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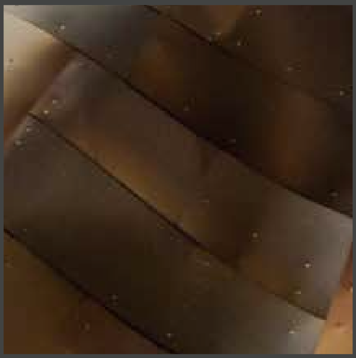

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The Legal 500, 2022

A Briefing Guide to

The Cum-Ex Guide for Financial Institutions

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The Cum-Ex Guide for Financial Institutions

Cum-Ex was a series of trade strategies which were designed to allegedly exploit tax differences across Europe. This was an arrangement where private investment holding companies and finance companies were organising double refunds of tax that had been paid on one dividend pay-out. The aim was to take advantage of credit to which there was no entitlement.

As a result of these trades, there are now active investigations in various European jurisdictions, including (but not limited to) UK, Germany, Denmark and Austria.

As such, there were no perceived risks involved at the time - only profit. Cum-Ex was one of the most lucrative models in recent years. There were no provisions put in place by European states to prevent Cum-Ex until it came to a head in 2012.

The Cum-Ex Trading Scandal

Cum-Ex is the name given to a huge volume of dividend trading strategies (dividend arbitrage stock trading transactions) that took place largely prior to 2012. The controversial practice involved exploiting a loophole on dividend payments to trade shares in a way that concealed the identity of the owner and enabled several parties to claim multiple tax refunds for the same dividend pay-out. It has also been known as dividend-stripping.

Germany is the country at the heart of the scandal and the country whose investigations into Cum-Ex are most advanced. The German authorities have claimed that Cum-Ex has cost the country approximately €30 billion in lost revenue. However, various other EU treasuries have also been affected, with some estimates of €55.2 billion being lost in tax revenue as a result of such schemes.

The Cum-Ex scandal is now a rapidly-widening cross-border tax fraud probe affecting many financial institutions and individuals across 11 EU jurisdictions; with investigators engaging in regulatory, civil and criminal proceedings against those involved.

How a Cum-Ex Trading Scheme Works

Cum-Ex is an example of a dividend withholding tax (WHT) refund model. Cum-Ex entitled overseas investors in domestic companies to obtain a refund on shares under double taxation treaties. It is worth noting that the UK does not use WHT, so the UK tax authorities are not affected by Cum-Ex transactions, unlike many other states.

Cum-Ex trading began when a tax loophole was discovered in the 1990s. The loophole was utilised by a network of institutions and professionals, including traders, investors, tax advisers, lawyers, brokerage firms and banks. It was a lucrative trading practice until legislative changes were introduced in 2012.

Put simply, banks and stockbrokers rapidly traded shares with (cum) and without (ex) dividend rights, in a way that enabled them to hide the identity of the actual owner. This meant that they could agree to sell a company stock before the dividend was paid out, but then deliver it after the dividend had been paid. This tactic enabled both parties to claim tax rebates of WHT on capital gains tax (a tax that had only been paid once, if at all) from EU tax authorities.

Rapid trading between the various parties could confuse the tax authorities regarding beneficial ownership of the shares, by creating an appearance that the shares were short sold (selling when the seller does not yet hold them) prior to the dividend record date (cum-dividend), when in fact they were sold after the dividend record date (ex-dividend).

Three or more entities are needed for a successful Cum-ex scheme. A simplified summary example is outlined here:

1. Three investors come together, Investors A, B and C.
2. Investor A owns shares in company X. The shares are worth €20 million.
3. Investor B sells the same shares worth €20 million to Investor C without owning them himself (short selling) before the dividend pay-out day.
4. Company X then distributes its pay-outs. Investor A receives a dividend pay-out of €750,000 (75% of total dividend - €1 million). After pay-out, Investor A's shares are worth €19 million.
5. Investor A receives a tax certificate to reimburse €250,000 of dividend tax (representing the 25% tax reclaim).
6. Investor A sells shares worth €19 million to Investor B.
7. Investor B delivers shares worth €19 million to Investor C and pays her an additional €750,000
8. Investor C sells shares worth €19 million back to Investor A.
9. Investor C receives a tax certificate to reimburse €250,000 of dividend tax. Investors A, B & C share the tax reimbursements.

