KEY POINTS
- "CumEx" stock trading has cost European treasuries over €55bn.
- Criminal investigations are expanding across Europe and several hundred suspects have been identified with the first two defendants recently convicted in a trial in Bonn.
- London traders and interdealer brokers were involved in the practice.
- UK regulators have shown interest and there may be significant implications for UK firms.

Feature

Author David Stern

The CumEx trading scandal: what are the implications for the UK?

Several European countries are currently engaged in civil proceedings, regulatory settlements and criminal proceedings surrounding the fallout from CumEx trading, a dividend arbitrage trading practice that focussed on multiple tax rebate claims worth an estimated €55bn. European investigations are intensifying and there are significant ramifications in the UK for the banks and brokers involved, and potentially those advising them.

INTRODUCTION

"CumEx" is a controversial dividend arbitrage stock trading practice currently under investigation in several European jurisdictions with, to date, limited involvement from the UK authorities. It allegedly caused significant losses to various treasuries of certain EU countries, which are currently engaged in civil proceedings, regulatory settlements and criminal proceedings, including against two former London traders who have recently been convicted in the first trial for tax evasion in Germany.

Many London stock loan desks and inter-dealer brokers were involved in CumEx trading, a type of dividend arbitrage trading, and the Financial Conduct Authority (FCA) has conducted a review into the practices of some firms involved with this form of dividend arbitrage.

This article sets out in broad terms:
- the background to CumEx;
- its operation;
- the legal issues surrounding beneficial ownership of shares and taxation from an English law perspective;
- the justifications raised in defence of the trading; and
- practical considerations for UK firms, their employees and agents connected to CumEx.

BACKGROUND

Under certain double taxation treaties, overseas investors are entitled to a refund of dividend withholding tax (WHT) on shares held in domestic companies. It is noted that not all EU jurisdictions operate a WHT scheme. The UK, for example, does not operate such a scheme.

CumEx is a WHT refund model, which uses share transactions to contrive multiple ownership of shares to facilitate multiple refunds of WHT from European tax authorities.
- Share transactions (to buy shares) are agreed prior to the dividend record date, the date the investors must be on the company's books in order to receive a stock's dividend (cum-dividend) and settled after the dividend record date (ex-dividend) (transaction A).
- Between agreement and settlement, the shares are short sold by the purchasers in transaction A who pay a dividend compensation payment or a manufactured dividend to the purchasers of the shorted shares, which mirrors the dividend payable on the shares (transaction B). Short selling is selling securities at a time when the seller does not hold them for delivery in the future (forward sale); delivery is made possible by borrowing the securities.
- This gives the impression that the shares were short sold cum-dividend, when in fact they were ex-dividend.
- The related transactions take place over a short period and this may confuse the relevant tax authority as to the ownership of the shares.
- Multiple WHT refunds are made on the shares, by the original owner of the shares who agreed to sell them to the purchaser prior to execution of transaction A and the short purchaser (under transaction B) which arguably should have been paid only once.

Commentators have likened CumEx transactions to parents claiming a benefit for two or more children when there is only one child in the family.

Of course, where appropriate tax loopholes are available, it may amount to mere sharp practice or simply effective trading. However, fraud has also been alleged and charged.

CumEx commenced in Germany in the 1990s, when a loophole in the tax code was identified. The essence of the loophole is that WHT reclamation is available not just for dividends but also for dividend compensation payments or manufactured dividends.

This loophole was exploited by highly sophisticated networks of equity traders, tax advisors, lawyers and investors until it was closed in 2012.

As with the alleged manipulation of the Libor benchmarks, arguably the authorities were aware of CumEx before the financial crisis but allowed it to continue as a profitable line of business. It might be said that it is only now in the spotlight due to the sheer scale of the tax reclaimed and as a result of concerns raised in the media.

