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INSIGHT: Cum-Ex—An Introduction to the 55 Billion Euro Heist

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''Cum-Ex'' is a term that many people outside trading floors have not (yet) heard of. It refers to an aggressive variation of dividend arbitrage in various European jurisdictions, now considered illegal in most countries.

Between 2002 and at least 2012, tax authorities were defrauded of an estimated 55 billion euros. The true risks from these dealings for participating financial services firms around the world are now starting to emerge.

This article introduces cum-ex and highlights the complexity and magnitude of the issue and the associated risks for financial services firms. We will continue to explore the topic in a series of articles over the coming months. In the series, we will explain the functioning of the schemes, assess the key risks in detail, discuss the actions senior management and heads of legal and compliance should take to protect their organizations, and how an internal investigation could successfully be conducted in light of the complex issues at hand.

A national tax issue with global dimensions

Germany is at the center of what the media has called the biggest tax fraud scandal in German history, with similar but smaller-scale schemes existing in jurisdictions including Denmark, the Netherlands, Austria, Belgium, France, and Italy. Cum-Ex's relevance, however, is not limited to these jurisdictions. Many beneficiaries were financial services firms around the world, with many well-known global financial institutions implicated. The UK played a key role as a major European trading hub.

The topic has gained substantial traction recently with the European Banking Authority (EBA) publishing a report on dividend arbitrage trading schemes (EBA Report) and a 10-point action plan to enhance its future regulatory framework, German authorities and prosecutors stepping up their efforts (not at least due to the statute of limitations otherwise barring prosecutions), and Dutch and Danish authorities actively pursuing claims.

What is cum-ex?

Cum-Ex schemes were first disclosed to the public in 2012 when European journalists, led by the German group CORRECTIV, investigated and published a documentary on the so-called Cum-Ex Files.

In summary, cum-ex schemes were complex equity trading transactions in which multiple institutions collaborated to receive multiple refunds of dividend withholding tax from the tax authorities that had only been paid once. Cum-Ex transactions thereby generated profit margins substantially above ''normal'' dividend arbitrage transactions, to the detriment of the tax authorities.

The term cum-ex refers to the trading of shares with (cum) or without (ex) entitlement to dividend after a company has declared but not yet paid the dividend.

German shares and global participants

The schemes emerged in Germany from 2002 and reached their height of activity between 2007 to 2012, before being forbidden by German law.

In Germany, dividend tax was levied in the form of a withholding tax, which was withheld at source, i.e., deducted by the corporation prior to distribution of the net dividend to shareholders. Institutional investors were exempt from the tax and could reclaim the withheld tax through the tax certificates issued by their custodian banks.

While shares needed to be traded on the German stock exchange, cum-ex schemes were not limited to German institutional investors. Lists published by German authorities of alleged participants include funds, asset managers, private banks, and large financial institutions from across the globe.

The basis of cum-ex: separation of economic and legal ownership in shares

Cum-Ex schemes were developed by tax and financial advisors and backed by legal opinions from reputable law firms based on an alleged loophole in German tax legislation resulting from the separation of economic and legal ownership of shares. This made it possible for two parties to reclaim dividend tax that had only been withheld at source once, whilst tax authorities were unable to detect and prevent the multiple repayments.

Landmark decision by a German court

For a long time, the legality of cum-ex schemes was unclear. In a recent landmark decision, a German court held that there had never been a gap or loophole under the then prevailing German tax laws. The court held that cum-ex schemes had always been illegal and—as this should have been obvious to all participants—that cum-ex transactions constituted serious tax fraud. In addition to suspended prison sentences for the two former London-based investment bankers who were found guilty of tax evasion offences, the private bank M.M. Warburg was ordered to repay 176 million euros to the tax authorities as part of the judgment. M.M. Warburg has appealed the decision. The case will be heard before the German Federal Court of Justice.

Some institutions have made voluntary repayments to limit their exposure, such as HypoVereinsbank, HSH Nordbank (now Hamburg Commercial Bank), LBBW, and the three main shareholders of Canada's Maple Bank, which became insolvent in 2016 as a result of its involvement in cum-ex.

Criminal prosecution and civil proceedings

It has been reported that nearly 900 individuals and firms are under investigation in connection with cum-ex schemes and that this number continues to rise. As the national tax authorities and thus, ultimately, states and their people suffered the losses, reclaiming these monies also bears a political dimension.

In addition, there appears to be an increasing number of legal proceedings brought by participants in the schemes against other involved parties. The current lawsuits are expected to be only the beginning of legal action.

The EBA Report: Robustness of AML controls and internal governance

The EBA recently raised an additional dimension of cum-ex: The EBA Report comments that there appears to be no uniform understanding by the domestic prudential authorities of dividend arbitrage schemes, which is attributed to differences in the domestic tax regimes. Nonetheless, the EBA concludes that the responses by the survey participants suggest that the "handling of the proceeds from tax crimes is likely to amount to money laundering, irrespective of where the tax crime took place." It urges institutions to critically assess the adequacy of their anti-money laundering systems, internal controls, and internal governance arrangements considering the risks highlighted through dividend arbitrage cases such as cum-ex, and mandates the prudential authorities to consider this in their reviews.

The risks and challenges

Cum-Ex presents substantial legal, financial, and reputational risks for institutions with a significant number of additional investigations, criminal prosecutions, and civil proceedings expected. In addition, regulatory reviews are now also likely to assess what action institutions have taken in response to the issue.

The biggest challenge for many current senior management teams and heads of legal and compliance will likely be to ascertain whether and to what extent institutions may have been involved in cum-ex in the past. Cum-Ex schemes are complex, and it is difficult to identify transaction patterns where individual transactions appear legitimate and the overall picture was deliberately concealed. Fortunately, there are some indicators and pointers that can guide your internal investigation.

A successful investigation should provide the necessary clarity and, if necessary, allow for the early development of an action plan to prepare for an investigation by the relevant authorities, to pursue the path of proactive disclosure or to prepare for potential exposure to civil liability.

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