



**REPORT ON COMPETENT AUTHORITIES'
APPROACHES TO TACKLING MARKET
INTEGRITY RISKS ASSOCIATED WITH
DIVIDEND ARBITRAGE TRADING SCHEMES**

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1. Background

1.1 Background

1. On 28 November 2018, the European Parliament asked the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA) to 'conduct an inquiry into dividend arbitrage trading schemes such as cum-ex or cum-cum in order to assess potential threats to the integrity of financial markets and to national budgets; to establish the nature and magnitude of actors in these schemes; to assess whether there were breaches of either national or Union law; to assess the actions taken by financial supervisors in Member States; and to make appropriate recommendations for reform and for action to the competent authorities concerned'.¹
2. In December 2018, the EBA's Board of Supervisors (BoS) discussed the extent to which such schemes are relevant from a supervisory perspective. At the time, not many competent authorities were aware of such schemes and some expressed the view that these were a matter for tax authorities, rather than for financial services supervisors. Nonetheless, the BoS considered that dividend arbitrage trading schemes may be relevant from two specific perspectives: (i) an anti-money laundering and countering the financing of terrorism (AML/CFT) perspective, if there is clarity that a predicate offence has taken place, and (ii) the more general governance perspective of prudential supervision. The EBA therefore decided to carry out two surveys in 2019 to take stock of competent authorities' approaches to supervising financial institutions involved in dividend arbitrage trading schemes and those handling the proceeds from such schemes.
3. In May 2019, EBA staff carried out a survey of competent AML/CFT authorities to gain an understanding of whether dividend arbitrage trading schemes such as cum-ex and cum-cum schemes were treated as tax crimes and, consequently, whether the handling of proceeds from such schemes would amount to money laundering in line with Directive (EU) 2015/849. In July 2019, EBA staff followed this survey up with a survey of prudential supervisors to gain an understanding of how financial institutions' involvement in such schemes complied with the prudential framework and in particular with the provisions on institutions' governance arrangements within Directive 2013/36/EU.
4. This report summarises the EBA's findings in relation to each survey and sets out what competent AML/CFT and prudential authorities should do to mitigate the risks associated with dividend arbitrage trading schemes, considering that tax authorities are generally better positioned to detect and combat tax crime.

¹ European Parliament Resolution of 29 November 2018 on the cum-ex scandal: financial crime and loopholes in the current legal framework (2018/2900 (RSP)) at http://www.europarl.europa.eu/doceo/document/TA-8-2018-0475_EN.html

1.2 Legal issues

5. Dividend arbitrage trading schemes involve the strategic placement of shares in different tax jurisdictions with a view to minimising withholding taxes, i.e. a levy deducted at source from income, for example dividends, which is paid by the company that generates the income or dividends. Where a withholding tax is imposed on dividends generated in one tax jurisdiction, shareholders in another tax jurisdiction can claim back a part of this tax if both jurisdictions have concluded a double taxation agreement.
6. There is evidence that certain cum-ex schemes were used before 2012. It is currently under discussion whether dividend arbitrage trading schemes have been used to claim withholding tax refunds twice since 2012. Multiple claims of the same withholding tax could amount to a tax crime. This gives rise to questions about the role of the financial institutions that were involved in facilitating those transactions, and in handling the proceeds from such transactions both from a governance and internal control perspective and from an anti-money laundering perspective.²

1.2.1 Anti-money laundering and countering the financing of terrorism

7. Directive (EU) 2015/849³ requires financial institutions to put in place and maintain risk-sensitive policies and procedures to detect and deter money laundering and terrorist financing (ML/TF). It also requires competent authorities to monitor financial institutions' AML/CFT efforts, and to take the measures necessary to ensure financial institutions' compliance with this directive.

