferred or sold by a securitisation company but the benefits in terms of tax raising of such a limitation are not obvious.

13. **Question 13: What are the characteristics of notes issued by ISPVs which create uncertainty as to whether the loan capital exemption applies to their transfer? How and to what extent does uncertainty related to the applicability of the loan capital exemption to transfers of such notes impact commercially on ILS arrangements?**

13.1 In a sidecar or collateralised reinsurance transaction, the return on participating notes issued by the ISPV is directly correlated to the underlying quota share reinsurance agreement. The return will therefore increase due to any premium payments or decrease due to any losses under the (re)insurance agreement, in line with the quota share. As such, the interest return on the securities is calculated entirely by reference to the underlying reinsurance book and therefore unlikely to qualify for the loan capital exemption.

13.2 In a catastrophe bond transaction, the notes issued are typically issued on a principal-at-risk basis, providing regular interest payments to investors, but which may have their principal reduced in the event a payment is triggered under the underlying reinsurance agreement. It is not especially unusual for such notes to carry substantial interest rates, even in excess of 15%, and so may be considered to carry a right to interest in excess of a reasonable commercial return, which may preclude the application of the loan capital exemption.

13.3 Notes which are intended to be traded are often issued directly into a depository receipt system or clearance service. However, this is not a perfect solution. For example, where securities are not intended to be traded between third parties (and therefore not issued into a depository receipt system or clearance service), it is not uncommon for notes to be transferred from one fund to another under common control. Stamp duty relief may not always be available for such transfers and, even where it is, is administratively burdensome. This creates an impression to overseas investors that the UK does not have a particularly modern tax regime which encourages inbound investment. A clearly legislated stamp duty exemption would therefore be welcome as it should be considerably easier to understand and simpler to understand, removing one barrier that may put an issuer off choosing the UK as the jurisdiction to establish its investment vehicle.

14. **Question 14: How could the government best address uncertainty related to the applicability of the loan capital exemption to the transfer of notes issued by ISPV companies? Could updated HMRC guidance provide sufficient certainty?**

14.1 We do not consider that updated HMRC guidance would provide sufficient certainty on this point. As noted above, there are many situations where the loan capital exemption clearly does not apply. Updated guidance therefore would not provide sufficient certainty to issuers or investors who would not wish to rely on guidance that is not consistent with the legislative analysis.

14.2 We would therefore welcome a clear statutory exemption from stamp duty for notes issued by ISPVs to help ensure the UK's ILS regime is able to compete with more established jurisdictions.

14.3 Further, we consider that there is no convincing reason to treat notes and preference shares any differently in this context, which the Consultation does not consider, and would therefore suggest that any statutory stamp duty exemption cover both notes and preference shares issued by ISPVs. The primary reasons for an ISPV choosing to issue notes over preference shares, or vice versa, are commercial and based on investor perceptions. We consider that a clear statutory exemption which includes both notes and preference shares, which feature substantially the same economics, would be an important step in ensuring the UK ILS regime is attractive to issuers and investors. Excluding preference shares from an exemption would, in our view, inexcusably limit the attractiveness of the regime to market participants.

POINTS OF CONTACT

Should you have any queries or require any clarifications in respect of our response or any aspect of this letter, please feel free to contact me by telephone on 020 7296 5783 or by email at Philip.harle@hoganlovells.com.

Yours faithfully

Philip Harle

Chair City of London Law Society Revenue Law Committee