Risk vs Reward Strategies

While the above is a simple example, the reality is that Cum-Ex involved a highly complex network of entities providing liquidity and services essential to its operation.

Hedge funds and their Chief Investment Officers (CIO's) would develop and create strategies for investments relating to Cum-Ex trades. This could involve incorporating companies in various jurisdictions with the purpose of investing in certain listed securities. The hedge fund would create relationships with prime brokers, custodians and banks. The investments would be funded through private equity and leverage provided by prime brokers. The global strategy was likely to involve obtaining a legal opinion approving such investment activities.

Cum-Ex transactions commonly involved four trade legs:

- purchase of the stocks (shares)
- sale of the stocks
- collateralised stock loan agreements to facilitate the short sale
- 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:

- Brokers to execute the purchase and/or sale of the stock.
- Custodians to hold the stock once purchased / sold.
- Equity finance agents to execute the stock borrowing.
- Legal and tax professionals to provide 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 to submit the tax refund applications on behalf of offshore investors, obtain the refunds and then distribute them accordingly. Multiple offshore investors would apply for refunds based upon allegedly falsified dividend credit advices from custodian banks and refund applications from reclaim agents.

Ownership of the shares was impossible to ascertain, given the speed of the transactions. The timing of the shorts and dividend compensation payments had the effect of essentially muddying the true beneficial ownership of the stock (shares).

Legal Issues Surrounding the Cum-Ex Investigations

Cum-Ex trading allowed two parties to appear to be the beneficial owners of the same shares, creating the opportunity for multiple WHT refunds on the same dividend payment. Any examination of the beneficial ownership of shares is likely to focus on whether beneficial ownership was actually transferred.

In the context of Cum-Ex transactions, beneficial ownership of the shares and the rights this carries includes:

- 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.
- General meeting voting rights.
- The Cologne tax court held that under German law, in the case of an over-the-counter short sale, the share purchaser would not become the beneficial owner of the shares to be delivered at a later stage at the settlement of the purchase agreement.

In the UK, the issue of beneficial ownership of shares was addressed in J Sainsbury Plc v O'Connor [1990], in which Millett J said beneficial ownership was "more than equitable ownership. It requires more than the ownership of an empty shell bereft of those rights of beneficial enjoyment which normally attach to equitable ownership."

Cum-Ex Defence

It is imperative that a defence strategy tailored to the needs of the situation is devised the moment it is anticipated that the authorities may take an interest in investigating a corporate body and /or its officers. In our experience, any defence will be dependent on the different trading strategies that were executed by the corporate bodies and the roles that were undertaken by CIO's and their teams.

Generally, most dividend arbitrage transactions at the time were considered sensible and legal tax planning. Those involved in the Cum-Ex transactions are sure to raise the point that the practice was not illegal or dishonest, and was actually typical market behaviour. The strategies deployed were market neutral. In many cases, companies relied on advice from their lawyers and accountants, and would argue that they did nothing more than see an opportunity due to the ambiguity of the law surrounding this area. Furthermore, it is a practice that had arguably been accepted by legislatures in some EU states, as they had known about Cum-Ex for many years and took no early action.

Corporate bodies (and individual parties) embroiled in Cum-Ex will, no doubt, have their own specific justifications for the practice. For example, they may state they had no responsibility over - or limited knowledge of - the overall strategy and the counterparties involved, with the understanding that all parties had applied their own robust legal and tax advice.

How it Affects the UK

Many UK-based financial institutions were involved in dividend arbitrage at the time, whether that be through equities trading, brokerage or in ancillary roles. Participants in the Cum-Ex trades, such as hedge funds, would purchase substantial amounts of shares in order to make a profit. Due to the borrowing facilities provided by UK prime brokers (who offered services such as financing, securities lending and overdraft facilities), CIO's or portfolio managers of hedge funds would be able to negotiate and leverage substantial borrowing terms. As a result, the relationships and agreements between these parties could now face scrutiny by the authorities. In our view, this is one of the many reasons why European investigations may well now have a particular focus on London. Investigations have already led to two former London traders being convicted in March 2020 of tax fraud in Germany – in what was the first criminal trial relating to Cum-Ex trades.