The CumEx trading model migrated from Germany to Austria from 2011 to 2012, then to Denmark from 2012 to 2015 and finally to Belgium and Switzerland until 2017. Italy was also targeted. It is understood that CumEx trading was sought to be introduced into other jurisdictions, but the necessary legal and tax advice may not have been favourable.

It is widely reported that CumEx caused losses of €55.2bn including an estimated €31.8bn in Germany, €17bn in France, €4.5bn in Italy and €1.7bn in Denmark.

German authorities are currently investigating around 100 domestic and foreign banks on suspicion of tax evasion arising out of the practice. In August 2019, the offices of the operator of the Frankfurt stock exchange, Deutsche Boerse AG, were searched as part of these investigations and more recently ABN Amro Bank was raided in February 2020.

Several financial institutions have made regulatory settlements with the authorities and one (Maple Bank) has closed down as a result of the claims brought by BaFin, the German financial regulator.

On 18 March 2020, two former London investment bankers were convicted in Germany's biggest post-war tax fraud trial. They were accused of structuring 33 CumEx transactions that cost the treasury and ultimately Germany's taxpayers circa €450m between 2006 and 2011. They both received suspended sentences with significant financial penalties, in large part due to the co-operation they provided to the authorities. One bank, M.M. Warburg Group, has been ordered to repay €176m, which was found to be the profit the lender made from deals. This ruling may be subject to an appeal.

At least two other trials appear likely to follow on from the conclusion of this case.

The trial has effectively determined that CumEx trading was illegal under German criminal law.

Other jurisdictions have to date focussed on the civil route, including Denmark which has brought proceedings in multiple jurisdictions, including in London against those alleged to have been involved in CumEx trading.

OPERATION

A CumEx illustration

A, **B** and **C** are offshore investors entitled to reclaim WHT of 25%. **A** owns €90 shares in a German company on dividend record date and agrees to sell the €90 shares to **B**.

B short sells the €90 shares to **C** for €100. A retains the WHT voucher and the entitlement to the WHT refund.

B sends **C** a dividend compensation payment mirroring the net dividend of €7.5.

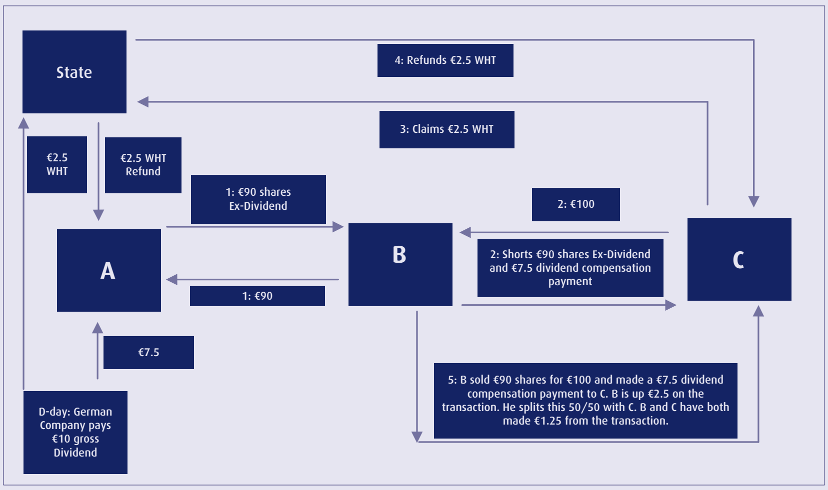
C's custodian bank issues a WHT voucher and **C** reclaims WHT.

B has made €2.5 on the transaction, which he splits with **C**.

The reason for **C**'s custodian bank to be able to issue a tax certificate lies in the concept of "economic ownership", which is used in the German tax system as opposed to legal ownership, according to the European Securities and Markets Authority (ESMA). ESMA prepared a report to respond to the European Parliament Resolution 2018/2900 (RSP) of 29 November 2018, whereby the European Parliament requested ESMA to conduct an inquiry into the CumEx schemes.[1]

In Figure 1 below, Investor **C** is the economic owner of the shares at the moment of the distribution of dividends, as Investor **C** bought the shorted shares before the distribution of dividends on the dividend record date. Therefore, at that time Investor **C** would bear any economic consequence attached to the ownership of the shares, even if the legal ownership would only be transferred on settlement.

