FCA FINANCIAL CONDUCT AUTHORITY

Market Watch

Newsletter on market conduct and transaction reporting issues

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Dividend arbitrage – our requirements for firms

Our rules require firms to establish and maintain effective policies, procedures, systems and controls to ensure they are not used to facilitate market abuse. They also mean a firm must minimise the extent to which it is possible for its business to be used for a purpose connected with financial crime.

We recently reviewed the activities of some firms engaged in dividend arbitrage. Here, we set out our findings, the background to this review and what firms may wish to consider.

Dividend arbitrage – what it is

The intention of dividend arbitrage is to place shares in alternative tax jurisdictions around dividend dates, with the aim of minimising withholding taxes (WHT)[1], or generating WHT reclaims. This may involve several different trading activities including trading and lending securities and trading derivatives, including futures and total return swaps, designed to hedge movements in the price of the securities over the dividend dates.

1. What is withholding tax?

Withholding tax (WHT) is a levy deducted at source from income and passed to the government by the entity paying it. Many securities pay periodic income in the form of dividends or interest, and local tax regulations often impose a WHT on such income.

In certain cases where WHT is levied on payments to a foreign entity it may be reclaimed if there is a formal treaty, called a double taxation agreement (DTA), between the country in which the income is paid and the country of residence of the recipient. DTAs allow for a reduction or rebate of the applicable WHT.

Our review – what we found

Most firms executing transactions with, or on behalf of clients engaged in dividend arbitrage, appear to comply with our requirements. However, 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. This raises the risk that some firms may become involved in potentially contrived transactions created in order to support fraudulent WHT reclaims. As well as being potentially criminal in nature, such activity may also amount to market abuse. This is because it could give false or misleading signals about the supply of or demand for the relevant security.

Firms which execute transactions with or on behalf of clients who are engaging in such strategies, should be alert to the risk that they may be used to facilitate market abuse or to further financial crime. Under our rules, firms are required to establish and maintain effective controls to ensure that they manage these risks and their strategies are compliant with the rules set out below under 'Relevant rules'.

Focus of our review

- We have looked at the activities of a number of inter-dealer brokers, settlement agents and custodians involved in trading European equities around ex-dividend dates. Our focus was to assess whether any aspect of this trading represented potential market abuse and whether custodians issuing tax vouchers, and/or shareholders making reclaims for the repayment of WHT, deducted from dividends at source, had received that net dividend and were entitled as shareholders to receive the WHT reclaim.

In particular, we assessed firms':

- provision of broking, market making, hedging and custody services to clients involved in dividend arbitrage
- trading activities in certain stocks around that stock's dividend period
- management oversight and whether the Money Laundering Reporting Officer has the correct experience, seniority and influence
- internal systems and controls including know your customer (KYC) controls
- approach to monitoring trades, including situations where the volume of shares traded in a particular stock is significant, relative to the average volumes traded in the market, or where the trades represent a significant proportion of the free float
- role in promoting dividend arbitrage opportunities to their clients
- approaches to assessing the appropriateness of this business for themselves and for prospective clients, including whether there is an understanding of the nature and purpose of the trading and a knowledge of how clients are funding the trading, and
- compliance with the Market Abuse Regulation (MAR)

Areas of concern

As mentioned, most firms executing transactions with, or on behalf of clients engaged in dividend arbitrage, appear to comply with our requirements. However, some firms may not have identified the risk posed by contrived or fraudulent trading for the purpose of making illegitimate WHT reclaims. As a result, some firms may not have adequate processes to allow them to assess the purpose for dividend arbitrage trading by prospective clients and/or do not establish or monitor clients' trading abilities and the true nature of the transactions involved. This could result in firms failing to identify clients who may be using this strategy for inappropriate purposes.

These transactions may include:

- off-shore funds instructing share transactions through UK broking firms
- the use of off-exchange over-the-counter (OTC) execution for stock trades
- the use of back to back securities lending agreements
- the use of OTC derivative instruments to hedge stock trades
- share transactions, where the volume traded may represent a significant proportion of the free float
- potential connection and/or associations between the owners of the off-shore funds and the firms involved in the custody, settlement and clearing of the stock
- lack of transparency as to the source and availability of funds supposedly being used to fund the trading
- lack of transparency as to the source of stock needed to fulfil a trade
- lack of realistic assessment/assurance of whether some of the institutions involved in the trading have sufficient financial standing to trade and/or clear and/or settle trades in the volumes being arranged

Firms' responsibilities

Firms executing transactions with, or on behalf of, clients engaged in dividend arbitrage need to comply with our requirements regarding financial crime risk. They must also have effective processes for carrying out due diligence on new business proposals, on new clients and for monitoring ongoing business.

We also expect firms to have a good understanding of the risks that are relevant to their business, as well as strong controls for mitigating those risks. A firm must have the appropriate management oversight and controls in place to minimise the extent to which it is possible for its business to be used for a purpose connected with financial crime.

The suspicious activity reports (SARs) regime (administered by the UK Financial Investigation Unit, National Crime Agency) requires firms to report transactions where there is a suspicion of money laundering. Failure to do so may result in an offence under the Proceeds of Crime Act 2002.

Furthermore, MAR, which took effect on 3 July 2016, requires persons professionally arranging or executing transactions in financial instruments to report suspicious orders and transactions (STORs), where they have 'reasonable suspicion' that an order or transaction could constitute market abuse, to the FCA without delay. In addition, MAR requires market operators and investment firms that operate a trading venue to report orders and transactions that 'could constitute' market abuse to the FCA without delay.

In addition, we expect firms to be aware of their obligations under Principle 11 of our Principles for Businesses (dealing with the regulator in an open and cooperative way). This includes reporting other suspicious trading activity not necessarily covered by the SARs regime, or by MAR.

Next steps for firms

You should consider the points we raise here about dividend arbitrage and the processes that your firm must follow in monitoring existing business, taking on new business and in accepting new clients. 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.

Relevant rules

PRIN principles for business

Principle 1 requires firms to conduct their business with integrity.

Principle 2 requires firms to conduct their business with due skill, care and diligence.

Principle 3 requires firms to take reasonable care to organise and control their affairs responsibly and effectively, with adequate risk management systems.

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.

SYSC senior management arrangements, systems and controls

SYSC 6.1.1R:
Requirement to establish, implement and maintain adequate policies and procedures sufficient to ensure compliance with its obligations under the regulatory system and for countering the risk that the firm might be used to further financial crime;

SYSC 6.3.3R:
Requirement to carry out a regular assessment of the adequacy of systems and controls to ensure they identify, assess, monitor and manage money laundering risk, and are comprehensive/proportionate to the nature, scale and complexity of its activities.

COND 2.5.1A(g):
Requirement to be a fit and proper person having regard to the need to minimise the extent to which it is possible for its business to be used for a purpose connected with financial crime.

MAR

Article 12 – Market manipulation

Article 15 – Prohibition of market manipulation

Financial Services Act 2012

Section 89 Misleading statements

Section 90 Misleading impressions