



Taxing Matters

Cum-Ex: a multi-billion tax trading scandal

Alice	<p>Hello, and welcome to Taxing Matters, your one stop audio shop for all things tax brought to you by RPC. My name is Alice Kemp and I will be your guide as we explore the sometimes hostile and ever-changing landscape that is the world of tax law and tax disputes. Taxing Matters brings you a fortnightly roadmap to guide you and your business through this labyrinth. In case any of you miss any crucial information or just want some bedtime reading, there is a full transcript of this and indeed every episode of Taxing Matters on our website at www.rpc.co.uk/taxingmatters.</p> <p>Long-time listeners of Taxing Matters may recall delving into the thorny issue of the CumEx scandal with Bloomberg journalist Donal Griffin, but that was a long time ago and much water has passed under the bridge since then. So, what has been happening in CumEx and why does it still matter?</p> <p>Joining us today, to both take a walk down memory lane and to bring us up to speed with all of the latest developments in UK and beyond, is David Stern, a barrister from 5 St Andrews Hill Chambers, who is the joint head of their business crime and financial regulation offering.</p> <p>David has acted in most, if not all, of the high-profile acronym-rich cases in financial crime – LIBOR, Forex rating, FISMA – dealing with an array of equally acronym-rich investigators: DOJ, CFTC, FCA, HMRC and SFO, to name but a few. But, much more interestingly, David is a Ski-mountaineer and has, in this capacity, traversed the entire of the European alps including once doing a 500 km race across the alpine region - feeling which must not be entirely dissimilar to working on CumEx matters.</p> <p>David welcome to Taxing Matters.</p>
David	<p>Thank you for that warm introduction, Alice - it certainly has been a challenge navigating the CumEx world.</p>
Alice	<p>David, we probably need to start with a refresher. What exactly is CumEx and why are we talking about it.</p>
David	<p>CumEx is a peculiar, dividen- arbitrage trading practice that focused on multiple tax rebate claims. In effect ,what it did was, it took advantage of a weakness in the European tax system. If you like, there was a “leaky-pipe”. The epicentre of this trading practice was, in fact, in London and, in order to understand what that weakness in the tax system was, you need to understand a little bit about ‘dividends’ and the ‘dividend record date’. In essence it took advantage of the time between executing a trade and its settlement around the dividend payment date. What it did was create what appeared to be two owners of the same shares at the same time, giving the impression that each was entitled to the withholding tax rebate under the national laws of its own country.</p> <p>This was done on a large scale, to such a degree that - in various European countries - the estimated loss to the Treasury amounts to some €55 billion - which is a chuck of change! This has led to multiple civil proceedings in the UK, New York and across Europe, various regulatory sanctions and, indeed, criminal proceedings against both individuals and certain participating banks, which have led to criminal convictions in Germany.</p> <p>Those European investigations are intensifying, further investigations are ongoing and we know that individuals are being extradited to face criminal proceedings in Europe and that is why we are here today. For those that are involved in managing, or running, regulated entities that may, or may not, have been involved in CumEx trading or a form of dividend-arbitrage trading at the time, it would be necessary to look at very carefully the extent of that trading and the implications for that entity.</p>
Alice	<p>The question of, ‘does it work?’ was probably one of the more hotly contested between prosecutors and defendants so, instead, I will ask, ‘how did it operate?’</p>
David	<p>Well, the best way of looking at this, Alice, is to take a quick example of a traditional CumEx trade. What it involved was, effectively, the ‘Seven steps to Heaven’ as I describe them. What you need is three parties: You need someone who owns the shares themselves which might be a traditional institution that would hold shares, let’s say, for this example, it would be a German car manufacturer. You need a “short-seller” - that is someone who doesn’t own the share, but is willing to enter into a trade with a third party, “the buyer” of</p>

shares that he, at that point of time, doesn't own but he's going to borrow the shares in order to facilitate that trade. So, you have got three parties, the owner, or the lender of the share, the short seller and the buyer.

The first step that would take place is, just before the dividend date, the short seller would enter into a sale agreement of that car manufacturer's shares with the buyer. What that does is it allows him to make payment of the share value, which would include a price for the dividend - because, remember, the buyer is buying a day before the dividend record date, therefore, he is assuming that he is getting the 'Cum' dividend value, in other words: the share with the benefit of the dividend.

