Tax motivated ex-dividend trading goes dark

Bernt Arne Ødegaard

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Abstract

We use the extensive tax-motivated trading of equities around the ex-dividend day as a laboratory to investigate the changes to trading of Norwegian equities following the introduction of MiFID in 2007. We show that extraordinary trading around the ex-dividend day is extensive, and has after MiFID moved from the traditional exchanges to less regulated market places, such as dark pools.

Dividend capture

If: Investors have different marginal tax rates on dividend income.
Relatively low taxed traders buy equities before the ex-dividend date, and sell them afterwards.

Research issues in this paper

- Is there such "extraordinary" trading volume linked to the ex-dividend date?
- Where is the "extraordinary" volume traded?
  - "Lit" market places
    - Oslo Stock exchange
    - Other limit order markets (Chi-X, BATS, etc)
  - "Dark" market places (OTC / Dark Pools)
- Motives for choice of venues for trading

Why this study?

Existence of tax motivated ex-day trading well documented in many markets.
Why revisit?

- Investigate in the context of equity market fragmentation, a recent phenomenon.
- Recent illegalities involving ex-day trading in Germany – Is this happening elsewhere?

Legalities, Norwegian taxation

- Domestic equity owners.
  - Dividends - taxed as financial income.
  - Capital gains: complex imputation system.
- Foreign equity owners
  - Dividends: witholding tax, tax rate varies by country.
    - Default percentage 25%
    - Lower (e.g. 15%) depending on tax treaty with country of origin.
  - Capital gains: Not taxed

Speculative issues

Sources of Risk in short-term ex-day trading:

- Stock prices may move for other reasons than the dividend before the stocks are bought back.
- Regulatory risk: Transaction may not be recognised as *bona fide* transfer of ownership for tax purposes.

Possibility: An (implicit or explicit) buyback agreement between the short-term equity traders would reduce the *price risk*, making ex-day trading more profitable.
However: This raises the probability of regulatory intervention, if discovered.

This paper

- Investigate ex-dividend trading of Norwegian shares in the 2008–2012 period.

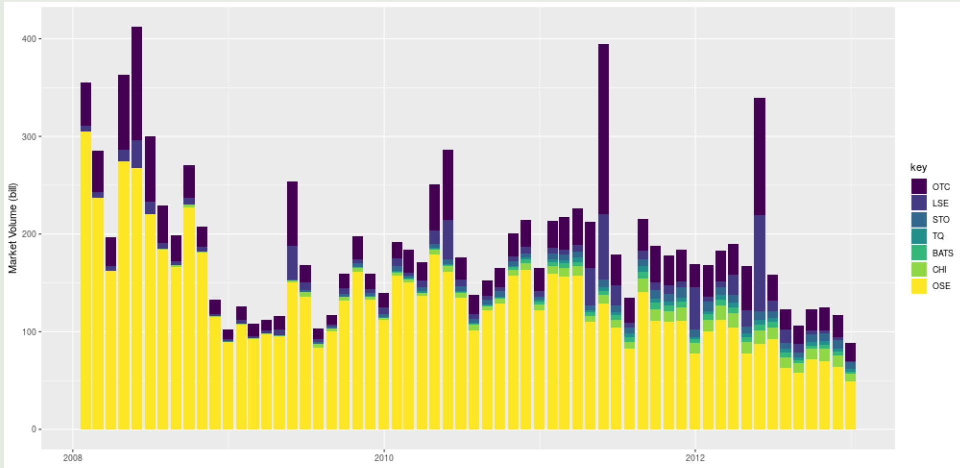
Background: Stock market fragmentation

2007: European introduction of MiFID mandates competition in equity trading.
→ Trading of Norwegian shares gradually moves from OSE monopoly to multi-exchange trading.

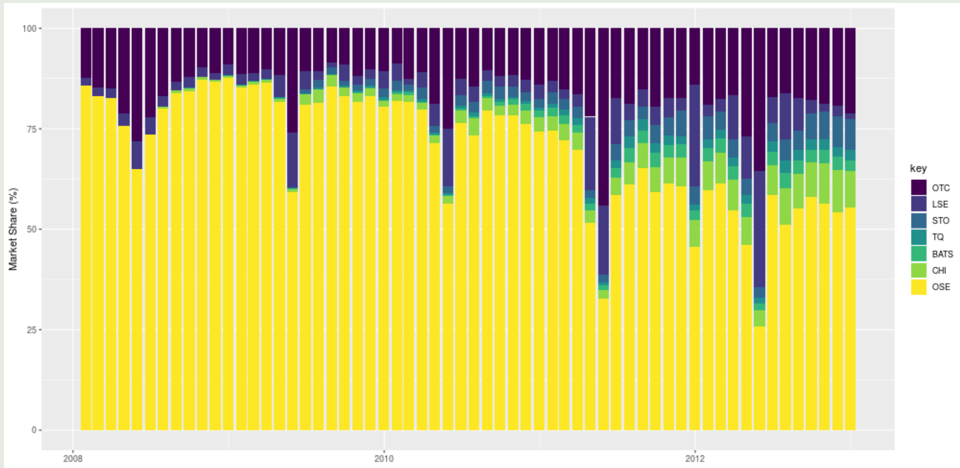
Market places

- OSE limit order book
- Other limit order markets (Chi-X, BATS, Turquoise, Stockholm, London)
- OTC trading

Monthly volume (in NOK bill), by exchange



Monthly market share, by exchange



Observations, Norwegian ex-day trading

Volume around the ex day much higher than "normal" trading.
Most of the ex-day trading happens on OTC market places.
Graphical evidence:

- Spikes of OTC trading volume in May (dividend paying month)
- See also: High OTC market share.

Estimates - CAV - total volume above "normal" volume (Largest shares OSE):

- OSE: 79%
- OTC: 603%

Why trade OTC?

- Lower trading cost? – Not likely, otherwise trade there all the time.
- Use the choice of market to signal that this is uninformed trading? – Possible.
- Is the non-anonymous nature of this market place important? – Possible.

Takeaways

- Show: ex-day trading has moved to the least transparent market places.
- Open question: What aspect of OTC trading attractive for ex-day traders?