FIGURE 1:



The wider marketplace

> "... It is a high-grade, collaborative market of banks, lawyers, tax advisors, investors, lobbyists. ... It is an industry of hundreds of people ... ." *the CumEx files*

In reality, CumEx involved a highly complex network of parties, providing liquidity and services essential to its operation.

CumEx transactions commonly involved four trade legs:

- purchase of the stocks;
- sale of the shorted stocks;
- collateralised stock loan agreements to facilitate the short sale, and;
- over the counter (OTC) forward agreements.

Several parties were essential to the transactions, including finance and stock lending providers. Access to liquidity in both the cash and the forward market was essential.

Each trade leg required a professional intermediary, including:

- a broker to execute the purchase and/or sale of stock; and
- an equity finance agent to execute the stock borrowing.

Legal and tax professionals provided advice and consultancy services. Immediately prior to key dates, high volumes of loans were taken out and several parties obtained legal and tax advice to seek to ensure the propriety of their activity.

Reclaim agents would submit WHT refund applications on behalf of offshore investors, obtain the refunds and distribute them accordingly. Multiple offshore investors would apply for refunds based upon allegedly falsified dividend credit advices (tax vouchers) from custodian banks and refund applications from reclaim agents.

Ownership of the shares was impossible to ascertain, given the speed of the transactions:

> "… the sales are very, very, fast … and so it is difficult for the fiscal tax services to know who exactly holds the stock when the dividend is paid … ." *according to MEP Eva Joly*

The timing of the shorts and dividend compensation payments had the potential effect of muddying the true beneficial ownership of the stock:

> "… the traded shares were traded with, cum, dividend, but it was a short sale so settlement took place ex-dividend … and that meant that the short seller had to deliver the shares with a compensation payment, with a manufactured dividend, and that manufactured dividend was not subject to a withholding tax although the custodian bank of the buyer [of the shorted stock] issued a second tax voucher … ." *according to Professor Christoph Spengel*

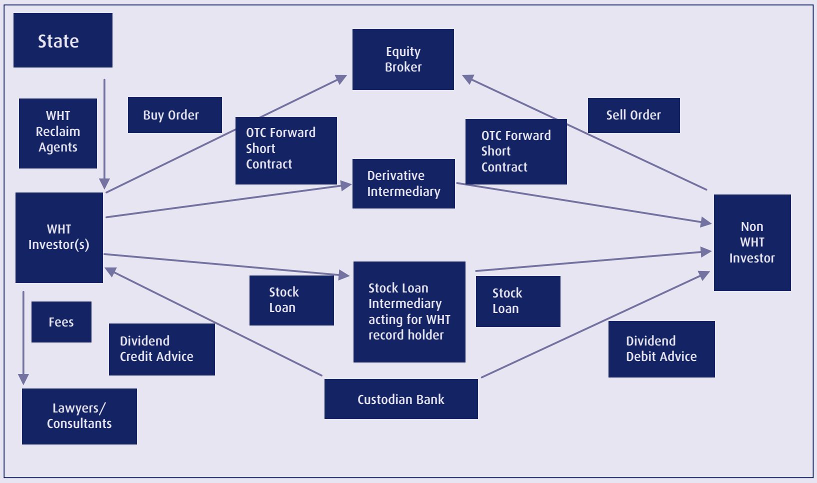
To understand how the CumEx trading model was carried out in all its variants, often with the effect of playing a "zero sum" game, in the sense that all of the trades had the cumulative effect of ultimately netting each other out, it is necessary to understand the parties and their various roles.

Parties and intermediaries

Figure 2 above shows the relevant parties, their intermediaries and the direction of travel of the various financial agreements.

