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Update on the enforcement and litigation issues arising out of cum-ex trades

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The shock waves from the German authorities' tax evasion investigation into cum-ex transactions, a complex form of dividend arbitrage, continue to be felt throughout Europe. A large number of UK and European financial institutions, their advisers and employees have been drawn into the allegations. While criminal and regulatory enforcement action is presently focused on Germany, there is a risk that enforcement action will spread to other European jurisdictions that had a similar dividend loop-hole.

This article discusses the enforcement risks created by cum-ex transactions and also the implications for jurisdictions, such as the UK, where cum-ex transactions per se have not been carried out but where dividend arbitrage trades carry a risk of facilitating tax evasion, money laundering or market abuse.

Background

A cum-ex transaction is a complex form of dividend arbitrage or dividend stripping. Dividend arbitrage is a practice whereby traders place shares in alternative tax jurisdictions around dividend dates, with the aim of minimising withholding taxes (WHT), or generating WHT reclaims. [1] Regulators have taken the position that the practice may amount to tax evasion if the conduct or transactions giving rise to the WHT reclaims are artificially contrived and the representations made to the relevant tax authority thereby dishonest. The profits from any tax evasion would be considered the "criminal property" as relevant to money laundering laws. Further, the practice may amount to market abuse under the EU Market Abuse Regulation when transactions have been deliberately manipulated.

Cum-ex trades specifically serve as a mechanism allowing both the buyer and seller of shares to recover Capital Gains Tax (CGT) paid only once on dividend income. The practice involves acquiring shares 'cum dividend' just before a dividend is due, and then selling 'ex dividend' after the dividend record date. The transactions are processed very quickly, making it difficult for tax authorities to identify the true owner of the shares, thus enabling multiple parties to claim tax rebates on CGT paid only once. This process often

[1] The FCA describes withholding tax (WHT) as a levy deducted at source from income and passed to the government by the entity paying it. Many securities pay periodic income in the form of dividends or interest, and local tax regulations often impose a WHT on such income – such as Capital Gains Tax. In certain cases where WHT is levied on payments to a foreign entity it may be reclaimed if there is a formal treaty, called a double taxation agreement (DTA), between the country in which the income is paid and the country of residence of the recipient. DTAs allow for a reduction or rebate of the applicable WHT.

It should be noted that not all European jurisdictions operate a dividend WHT scheme. The UK in particular has no dividend WHT provisions.

involves the original owner of the shares, the bank or broker which borrows them and sells them short, and the buyer who purchases them on dividend day. It has been common for the parties to split the proceeds of the tax refunds.

Cum-ex transactions allegedly involve significant sections of the financial industry, with buy-side investors taxable in Germany and short sellers borrowing the stock in question from pension or investment funds located around the world, all enabled by traders and brokers working for financial institutions around Europe. It is estimated that approximately 100 banks, both German and international, are under investigation for participating in the scheme and subject to litigation and enforcement risk.

Two British investment bankers, Martin Shields and Nicholas Diable, are currently on trial in Bonn in Germany, accused of defrauding the German state of c. €447.5m (£405m) having engaged in cum-ex trading between 2006 and 2011. This is a fraction of the €55bn estimated to be lost to European treasuries through these controversial transactions. This trial will likely set the parameters for further cases in Germany and beyond. Indeed, the practices are reported to affect a number of other European states, including France, Spain, Italy, the Netherlands, Denmark, and Switzerland.

The German criminal trial

The Cologne public prosecutor charged Shields and Diable alleging that they have engaged in tax evasion through the cum-ex transactions. The trial is being held in Bonn since that is the location of the Federal Central Tax Office, where foreign financial institutions and investors applied for the reimbursement of dividends on the securities.

In 2007, following complaints about abuse of the WHT model through cum-ex trades, the German finance ministry sought to close the loophole allowing double recovery of rebates. However, the legislative amendment was open to interpretation and legal opinions appear to have been given that it remained legal to reclaim rebates on cum-ex trades. Certain non-German financial institutions continued the practice. That was until 2012, when the cum-ex loophole was definitively closed for non-German financial institutions. A further 2016 amendment made the cum-cum iteration unlawful also.

One of the issues to be decided at trial is whether, following the 2007 amendment, participants were aware (or should have been aware) that cum-ex trades were unlawful, but took steps to artificially contrive transactions and made false representations to support tax rebates to which they knew they were not lawfully entitled. In doing so, this amounted to tax evasion. Evidence has been given in the trial on the mechanics of the transactions by former traders implicated in the alleged wrongdoing.

