FCA fines Sapien over AML lapses, suggesting a back door into cum-ex probes, say lawyers

Published 10-May-2021 by
Alex Davidson, Regulatory Intelligence

The Financial Conduct Authority (FCA) has fined broker Sapien Capital £178,000 for anti-money laundering (AML) related failings in an action that suggests a possible back door way of investigating cum-ex trading, which some of its clients practised, lawyers said.

Cum-ex trading involves trading of shares on or just before the last cum-dividend date, and, if in a suitable jurisdiction, it can allow a party to claim a tax rebate on withholding tax, sometimes without entitlement. Sapien acted as a broker in relation to purported trading in high volumes of shares, which the FCA found suggestive of sophisticated financial crime.

Sapien, as a broker, executed OTC trades worth £2.5 billion in Danish equities and £3.8 billion in Belgian equities. The FCA considered it was likely Sapien had seen only one side of the purported trades, which were part of a circular pattern of purported cum-ex trading, a form of dividend arbitrage aimed at placing shares in certain tax jurisdictions around dividend dates to generate withholding tax reclaims.

"The reasons for these fines being imposed demonstrates the UK regulator's assessment that cum-ex trading is linked to fraud and money laundering. It is clear the FCA is suggesting that the allegedly fraudulent schemes were not consistent with market practice. Alleging a failure to adequately monitor and scrutinise money laundering risk can be seen as a 'back door' way of investigating individuals and institutions involved in cum-ex trading," said Syed Rahman, partner, Rahman Ravelli in London.

Between February and November 2015, Sapien had inadequate systems and controls to identify and mitigate the risk of being used to facilitate fraudulent trading and money laundering in relation to four authorised firms, including Solo Capital Partners, known as the Solo Group. The firms were owned by Sanjay Shah, a British national residing in Dubai, the FCA said. Sapien failed to exercise due skill, care and diligence in applying its anti-money laundering (AML) policies and procedures, it said on May 6.

The Solo Group has not been permitted to carry out any activities regulated by the FCA since December 2015 and Solo Capital Partners formally entered special administration insolvency proceedings in Setember 2016, the FCA said. The other three entities are in administration proceedings.

The Solo clients were offshore companies introduced by the Solo Group which purported to provide clearing and settlement services to clients. On behalf of Solo clients in the British Virgin Islands and the Cayman Islands, Sapien as broker executed OTC trades worth £2.5 billion in Danish equities and £3.8 billion in Belgian equities.

The Solo trading was characterised by a purported circular pattern of high value OTC equity trading, back to back securities lending arrangements and forward transactions, involving EU equities on or around the last day of cum-dividend, the FCA said.

Following the purported cum-dividend trading that took place on designated days, the same trades were subsequently purportedly reversed over several days or weeks to neutralise the apparent shareholding positions, the regulator said.

The purported OTC trades were filled within minutes, almost invariably, and yet represented up to 20% of the trades outstanding the companies listed on the Danish stock exchange, and up to 10% of the equivalent Belgian stocks.

The purpose of the purported trading was so that the Solo Group could arrange for dividend credit advice slips to be created, purporting to show that the Solo clients held the relevant shares for dividend.

These slips were then used to make withholding tax reclaims from the tax agencies in Denmark and Belgium. In 2014 and 2015, in relation to reclaims made, which are attributable to the Solo Group, the Danish and Belgian tax authorities paid £845 million and £42 million respectively.

Suggestive of financial crime

The FCA refers to the trading as purported because it has found no evidence of ownership of the shares by the Solo clients, or custody of the shares and settlement of the trades by the Solo Group. "This, coupled with the high volumes of shares purported to have been traded, is highly suggestive of sophisticated financial crime."

The FCA said Sapien did not have policies and procedures in place to assess properly the risks of the Solo business, and so lacked an appreciation of the risks involved in the purported equity trading in which the Solo clients were engaged. This resulted in inadequate customer due diligence, and a failure to monitor transactions adequately and to identify unusual transactions.

"This heightened the risk that the firm could be used for facilitating financial crime in relation to the purported equity trading executed by Sapien between May 4, 2015 and September 29, 2015," the FCA said.

The case is indicative of the FCA's approach of focusing at this stage on regulated entities' failures in systems and controls, as in the extra due diligence and anti money laundering (AML) arenas and the failure to carry out adequate risk assessments, particularly where the volume of shares being purportedly traded accounted for such a vast amount of the available market of shares just prior to the dividend record date, said David Stern, barrister at 5SAH in London.

"From the FCA standpoint, this avoids it having to make a final determination of the actual legality of the underlying cum-ex trading," he said.

The FCA said Sapien failed to take reasonable care to organise and control its affairs responsibly with adequate risk management systems, as required by Principle 2, and failed to act with due skill, care and diligence as required by principle 2. The £178,000 fine represented the disgorgement figure, inclusive of a settlement discount. The FCA held that the full penalty would cause the firm serious financial hardship.

Future claims

Last month, the High Court in London dismissed a case between Skatteforvaltningen, the Danish Customs and Tax Administration, and Solo Capital Partners (in special administration) and many others, including the Sanjay Shah defendants, for £1.5 billion in tax payments. The case, which related to cum-ex tax reclaims, had been in the form of a civil action for damages for fraud. The court found that the claims had, in substance, constituted an attempt to enforce Danish tax legislation and so the case was inadmissible in the UK court. In that case, the judge found that the principal focus of the main fraud allegation was the activity of Shah through his business Solo Capital Partners, together with other entities associated or said to be associated with Solo.

"The FCA may not be able to move on cum-ex easily now, as the Danish Customs and Tax Administration is appealing its claim against Shah and others that was thrown out of the High Court recently, but it will focus on other companies like Sapient that are weaklings in the chain. It will be harder for the FCA to move against individuals," Neil Williams, partner at Gherson Solicitors in London.

Following the High Court outcome, governments or tax authorities contemplating the pursuit of civil claims in other countries with respect to dividend arbitrage tax refunds may exercise greater caution, said Robert Falkner, partner at Reed Smith in London.

New dividend arbitrage

New dividend arbitrage is taking place and UK banks could face a first criminal prosecution by HM Revenue & Customs (HMRC) under the Criminal Finances Act 2017 if they have failed to prevent the facilitation of foreign tax offences. Schemes issued since September 2017, which are not cum-ex trading, could be caught by the legislation.

HMRC could bring such a prosecution in relation to dividend arbitrage given the large sums of tax at stake, said Michelle Sloane, partner at RPC, a law firm in London.

"This is a strict liability offence, and the only defence is for financial institutions to have reasonable preventative procedures in place," she said.

HMRC is investigating 13 live cases involving corporate offences of failure to prevent facilitation of tax evasion. A HMRC spokesman declined to comment on how many are overseas-related, or whether any cases are focused on dividend arbitrage.

As of February 2021, eight individuals and 14 firms were under investigation by the FCA in relation to cum-ex trades, up from six individuals and 14 firms in October 2020, according to a response to a request under the Freedom of Information Act by Rahman Ravelli.

Sapien could not immediately be reached for comment.

Complaints Procedure

Produced by Thomson Reuters Accelus Regulatory Intelligence 10-May-2021