

Net paying securities annex with guidance notes

PSA/ISMA Global Master Repurchase Agreement

Net Paying Securities Annex Explanatory Notes

Introduction

In ISMA circular to members no. 8 of 1996, dated 5 November 1996, ISMA referred to some recent legislative changes in the UK which narrowed the circumstances in which UK tax was required to be withheld from payments under paragraph 5 of the GMRA representing income on securities

The accompanying annex deals with issues arising under the GMRA in relation to debt securities where tax is withheld or deducted at source.

In what follows capitalised terms generally have the same meaning as in the GMRA itself.

Net paying debt securities

In relation to debt securities where withholding tax applies at source to the interest, the form of language embodied in Annex VIII would permit debt securities where interest is paid net to be the subject of Transactions under the GMRA.

In a little more detail, the nature of the changes envisaged by Annex VIII is as follows.

If Annex VIII is used, securities where interest is paid under a deduction or withholding may be the subject of Transactions under the GMRA. Under the existing GMRA (November 1995 version) it is provided (in paragraph 1(a)) that "Net Paying Securities" should not be the subject of Transactions under the GMRA. Annex VIII will remove this prohibition. However, the prohibition on the use of the GMRA to conduct transactions in *equities* will remain.

The question arises as to what amount should be paid where a Transaction crosses a coupon date in relation to debt securities where tax is deducted at source. The approach adopted in Annex VIII, in line with the consensus of views ISMA has received from market participants, is that paragraph 5 should apply to Transactions in securities of this type as it applies to gross paying securities. Accordingly, unless otherwise agreed, the amount payable by Buyer under paragraph 5 will be the full amount of the amount of Income payable by the issuer, without any reduction for any tax withheld or deducted at source.

The consensus is that it is appropriate for the paragraph 5 payment to be equivalent to the gross interest, since this is already understood by the market as the basic rule under the GMRA. Furthermore it is desirable to make the documentation of trades as standard as possible and it is thus highly desirable to avoid there being a separate rule for debt securities which pay their interest net. Naturally, members who are prospectively acting as Buyer will need to take into account whether it is acceptable to undertake an obligation to make a payment under paragraph 5 equivalent to the gross amount of interest in the case of a security where the interest payment is received net of tax withheld at source. This may depend for example on the position which may be agreed with other parties to whom the securities are to be transferred, and members' own tax position (including whether a tax credit or other relief is available in respect of any tax withheld). If draft Annex VIII is adopted, it will however be the responsibility of members who do not wish paragraph 5 payments to be made "gross" to seek to agree a lower rate of payment in relation to the relevant Transactions. This

is contemplated by the drafting of paragraph 5 itself in its opening phrase (“Unless otherwise agreed...”).

Since the logic of draft Annex VIII is to treat securities which pay interest under deduction or withholding of tax at source in the same way as gross paying securities, it is appropriate where draft Annex VIII applies to delete the definition of “Net Paying Securities” from the GMRA as it is no longer of any relevance. Annex VIII provides for this.

The obligation to make a paragraph 5 payment in relation to Margin Securities will similarly, under Annex VIII, be an obligation to make a gross payment. If securities which pay interest net are offered as Margin Securities, the person calling for the Margin Transfer may wish to consider whether the requirement to make a payment of a gross amount under paragraph 5 might make those securities ones which are not “reasonably acceptable” as provided for in the definition of “Margin Securities”.

Finally, Annex VIII adds some language to the definition of “IR” in Annex III (Buy/Sell Back Transactions). The purpose of this language is to make an equivalent change in the case of Buy/Sell Back Transactions to that described above in the case of Transactions where paragraph 5 applies. The additional language will make it clear that, in the case of a Buy/Sell Back Transaction of a security whose interest payment is received net of withholding, the adjustment to the Purchase Price effected in the occasion of a payment of income operates by reference to the gross amount.

In due course, under the next reprint of the GMRA, it is intended to adopt the language of Annex VIII in the body of the GMRA. Before then it will be necessary for ISMA members to agree the annex on a bilateral basis. In seeking to agree the annex with any counter party, members will wish to consider (and make it clear in the documentation entered into between the member and that counter party) whether the annex should be regarded as affecting only Transactions which are first entered into after the agreement on the annex is reached, or should extend to cover Transactions entered into before that date but which have not yet been closed out.

ANNEX VIII

Net Paying Securities

The term “gross paying securities” shall be deleted from the title page, and in both the heading to the Agreement and paragraph 1(a) the phrase “other than equities, U.S. Treasury instruments and Net Paying Securities” shall be replaced by the phrase “other than equities and U.S. Treasury instruments”.

The definition of “Net Paying Securities” shall be deleted.

In Annex III (Buy/Sell Transactions) the following words shall be added at the end of the definition of the expression “IR”: “and for the avoidance of doubt the reference to the amount of Income for these purposes shall be to an amount paid without withholding or deduction for or on account of taxes or duties notwithstanding that a payment of such Income made in certain circumstances may be subject to such a withholding or deduction.