The offshore investors were in practice often US pension funds, known as 401ks, which benefitted from favourable tax treatment and were entitled to a reclaim of WHT on foreign paid dividends.

FIGURE 2:



SKAT, the Danish tax authority, has brought civil fraud proceedings in the US against many of the 401ks which acted as the overseas parties to the CumEx trades seeking the recovery of WHT paid to them.

Documentation

CumEx trading used unremarkable documentation in line with established market custom and practice and then effectively spliced them together to achieve the trading aims to maximise the recovery of the WHT:

- stock trades were executed by regulated brokers under standard confirmations;
- forward short trades were executed under standard International Swaps and Derivatives (ISDA) agreements;
- stock lending and borrowing transactions were executed under standard Global Master Securities Lending Agreement documentation;
- dividend credit advices were produced in accordance with market practice; and
- custodian bank fee agreements were in line with market standard rates for the services they provided.

Of course, the fact that standard market forms were being used and that global securities were now held in a dematerialised form (electronic recording rather than in physical certificated form) would have lent a degree of propriety and ease to CumEx trading.

LEGAL ISSUES SURROUNDING BENEFICIAL OWNERSHIP OF SHARES AND TAXATION

Was beneficial ownership transferred?

As seen above, the concept of economic ownership in German tax law facilitated the production of second or multiple WHT certificates based on dividend compensation payments or manufactured dividends.

Nonetheless, the question of whether CumEx transactions transferred the beneficial ownership of the shares and the rights under them under English law may become relevant in due course.

This would mean examination of the key aspects of beneficial ownership, including:

- the right to share in the company's profitability, income, and assets;
- a degree of control and influence over company management selection;
- pre-emptive rights to newly issued shares; and
- general meeting voting rights.

Recently, it was held under English law that the concept of an "interest in securities" must denote something more than a contractual right or economic interest in them: see *SL Claimants v Tesco Plc* [2019] EWHC 2858 (Ch), in which the term "interests in securities" was held to connote beneficial interest per Hilyard J at para 85:

Feature

Biog box
David Stern is an experienced barrister practising in financial crime. He is Joint Head of Business Crime at 5 St Andrew's Hill, a specialist chambers in London.
Email: davidstern@5sah.co.uk

"In my judgment, the expression denotes something more than a mere personal or contractual right; the expression 'ultimate beneficial owner' captures the position of the investor as the owner of 'a right to a right' held through a waterfall or chain of equitable relationships … ."

It is noted that the Cologne tax court has recently answered this question, holding that, under German law, in the case of an Over-The-Counter short sale, the share purchaser of the shorted stock would not become the beneficial owner of the shares to be delivered at a later stage at the settlement of the purchase agreement (transaction A above).

New rules

Even after attempts were made to clamp down on CumEx, it appears that the trading model may have continued. More recent attempts have been made by legislation in certain EU jurisdictions to clarify the issue of beneficial ownership through statutory provision, rather than the interpretation of complex financial agreements. For example, Belgian legislation has made a raft of new requirements in order to limit any reclaims of WHT and imposes a sixty-day holding requirement on any shares. These measures became effective on 22 January 2019 (Law of 11 January 2019 on Combatting Tax Fraud and Tax Avoidance Regarding Withholding Tax).

JUSTIFICATIONS GIVEN FOR THE CUMEX TRADING MODEL

Those involved in CumEx have raised multiple justifications for the practice similar to those that were raised for Libor manipulation, including that it was standard market custom and practice, was not illegal and that its participants were not dishonest.

Others claim that CumEx merely exploited the "economic ownership" loophole in the state's tax law, a loophole created when wording proposed by the Federal Association of German Banks to the Ministry of Finance was then inserted verbatim into the Annual Tax Act 2007.

Some may claim that they acted in reliance on legal advice, satisfied reporting requirements and were not responsible for the legal, tax or investment activities of other participants.

Investors may blame the banks for not disclosing the source of their investment return.

A further justification could prove to be the tacit acceptance of CumEx by the German state as a profitable line of business for banks. This is perhaps indicated by two factors.