Having done that he would be in the position of seeking to make a reclaim of that dividend withholding tax - which in typical terms would be 25% of the value - from the German tax authority clearing system, called ClearStream. The dividend compensation payment would be paid across to the buyer's custodian bank, that would generate the necessary certificate, which would allow the reclaim to be made but, of course, the share needs to actually be fulfilled and so the share would be borrowed by the short seller. The German tax authority would also get a reclaim from the original owner of the share - because, remember, he actually held onto that share at the relevant date - and it's because it takes several days for this share to be actually closed out that the Central Clearing House would have seen what appeared to be two owners of the same shares on the relevant date and this then created a scenario with tax, which had only ever been potentially paid once, has actually been reclaimed on more than one occasion.

Alice You've described these parties involved in the CumEx trade, but who were the businesses and individuals that were assuming these roles?

David If we look at the wider marketplace it is a highly complex network of parties, because you have got those providing liquidity to its operation and services essential to its operation. You have got the lender of the share and you have got the purchaser of the share, you have got the short seller but in between that you have also got the use of various brokerage houses and they are critical to making this system work, because the shares which were lent out effectively return to the same owner at the end of the various agreements. So, you have got five trading legs, in fact. The sale of the shortage stocks, purchase of those stocks, the collateralised stock loan agreements to facilitate the short-sell and a hedging agreement, which allowed for the risk to be offset and you have got the return of the borrowed stock.

So, each of these legs involve the use of inter-dealer brokers to manage - and it might be more than one brokerage house that would be managing each of those legs. So, you've got in play, not only the lenders of the shares, the financial institutions providing the backing to it, the short-seller and the buyer, but you have got the key component which is the inter-dealer brokers who are, effectively, meshing all of this together which then allows the position which existed before any of the trades took place to be unwound and put back into the exact same position.

The whole question, of course, is whether this was legal and that would be down to the individual laws in the particular jurisdiction at the time as to how this would be recognised. You have also got, for those who had less appetite for the risk, the investors themselves and those finance houses providing the financial backing, but they still face a risk and they are still exposed to the potential fallout from CumEx trading.

Alice You have mentioned there that CumEx, because of the way the UK tax system operates, doesn't actually impact the UK tax process but it has still impacted the UK. How is that impact been felt?

David The short answer is to why it has not affected the UK in pure financial terms is because we don't have a withholding-tax regime on the payment of dividends, but what we do have was the fact that London, being a large international finance centre, was used to facilitate much of the trading. Most of these entities are regulated by, among other things, the Financial Conduct Authority and I think the best way of looking at this is to take an example which is not hypothetical, but it would illustrate the potential impact.:

Last year there were two financial penalties imposed on London Brokerage Houses and it was rather clever in the way in which the FCA went about its work, because it tried not to unwind the murky world of CumEx trading, but rather, use it as the grounds for which it was able to impose its sanctions.

It was a UK based corporate finance advisory and brokerage firm that offered diverse capital services to global clients and, for a period of many months, it executed over the counter equity trades to the value of £2.5b in Danish equities and £3.8b in Belgium equities. I mention the figures not to be alarmist but just because it is a relevant feature to the sort of controls and systems one ought to have in place when one is dealing in that sort of large-scale value trading.

These over the counter trades were linked to CumEx and they had a circular pattern of high value trades that seemed to be undertaken to avoid the normal need for payments and delivery of securities in the settlement process. In other words, they were unwound before the actual delivery out of the share certificates would ever be required and so fundamentally the transaction patterns, ultimately, showed no change in the ownership of

the traded shares. So, what was the reason for the trading? Well, fundamentally, the reason for the trading was to gain that tax advantage.

Ultimately the FCA find the brokerage house a sum short of a quarter of million pounds for systems and control failings and, as I have mentioned, that was the mechanism that the FCA used to be able to wield its power without having to ultimately face the daunting task of proving, under UK law, that CumEx trading itself is an unlawful activity.

So, what we can see there was that the failings that were criticised were not purely critical of CumEx trading but there ought to be a suspicion relating to that sort of transaction where there's no commercial basis other than the tax advantage. The FCA focused on the significant gaps and weaknesses in the company's financial crime systems and its internal controls and the adequacy of its due-diligence both customer due-diligence and enhanced due-diligence.