Authorities in EU member states may well obtain evidence from the UK authorities to assist in criminal investigations. This process is governed by the Criminal Justice (European Investigation Order) Regulations 2017 (the 2017 regulation). It is essentially a request for sharing evidence in criminal investigations through mutual legal assistance.

The requests are generally made to the Home Office. But for investigations relating to tax and fiscal customs matters the requests are sent to HM Revenue and Customs (HMRC). The issuing authority in a European country will make an application to HMRC, explaining that an offence has been committed or that there are reasonable grounds for suspecting that an offence has been committed. The application will include the names of the subject of the request, the operation name and the reasons why a European Investigation Order is sought.

An order following such an application will only be made if it is necessary and proportionate to make it for the purposes of the investigation or the proceedings in question. A designated public prosecutor in England and Wales will then validate an order pursuant to s7 of the 2017 regulation once the above conditions are satisfied.

In the UK itself, the Financial Conduct Authority (FCA) has been conducting a review into the practices of some firms involved in dividend-stripping trades in Germany. The FCA has confirmed it is currently investigating financial institutions and individuals implicated in the scandal. With the passage of time, there are now extensive numbers of Cum-Ex-related criminal and civil investigations ongoing, as well as significant amounts of litigation. It is highly likely there will be more in the near future.

The full extent of how the Cum-Ex scandal is affecting the UK is, therefore, still yet to be seen.

Considerations for UK Financial Institutions

Financial institutions involved with dividend arbitrage could be at risk of a number of consequences of Cum-Ex investigations. These include both civil and criminal sanctions and the reputational effect that either of these can have upon a firm.

Firms will be subject to FCA requirements, the Money Laundering Regulations 2017 and any legislation preceding this, depending on the period of alleged offending. In addition to this, firms may well be subject to EU Market Abuse Regulations (MAR). Financial institutions will need to have adequate and considered systems and controls in place to satisfy AML requirements, including due diligence on clients/transactions. Firms who are concerned about their exposure should consider conducting an internal investigation and be prepared to self-report anything untoward to the FCA and, possibly, the German authorities.

It is highly likely that European enforcement agencies will target financial institutions, in particular those with substantial resources. This is so that significant financial penalties can be agreed; depending on how corporate bodies are perceived by investigators and what investigations discover about those bodies' activities. Depending on the merits of the case, a corporate body will need to carefully consider a robust defence and/or remediating measures in order to limit reputational harm.

Glossary of Key Terms

Cum dividend

A share-quoted cum dividend carries the right to receive the next dividend. This is the opposite of ex-dividend.

Custodians
Custodians are those who hold and settle trade equity. This is a service to hold and settle shares.

Declaration date
The date that the dividend is announced by the company's board of directors. On this day, the company will give information about the size of the dividend, the date of record and the payment date. The company usually has a legal responsibility to pay the dividend once it has been declared.

Delivery vs Payment (DVP)
This is a mode of settlement of securities. In DVP, the transfer of securities and funds happen simultaneously. DVP settlement ensures that funds are paid, and the securities are then delivered.

Dividend arbitrage
Dividend arbitrage is an options trading strategy that involves purchasing put options and an equivalent amount of underlying stock before its ex-dividend date, and then exercising the put after collecting the dividend. When used on a security with low volatility (causing lower options premiums) and a high dividend, dividend arbitrage can result in an investor realising profits while assuming very low to no risk.

Ex-dividend date
Ex-dividend is where a stock is trading without the value of the next dividend payment. The ex-dividend date is the day the stock starts trading without the value of its next dividend payment. Typically, the ex-dividend date for a stock is one business day before the record date. This means traded positions at the start of business on the ex-dividend date represent the beneficial owner who is entitled to the dividend, whether that is paid as a real dividend (if they are also the holder of record) or paid as a manufactured dividend (if the shares have not settled by close of business on record date). It is this beneficial owner who is entitled to apply for a WHT reclaim.

Ex-dividend
A term used in share listings to denote that the share is sold without the right to receive the dividend payment, which is marked as due to those shareholders who are on the share register at a pre-announced date. This is the opposite of cum dividend.