On one hand, the state may have been made aware of CumEx by whistle-blowers in 1992. Over time, several whistle-blowers came forward but were ignored.

On the other, the enormous trading volume created by CumEx around the dividend record date was either ignored or not investigated fully by the German tax authorities or BaFin.

In the course of the Libor investigations, third party disclosure from the Bank of England allegedly demonstrated that it knew of the manipulation but took no action. A similar story may arise with CumEx in Germany.

Of course, different parties to the CumEx trading model may well have their own independent bases for suggesting a lack of any wrongdoing. For example, the custodians of the relevant shares or the brokers will no doubt suggest that they bear no responsibility for the tax affairs of any shareholders or customers. Lenders to the scheme will not necessarily know the purpose of any trading carried out backed by their security. The shareholders themselves may have had limited actual knowledge of the counterparties involved and how the reclaims for WHT were made. The reclaim agents may have relied upon the accuracy of the information provided to them prior to making any reclaim of WHT. All will claim that they had understood that such trading would not have occurred without at least one party receiving the appropriate tax advice as to its propriety.

CONSIDERATIONS FOR UK FIRMS

"… traders at the stock loan desks, quite often in London, pulled all the strings and they traded quite extensively … in the UK, the traders needed to evade the system and they … used SnapChat on their private mobiles … these messages disappear immediately so you don't leave any trace behind … ." *according to one commentator, Christian Salewski*

Financial Conduct Authority review

In 2017, the FCA reviewed a number of inter-dealer brokers, settlement agents and custodians involved in dividend arbitrage, CumEx in all but name, which placed shares in various jurisdictions to either minimise WHT or generate WHT reclaims.

The FCA sought to establish whether this trading amounted to market abuse and found that:

"… a small number of firms may not have undertaken a sufficiently detailed assessment of the purpose and nature of transactions that appear to be linked to WHT reclaims… some firms may not have identified the risk posed by contrived or fraudulent trading for the purpose of making illegitimate WHT reclaims … ."[2]

FCA requirements

Firms involved with dividend arbitrage must comply with the FCA's requirements, which require them to:

- conduct their business with integrity, due skill, care and diligence;
- organise and control their affairs responsibly and effectively;
- have adequate risk management systems;
- maintain adequate policies and procedures to ensure regulatory compliance and to counter the risk of the firm's involvement in financial crime; and
- regularly assess the adequacy of counter money laundering systems and controls.

Crucially, FCA principle 11 requires:

"… firms to deal with their regulators in an open and cooperative way, and to disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice … ."[3]

Biog box

David was at the forefront of the LIBOR benchmark manipulation scandal successfully representing senior bankers and inter-dealer brokers in SFO criminal proceedings. He is also considered a leading legal expert in CumEx dividend arbitrage trading. David is repeatedly ranked in Chambers & Partners as a leader in the field of Financial Crime (London) as well as the Legal 500 for Business and Regulatory Crime (including Global investigations) (London).

Accordingly, firms must monitor new and existing clients and transactions and self-report anything that would reasonably be expected to be of interest to the FCA.

This reporting requirement is reinforced under Art 16 of the EU Market Abuse Regulation, effective 3 July 2016 (MAR), whereby firms are obligated to report anything that "could constitute" market abuse to the FCA "without delay".

The FCA Review concludes:

> "If, when reviewing processes, you identify any areas of concern, we expect your firm to conduct an assessment and also to consider whether you should disclose the details to us under Principle 11 … ."

ESMA interim report and consultation

In July 2019, ESMA published its preliminary findings of its review into WHT reclaim schemes.[4]

In October 2019, ESMA published a consultation which considers on behalf of the European Commission potential changes to the MAR regime to tackle perceived gaps in the regulatory framework concerning WHT reclaim schemes. Whilst the consultation is careful to avoid any specific characterisation of the schemes, it is seeking views on whether to amend MAR to give National Competent Authorities (NCAs) the power to investigate and sanction unfair behaviours carried out by regulated entities that represent a threat to the integrity of the financial markets as a whole, beyond insider dealing and market manipulation and to grant NCAs the possibility to co-operate and share information with tax authorities upon request, including an exchange of information across the EU. ESMA is due to provide its recommendations to the EC in spring 2020.[5]

ESMA's inquiry into CumEx is ongoing.