1.2.2 Governance arrangements

8. Article 74 of Directive 2013/36/EU requires banks to put in place robust governance arrangements to ensure that they use effective processes to identify, manage, monitor and report the risks they are or might be exposed to. This includes the risk of committing or facilitating financial crime, including tax fraud. Article 85 of this directive requires banks to implement policies and processes to evaluate and manage the exposure to operational risk, which includes internal and external fraud and the risk of losses caused by the circumvention of laws by a third party. Shortcomings in the identification and management of such risks are relevant to supervisors' assessments of institutions' internal governance arrangements and potentially the suitability of the members of the management body and key function holders if they failed to put appropriate policies and processes in place.

² For a detailed description of dividend arbitrage trading schemes, please refer to ESMA's 2019 report on preliminary findings on multiple withholding tax reclaim schemes at https://www.esma.europa.eu/sites/default/files/library/esma70-154-1193_preliminary_findings_on_multiple_withholding_tax_reclaim_schemes.pdf

³ Applicable from 26 June 2017; please note that Directive (EU) 2015/849 (the Fourth Anti-money Laundering Directive (4AMLD)) introduces, as primary offences, tax crimes relating to direct taxes and indirect taxes and as defined in the national law of the Member States, which are punishable by deprivation of liberty or a detention order for a maximum of more than one year or, as regards Member States that have a minimum threshold for offences in their legal system, all offences punishable by deprivation of liberty or a detention order for a minimum of more than six months.

1.3 Methodologies

9. In May 2019, EBA staff approached members of the Joint Committee's AML/CFT sub-committee (JCAMLC) that are responsible for the AML/CFT supervision of financial institutions (AML/CFT supervisors) within the EBA's remit to gain an understanding of whether double tax refunds were treated as a tax crime, as handling the proceeds from tax crime might amount to money laundering. AML/CFT supervisors were asked to respond to a questionnaire that explored the legal status of cum-ex schemes; supervisory measures taken or planned; coordination between competent authorities and other public authorities; findings on cum-cum schemes; and the role of the EBA. Twenty-four AML/CFT supervisors responded to the questionnaire.
10. In July 2019, EBA staff carried out a survey of all competent authorities responsible for prudential supervision (prudential supervisors) in the European Economic Area that are members of its Standing Committee of Regulation and Policy (SCRePol) to gain an understanding of the nature of these practices and their compliance with the prudential framework and in particular with the provisions on institutions' governance arrangements within Directive 2013/36/EU. Twenty-eight prudential supervisors, including the ECB-SSM, responded to the questionnaire.
11. Although the focus of the JCAMLC is different from that of SCRePol, the competent authorities that are responsible for the supervision of financial institutions within the EBA's remit are largely the same in both committees.
12. Responses to these surveys, and the analysis of responses by EBA staff, were shared with ESMA and competent authorities, discussed by the JCAMLC and shared with the EBA's Subgroup on Governance and Remuneration and Subgroup on Ongoing Supervision.

2. Findings

13. Not all competent authorities responded to the EBA's questionnaires, and not all competent authorities that responded had considered the risks associated with dividend arbitrage trading schemes. This was due at least in part to differences in Member States' domestic tax regimes.

2.1 Dividend arbitrage trading schemes as tax crimes

14. In May 2019, eight AML/CFT supervisors confirmed that, in their Member State, dividend arbitrage trading schemes such as cum-ex schemes are tax crimes and therefore constitute a 'criminal activity' for the purpose of point 4(f) of Article 3 of Directive (EU) 2015/849. One AML/CFT supervisor suggested that dividend arbitrage trading schemes such as cum-ex schemes did not constitute a tax crime in their Member State.

15. In all other cases, national AML/CFT supervisors indicated that dividend arbitrage schemes were not tax crimes under national law, but responses suggested that, in some Member States, dividend arbitrage trading schemes were treated as tax crimes on the basis of case law.

16. In July 2019, nine prudential supervisors indicated that they were aware of ongoing investigations by their Member States' tax authorities or public prosecutors, but they had no role to play in these investigations. This means that they were unable to share information about those cases with the EBA.