Futures contracts
Futures are a contract that requires the buyer to purchase an asset at a specific price on a future date. A seller of the futures contract is contracted to deliver that asset at a specific date and price. This is a method that is often used by sophisticated traders and financial institutions as part of hedging strategies.

Hedge funds
Privately-owned and privately-managed funds that are generally formed by institutional traders who have expertise working in investment banks, creating strategies that would be funded by private capital. Private investors invest in the fund for a return on investment based on those strategies.

Institutional Trader
A trader who works for an investment bank, brokerage firm, mutual fund or hedge fund.

Interdealer broker
This is an intermediary who helps with the transactions between the financial institutions and the banks.

Leverage
The margin your broker provides you with, based on the capital in your account. The leverage varies between brokers and may depend on what you are holding in the account (cash and securities) and share price.

Payment date
The date dividends are actually paid. The length of time between the initial record date and payment date varies between stock exchanges but is typically anywhere between the ex-date and one or two months.

Prime brokers
In short, prime brokers would hold and settle shares and offer additional services such as financing, stock lending, overdraft facilities and credit lines.

Record date
The record date is used to determine who is on the share register and, therefore, entitled to the dividend. The company sets the date of record after it has announced that it will pay a dividend. At the close of business on the record date, the registrar takes a snapshot of who is physically holding the shares (the holders of record) and pays the real dividends to these holders. Recent changes in most markets mean that the record date is timed to ensure that cum-dividend trades, i.e.: those executed before ex-date, should have settled before the close of business on the record date. The opportunity for Cum-Ex existed where this was not the case, as described above. Share registers are kept electronically. Settlement is the delivery of title to shares against payment in accordance with the sale contract.

Short selling
This occurs when you borrow shares from a broker and sell them with the expectation that the price will go lower and can be bought back at a lower price. You return the borrowed share to your broker and keep the profit.

T + 2 Settlement
This is a processing time. When an order is placed and executed on the stock exchange between buyer and seller, this is known as the trade day (T – day). The transaction is then entered into the company's record books (settled) "T + 2" days after the trade day (i.e.: 2 days after the settlement of the transaction).

Withholding tax ("WHT")
A withholding tax takes a set amount of money out of an employee's payslip and pays it to the government. The money taken is a credit against the employee's annual income tax. If too much money is withheld, an employee will receive a tax refund; if not enough is withheld, an employee will have an additional tax bill.

Meet our CUM-EX Investigations Team

Rahman Ravelli was one of the very first UK law firms to recognise the possible legal implications of Cum-Ex and its potential impact on all levels of the financial services industry. As a firm that prides itself on a rapid response to the needs of existing or potential clients, we compiled a team of specialists in anticipation of a Cum-Ex caseload. That caseload continues to grow – and our experts are on hand to manage each and every aspect of such cases.

AZIZ RAHMAN

Aziz's success in some of this century's most notable financial crime cases and his robust, incisive defence of clients mean he is viewed by legal guides and the profession itself as one of the elite international solicitors handling large-value, high-profile investigations. He is a solicitor who has set legal precedents.

His expertise in criminal and regulatory matters and his skill in leading cross-border legal teams ensure that the organisations and individuals he represents benefit from bespoke, intelligent defence that challenges each and every aspect of the allegations made against his clients.

SYEDUR RAHMAN

Syed's great depth of experience and his accomplishments in cross-border fraud and business crime cases and high-stakes commercial and financial investigations have put him in high demand with corporates and their directors, financial institutions and high net worth individuals

His caseload includes many of the most complex, challenging cases involving national and international agencies. He has expertise in handling regulatory and compliance cases in a wide variety of countries and regularly handles the most notable financial services cases.

JOSIE WELLAND

Josie is highly-rated for her defence of white-collar crime cases, having built a reputation for intelligent and forceful representation of corporates and individuals in investigations spanning countries and continents.

Her intelligent management of investigations in various jurisdictions and her eye for detail in large, complex cases have led to her impressing senior figures in both the legal and business world. As a result, she has been heavily involved in some of the most significant tax fraud cases of recent years.

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