That is one aspect of the impact that this sort of trading can have, but another was in relation to a UK case, which is currently the subject of appeal, which was heard in the last couple of weeks, which was an appeal from the High Court in relation to SKAT - which is the Danish tax authority - that had brought a civil case seeking recovery of large sums of money into the tune of €1.9b from "Solo Capital". This was through CumEx trading schemes that were based in Denmark. We don't have that ruling yet, it will come out shortly. The high court initially dismissed it on the basis that to recover tax losses that ought to be done in the jurisdiction where the loss is faced in other words in Denmark and not in the UK. The argument on the appeal is, in fact, "well, not it is not a tax-loss, it's an out-and-out fraud. We will see where that goes."¹

So, what we see here is a pattern and it is a pattern of increased focus on the controls and any weaknesses in those control and any failures in those controls, rather than the underlying trading itself.

Alice Well, that is a very thorough background so how is it that these developments might impact listeners and what should businesses be doing about it?

David If we look, just very briefly, at the summaries it will provide the highlight as to what you should be doing. Principle two is that a firm must conduct its business with due skill, care and diligence and what the FCA found was that the companies that it looked at, in relation to the brokerage on these trades, had failed specifically to conduct customer due-diligence. We're dealing with a large scale trading, very often the customers were based in foreign parts and so, the customer due-diligence would be looking at who these entities were. In many cases you'd discover that the buyers, for example, looked like they had very little trading history and very little purpose to them.

They failed to gather information to enable them to understand their customers business, to undertake and document a risk assessment for each client, to complete enhance due-diligence for the clients and to assess clients against categorisations in the conduct of business source book with the criteria set out there.

Failures to conduct transaction monitoring during the purported trades and a failure to recognise numerous red flags. There were failures under principle two to report payments to the FCA, as required, and the third principle '...a firm must take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems'. All of this, effectively, led to the overall thought that any suspicious transactions were simply not going to be identified.

Now, with that background it becomes easier to understand what you would need to do. So, on the one side of the scales you need to work out what your organisations, role or involvement, in CumEx trading was. Which one of those parties were you, or which agent for those parties were you? That would then allow you to understand whether you have active involvement in CumEx trading as a broker, or an investor, a lender or a trader or as a custodian bank. That would also allow you to consider your other risks as to whether you had more of an indirect involvement, for example, were some of your clients implicated, or did you provide financing or lending facilities, or did you loan the shares out yourself? So, all of those would be into the past side, but what about new requirements and obligations for all financial institutions? Because the one thing that, I think, CumEx has truly shown is that dividend-arbitrage trading practices which focus purely, or solely, on gaining an advantage in the tax system are going to require very careful thought before you enter into them.

So, let's look at what you could be doing. First of all, I would suggest that enterprise-wide risk assessment ought to be carried out to identify any form of dividend-arbitrage trading, 'when was it, what type was it?' - because CumEx is only one example of it. CumCum was another way of moving shares around to create the

¹ The Court of Appeal has since released its judgment, largely overturning the decision of the High Court. The Court of Appeal decision can be found here

same benefit, but only, on this occasion it was done before the dividend was paid out, hence, why it is CumCum with the dividend rather than with, or without the dividend.

Once you have identified an enterprise-wide risk assessment, you can look at product risk assessment and what I like to call product lifestyle. This would allow you to drill down on the element involved.

I should point out that it has been suggested that lawyers were involved approving some of these schemes. Well, you look at that very carefully because the lawyers would only give advice in relation to the part that they were asked to advise on and you as the organisation involved in it would need to have an overview as to the entirety of the arrangements.

The most important is to have a robust approach to KYC and customer due-diligence and enhanced due-diligence. Simply box-ticking exercises - that might have been carried out in the past - are just not going to be sufficient when you are dealing with trading volumes in the billions, when they are looking at the scale of the tax reclaims that were being made. As an organisation, anyone that is regulated would want this - but particularly so if you are involved in dividend arbitrage-trading - is to ensure that your policies and procedures are thorough and robust and that you have got ongoing monitoring including a robust approach to trade monitoring.

Those are the general points that I would say. You've also got the FCA rules, you have got to take those together with the market abuse regulations and when you see those two combined, they indicate the firms potentially exposed or involved in this sort of trading should both conduct to extend to due-diligence on a relevant clients transactions, but also that they should document any concerns and consider those for reporting to the FCA. Now, if you are involved in that trading on a historical basis, it is pretty clear, in my view, that a prudent UK firm with CumEx exposure would be considering a thorough internal investigation into its practices with a view, not only to enhancing its effectiveness of its compliance programme, but also to make sure that it's managing its exposure and risk in the very best way possible.