2.2 ML/TF and prudential risks associated with dividend arbitrage trading schemes

17. Competent authorities' assessments of risks associated with dividend arbitrage trading schemes differ because of divergent national approaches to tax law. In May 2019, only two AML/CFT supervisors considered that dividend arbitrage trading schemes gave rise to ML/TF risk, and particularly the risk that a financial institution does not have in place policies and procedures to effectively identify and manage the risk that they may be abused for ML/TF purposes. Contrariwise, while AML/CFT supervisors' interest in the AML/CFT impact of those schemes on their sector was limited, five AML/CFT supervisors indicated that dividend arbitrage schemes were being assessed as part of their Member States' national ML/TF risk assessment under Article 7 of Directive (EU) 2015/849.

18. Nine AML/CFT supervisors in May 2019, considered that these schemes gave rise to the risk that a financial institutions' governance and internal control framework would be insufficient to adequately manage the risk of the financial institution, or someone acting on the financial institution's behalf, committing or facilitating tax crimes. A small number of AML/CFT supervisors thought that financial institutions' involvement in dividend arbitrage trading schemes gave rise to solvency risks.

2.3 Supervisory action in response to dividend arbitrage trading schemes

19. Responses to both surveys suggest that most competent authorities have not considered the relevance that dividend arbitrage trading schemes may have for financial institutions' sound and prudent management and for ML/TF risks due to weaknesses within the internal control framework and, consequently, few have taken supervisory actions. Where competent authorities took action, this was largely in response to ML/TF or governance risks that had already crystallised. In those cases, most competent authorities took a narrow view of risks and few appeared to have considered whether there was a link between tax crimes, ML/TF and governance failings.

2.3.1 AML/CFT supervisors

20. In May 2019, four AML/CFT supervisors indicated that they were reviewing financial institutions' handling of dividend arbitrage trading schemes as part of their current inspection plans. Of these, two were clear that their focus was on the role that financial institutions could have played in promoting such schemes, rather than on their handling of proceeds from such schemes, and one AML/CFT supervisor had issued guidance to financial institutions on detecting tax evasion.

21. Most AML/CFT supervisors had not taken any action in relation to financial institutions' handling of proceeds from dividend arbitrage trading schemes, though some respondents suggested that this was because they were waiting for the outcome of criminal investigations before considering the impact on their sector.

2.3.2 Prudential supervisors

22. In July 2019, six prudential supervisors indicated that they had taken specific supervisory actions in response to risks associated with dividend arbitrage trading schemes. In most cases, this consisted of targeted onsite inspections or thematic reviews of financial institutions' dividend arbitrage trading practices.

23. In cases in which prudential supervisors had identified weaknesses in financial institutions' internal control and risk management frameworks in relation to dividend arbitrage trading schemes, these were linked to processes and their effective implementation; internal reporting; the detection of suspicious transactions; and management body involvement.

24. Most prudential supervisors had not taken any action in relation to financial institutions' facilitation of dividend arbitrage trading schemes, though some suggested that they would do so if they suspected, in the context of their ongoing supervisory and prudential assessments that an institution was in breach of its prudential obligations. It was not clear how those prudential supervisors would become aware of breaches specific to dividend arbitrage trading schemes.

2.4 Cooperation

25. Most competent authorities (prudential and/or AML/CFT supervisors) had not cooperated with other public authorities in their jurisdiction (such as tax authorities) or other competent authorities in their jurisdiction or in other Member States because they believed that there were no dividend arbitrage trading schemes in their Member State.

26. Three competent authorities that had identified failings had reached out to competent authorities in other Member States in light of the international nature of those schemes. In those cases, competent authorities had exchanged information in the context of prudential colleges, and one competent authority indicated that joint action had ensued.

27. In spite of the link between dividend arbitrage schemes and tax crimes, only one competent authority had cooperated with tax authorities in their Member State.

3. The EBA's expectations of AML/CFT and prudential authorities and next steps

28. Responses to the EBA's surveys suggest that competent AML/CFT and prudential authorities do not share the same understanding of dividend arbitrage trading schemes and the extent to which financial institutions' handling of the proceeds from these schemes constitutes money laundering. This is because of differences in Member States' domestic tax regimes; dividend arbitrage trading schemes are not possible in some cases and, where they are possible, they are not always treated as tax crimes.