We expect that the defendants will argue that they themselves and the market more broadly understood the mechanisms behind the transactions to be legal and that the practices were known to and tacitly endorsed by the German regulator – BaFin.

According to one German lawmaker Gerhard Schick, the trial will "*be a pilot case that'll write legal history and break ground for others to come. The criminal clean-up is finally entering its crucial phase*"[2].

[2] https://www.bloomberg.com/news/articles/2019-09-02/the-german-tax-case-putting-the-entire-finance-industry-on-trial

Outlook

Unlike the UK LIBOR criminal trials, the German trial of Shields and Diable may prove to be the mid-point rather than the end of the scandal. Other reported enforcement actions and litigation arising from the scandal include:

- Criminal proceedings are ongoing in charges brought by Frankfurt prosecutors. In this instance, six people have been charged (including bankers and a former lawyer) in relation to short sales of securities between 2006 and 2008. The loss to the authorities is estimated at €106m.
- A number of household financial institutions (including UK and US institutions) who lent capital to the schemes are under investigation by the German authorities and are in line for regulatory enforcement fines. To date, DZ Bank has repaid €149m plus interest in wrongly claimed tax refunds to German authorities, with HypoVereinsbank paying €19.8m in fines for its role.
- One institution that was reportedly close to settling with the German tax authorities, Macquarie Bank, has been sued in Germany by investors. The claimants brought a class action law suit in relation to transactions which Macquarie lent money to fund. One former Macquarie trader has also given evidence in the trial of Diable and Shields.
- An international law firm was sued in the English high court by a former client's creditors alleging that it gave negligent advice on the lawfulness of cum-ex trades between 2006 and 2010. This claim has reportedly recently been settled. Prosecutors have twice raided the same law firm's offices and, in a considerable development of the Cologne prosecutor's criminal investigation, on 21 November 2019 the firm's former head of tax was arrested, held in custody and charged with aiding and abetting tax evasion linked to cum-ex transactions.

Taken together, any party dealing in profits from cum-ex trades in Germany, or for that matter any of the other exposed jurisdictions is likely to suspect they are dealing in the proceeds from tax evasion. Consequently, they are likely to have made disclosures to their national Financial Intelligence Unit given their suspicions that either the institution itself and / or counter-parties / clients may be liable to have dealt with criminal property and thereby committed a money laundering offence.

Next Steps

The UK does not allow dividend WHT and therefore the UK exchequer has not been exposed to cum-ex losses. However the FCA has carried out a review into dividend arbitrage regulated activities and has alerted participants to the risks that these transactions may facilitate financial crime and market abuse. In a note from June 2017,[3] it reminded firms of the risks and the FCA's requirements when carrying out dividend arbitrage. Firm are required to establish and maintain effective policies, procedures, systems and controls to ensure they are not used to facilitate market abuse (Article 12 MAR) or financial crime including money laundering (SYSC 6.1.1R and 6.3.3R). The FCA noted that:

"*Most firms executing transactions with, or on behalf of clients engaged in dividend arbitrage, appear to comply with our requirements. However, some firms may not have identified the risk posed by contrived or fraudulent trading for the purpose of making illegitimate WHT reclaims.*"

[3] https://www.fca.org.uk/publication/newsletters/marketwatch-52.pdf

The FCA described a number of red flags which should indicate to firms that clients may be using dividend arbitrage for “inappropriate purposes”.

In addition, as of 30 September 2017 provisions within the Criminal Finances Act 2017, made it an offence for corporates wherever incorporated to fail to prevent the facilitation of UK tax evasion. Companies with a link to the UK (which either carry on a business in the UK or where the criminal conduct occurs in the UK) may also be liable for the failure to prevent overseas tax evasion. While these offences are not retrospective and therefore will not apply to the German cum-ex schemes, they could be relevant to other European cum-ex loopholes closed after 30 September 2017 or in relation to ongoing dividend arbitrage schemes which are alleged to be fraudulent.

All firms involved in cum-ex but also other forms of dividend arbitrage will undoubtedly have conducted risk assessments to understand their exposure to the financial crime risks both in Germany and in other jurisdictions, including in the UK. Those risk assessments should be refreshed annually and re-considered in light of emerging risks. Firms may also wish to carry out heightened due diligence on clients at take-on and seek to get a detailed understanding of the rationale for the structuring of the transaction particularly if it involves any of the red flags identified in the FCA’s note.

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