Due diligence, compliance and co-operation

The FCA rules, taken together with MAR, clearly indicate that firms potentially exposed to or involved in dividend arbitrage should conduct extended due diligence on relevant clients and transactions.

Where any clients or transactions raise any concerns, these should be properly documented and considered for reporting to the FCA.

It is likely that a prudent UK firm with CumEx exposure will be considering a thorough review of its operations and an internal investigation into its practices, with a view to enhancing the effectiveness of its compliance program.

Pro-active co-operation with the authorities may also become relevant if the FCA were to make any referral to the Serious Fraud Office (SFO) to conduct an investigation into any specific CumEx allegations.

Now that the first German criminal trial has resulted in convictions, the risk of SFO involvement has increased and corporate co-operation plays heavily into its charging decisions.[6]

There have been significant other recent developments in the CumEx story in early 2020, which reinforce the need for UK firms to take note and act, including:

- German prosecutors have stated that they will pursue around 400 more suspects arising out of 56 investigations;
- dozens of law firms and lawyers may also face penalties, having drafted highly priced opinions contending that CumEx trading was legal;
- this increased prosecuting intensity may well stem from the 10-year limitation period common to German tax fraud cases; and
- Barclays Plc and Bank of America Corp's Merrill Lynch face renewed exposure having been caught up in Germany's expanding CumEx scandal, with prosecutors alleging that they were among several companies used by the now defunct Maple Bank as short sellers or brokers to expand profits and "better veil" the controversial transactions.

If the history of the Libor investigations and prosecutions is to be considered as a reasonable benchmark, the outcomes of CumEx for individuals at UK firms will likely be somewhat haphazard. Some will likely face no or limited inquiry, whilst others may face some form of FCA regulatory intervention. It remains too early to tell if any UK firms or its individuals will face more serious or even criminal proceedings before the English courts or how many others will face further proceedings in Europe.

It should be noted that, while enacted after the height of CumEx trading, the provisions of Pt 3 of the Criminal Finances Act 2017 should be considered as an important statutory framework. In particular, while noting the distinction between legitimate tax avoidance schemes and tax evasion, UK firms will wish to ensure there are no breaches of the provisions of s 46 – failure to prevent facilitation of foreign tax evasion offences – and that all reasonable measures have been taken to seek to prevent any such facilitation. This alone will require a careful review of all dividend arbitrage trading platforms which are or were operative within the relevant timeframes. ■

1 https://www.esma.europa.eu/sites/default/files/library/esma70-154-1193_preliminary_findings_on_multiple_withholding_tax_reclaim_schemes.pdf
2 See https://www.fca.org.uk/publication/newsletters/marketwatch-52.pdf
3 https://www.handbook.fca.org.uk/handbook/PRIN.pdf
4 https://www.esma.europa.eu/sites/default/files/library/esma70-154-1193_preliminary_findings_on_multiple_withholding_tax_reclaim_schemes.pdf
5 https://www.esma.europa.eu/sites/default/files/library/mar_review_-_cp.pdf
6 https://www.sfo.gov.uk/publications/guidance-policy-and-protocols/sfo-operational-handbook/corporate-co-operation-guidance/?wpdmdl=24184&refresh=5ea6e4e6ce4a21587995878

Further Reading:

- Withholding tax: the impact of the OECD Multi-lateral Instrument (2017) 11 JIBFL 713.
- Germany: VAT treatment of factoring and asset backed security transactions (2003) 11 JIBFL 428.
- LexisPSL: Banking & Finance: Dealings on a specially cum or ex dividend basis.