Alice

So, if we assume that, having shined a light into the dark places, CumEx is probably not going to be rising from the ashes as a trading scheme anytime soon - not least because of the various tightening of loop-holes in the European jurisdictions involved. What does the future look like for CumEx investigations and dividend arbitrage schemes more generally?

David

It is a bit of crystal ball gazing. It is certainly true that forms of dividend-arbitrage trading are ongoing, today, as we speak. Parties will be, inevitably, more careful. Put simply taxation is based on a national basis and finance on a global basis. The question is not necessarily, 'what schemes are ongoing?' but, 'what does it really mean, going forward?'

The tendency, now, for financial crime and tax evasion - rather than tax avoidance - to be found in the statute book is neatly summarised by the implementation of the Criminal Finances Act in 2017. That Act does not have retrospective effect, but it does impose corporate-criminal liability on any organisation that facilitates tax evasion. It is effectively a strict-liability offence and so the only way in which you can avoid liability - where your organisation has been proven to facilitate a tax evasion scheme - would be to demonstrate that you had put in place all reasonable measures to prevent such facilitation. So, even if you were doubting for a moment all of the recommended methods and procedures that I had highlighted, this alone would provide serious justification for making sure that there is a long overdue overhaul of those procedures and to, actually, test them in the real world to look at what it is that you are doing to ensure that your policies and procedures are safeguarding the future.

This space is not going to get any easier for those involved in it and I think what we will see, eventually, is some large-scale settlements carried out which will probably involve the likes of the SFO and various equivalents in Europe and elsewhere - but that will take some time to come. At the moment the 'wait and see' policy of the UK prosecuting authorities tends to mitigate against any immediate action, but the FCA will do its work using its other powers without delving too deeply into the murky world of CumEx.

One aspect that I think ought to be touched upon as well is the fact that the brokerage houses involved with the FCA to date, had not really actively cooperated with them. It's a really difficult decision for any organisation to take: on the one hand do you engage with the FCA or not and at which stage. But on the other hand, a failure to do so is likely to leave you more exposed in the event that they come looking at whatever type of trading you have been doing. So, proactive cooperation with the authorities is likely to become relevant, not only with the FCA but also in the event that the serious fraud office decides to conduct any investigations in to specific CumEx allegations.

For some time, it was seen as 'lawful' to conduct this type of trading, but the German courts have been upheld on appeal and have made it very clear that CumEx trading, done in the way in which I have described in that example, would not be considered lawful. It's true to say that the loopholes were closed over a number

of years - and not very effectively to start off with but - now that they have been it's very clear that the conduct being looked at has a criminal element to it.

That cooperation that I talked about plays very heavily in any charging decision and we have all seen the tendency for the SFO to move down a slightly 'American' route of deferred prosecution agreements and entering into financial deals with its' investigating. That's only true where cooperation has taken place.

We're seeing MLA requests - those are mutual legal assistance requests - coming in from EU authorities, mainly to HMRC, and that has caused search warrants to be effected in London, with a large amount of documents being seized and reviewed for the purpose of transmitting those documents to prosecuting authorities in Europe. Those criminal cases exist in Germany, Austria and are starting to be looked at in other jurisdictions as well.

As I have mentioned there were 500, or thereabouts, letters that were sent out to suspects in the UK - that's an awful lot of suspects - and those were primarily traders and brokers and others that were involved in CumEx trading. Some of those letters, which were sent by the German prosecuting authorities, have ended up with European arrest warrants being issued and with those individuals being extradited to European countries.

It's clear that CumEx has got a long way to go. We may well be back, Alice, in a year or looking at this topic again!

Alice

Fantastic, David! And unfortunately that is all we have got time for in this week's episode. So, thank you again David for joining us.

You can find David through his email davidstern@5sah.co.uk. You can also find David on LinkedIn. If you have any questions for me, or for David, or any topics you would like us to cover in a future episode, please do email us on taxingmatters@rpc.co.uk. We would love to hear from you!

RPC would like to thank Josh McDonald. Our original score is composed by Inciter Music who also produce this podcast series. To hear a full, uninterrupted version of our podcast theme go to Instagram [@incitermusic](https://www.instagram.com/incitermusic) and follow the link in bio.

And, of course, a big thank you to all of our listeners for joining us.

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