29. Notwithstanding differences in domestic tax regimes, responses suggest that:

- a. Few competent prudential supervisors have considered the link between weaknesses in financial institutions' internal control and wider governance frameworks and tax crimes.
- b. Few competent authorities have considered the impact of tax crimes committed at home or abroad on their institutions' exposure to ML/TF risks. Handling the proceeds from tax crimes is likely to amount to money laundering, irrespective of where the tax crime took place.
- c. Cooperation and information exchange between competent authorities, and between competent authorities and other public authorities, for example tax authorities appear to have been attempted in a minority of cases and only where risks had crystallised.

30. Facilitating tax crimes, or handling proceeds from tax crimes, undermines the integrity of the EU's financial system. For this reason, the EBA expects institutions and competent AML/CFT and prudential authorities⁴ to take a holistic view of the risks highlighted by dividend arbitrage trading cases, for example the cum-ex scandals, which may give rise to questions about the adequacy of financial institutions' anti-money laundering systems, internal controls and internal governance arrangements. To that end, competent prudential authorities should take information received from AML/CFT supervisors into account when performing their reviews of institutions' internal controls and internal governance arrangements including suitability assessments.

31. As part of this, AML/CFT supervisors should reach out to local tax authorities to establish whether certain dividend arbitrage trading schemes constitute tax crimes, and, if so, inform competent prudential authorities. The EBA recognises that cooperation with tax authorities at cooperation with tax authorities, while required under the AMLD, is not yet reflected in

⁴ Without prejudice to the specific tasks and responsibilities under the remit of prudential competent authorities.

the CRD. This may make the exchange of information between competent authorities and tax authorities difficult.⁵

32. In such cases, cooperation arrangements allowing information exchange between relevant competent authorities, including tax authorities, in respect of financial institutions' involvement in such schemes are needed. This will support their determination and assessment of:

- a. the adequacy of financial institutions' internal control systems and governance arrangements and the risk that financial institutions in their sector may be facilitating illicit dividend arbitrage schemes; and
- b. the risk that financial institutions in their sector may be handling the proceeds from illicit dividend arbitrage trading schemes.

33. Where appropriate, competent authorities should take mitigating measures that are commensurate with those risks.

34. Examples of mitigating measures taken by some competent authorities that may also be relevant for other competent authorities include:

- a. setting out regulatory expectations in guidance to financial institutions; competent authorities may wish to refer to ESMA's report on preliminary findings on multiple withholding tax reclaim schemes in this context;
- b. carrying out targeted inspections in cases of concern, or conducting a fact-finding thematic review of several institutions to inform the competent authority's understanding of the nature and scale of the risks, looking in particular at:
 - the adequacy of institutions' assessment of risks associated with dividend arbitrage trading schemes and their capacity to identify customers who may be using those schemes for illicit purposes;
 - the existence of adequate and effective internal governance and internal control frameworks, including in relation to AML/CFT;
 - accountability and the extent to which relevant staff at all levels are capable of performing their roles in line with the institution's risk appetite and risk capacity; and
 - "the tone from the top" and the extent to which the management body promotes, monitors and assesses the institution's risk culture;

⁵ Article 49 of Directive 2015/849/EU as amended by Directive 2018/843/EU

- c. reassessing the suitability of members of the management body.

35. Cooperation and information exchange between all relevant authorities and prudential and AML/CFT competent authorities are recommended, where permitted under applicable laws, to ensure a more effective and joined-up approach to support these actions.

36. In the context of the forthcoming entry into force of Directive 2019/878/EU, which makes explicit the link between AML/CFT and the prudential framework, the EBA may consider:

- a. whether to amend its guidelines on internal governance and the guidelines on the assessment of the suitability of members of the management body and key function holders to address and reinforce relevant requirements, in particular those on risk culture and suitability;
- b. whether to update the European supervisory authorities' risk factors guidelines with more specific risk factors on tax crimes;
- c. whether to update its supervisory review and evaluation process guidelines with regard to the section on governance, including the link with AML/CFT; and
- d. monitoring and following up on the points raised in this report through its participation in supervisory colleges in 2020.



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