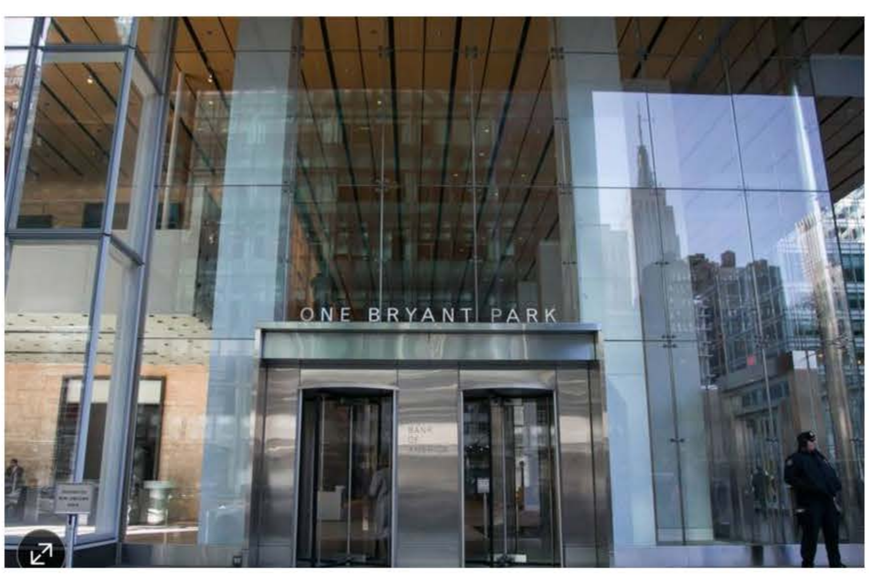
BUSINESS

Tax-Trade Mess Lingers at Bank of America

BofA dismantled group that helped clients avoid paying, but regulators press on with probes; a ban on 'SEFT'



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By JENNY STRASBURG

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A group at Bank of America Corp. that specialized in arranging trades to help clients around the world avoid taxes has been dismantled. Some employees claim they aren't even allowed to say the group's name anymore.

But escaping the troubles left by the group, called Structured Equity Finance and Trading, hasn't been so easy. Regulators have intensified their scrutiny of certain dividend-tax trades and deepened an investigation into whether Bank of America broke rules designed to safeguard client accounts, people familiar with the matter say.

Bank of America also is still grappling with internal dissent and client disputes related to the group, which at its peak had just a few dozen employees working from a quiet corner of a Manhattan trading floor and an office in central London. They spent hour after hour discussing the minutiae of tax codes, accounting and internal bank financing, current and former employees say.

SEFT was never a big moneymaker, generating revenue of $259 million in 2013, or about 0.3% of Bank of America's total, according to an internal document reviewed by The Wall Street Journal.

Still, clients flocked to SEFT's pioneering trading strategies, some of which helped customers reduce withholding taxes on stock dividends. The impact of some trades was magnified by using money from the parent company's federally insured bank, other company documents show. SEFT also made stock-based loans to a wide variety of corporate and financial clients.

In a sign of the group's importance, some employees pocketed bonuses of $1 million to $3 million apiece in certain years, spawning envy from nearby colleagues who mostly saw SEFT as a bunch of nerds who milked other employees' client relationships for additional profits.

Bank of America hasn't commented on the various tax-trading inquiries by regulators in Europe and the U.S., including the Federal Reserve Bank of Richmond. Executives at the bank say it has increased the involvement of senior risk and compliance executives in reviewing potentially problematic trades, while curtailing some activities that have drawn scrutiny.

Numerous banks, hedge funds and brokerage firms have faced investigations for so-called dividend-arbitrage tax strategies that might have generated improper tax rebates or credits.

Unusual scrutiny

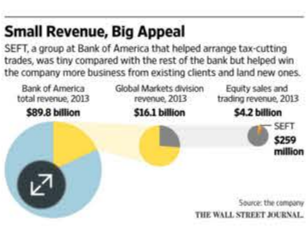
SEFT has drawn unusually intense scrutiny partly because the group engaged in controversial tax trades for much of the past decade. In the wake of the regulatory mess, SEFT has largely been wound down, according to current and former employees.

Bank of America, which ranks second in assets among U.S. banks, inherited the operation that became known as SEFT through the 2009 takeover of securities firm Merrill Lynch & Co.

SEFT was already known for its expertise at using a series of carefully timed trades to temporarily shuffle ownership of a client's shares to a lower-tax jurisdiction around the time when the client expects to collect a dividend on those shares. Banks and hedge funds say dividend arbitrage is a legal way to reduce tax bills through differences in withholding rates.

The maneuver sometimes enabled clients to cut taxes from as much as 30% of the dividend payment to a fraction of that—or even zero. The strategy helped Merrill and then Bank of America win more trading business from existing clients and attract new ones, according to internal documents.

U.S. tax authorities started to clamp down in 2008 on dividend arbitrage with U.S. stocks, which had been a large and lucrative market. Bank of America and other financial institutions responded by shifting their focus to European stocks, say people involved in the trades.



Fabrizio Gallo, who joined Bank of America in 2011 to oversee its equities business, encouraged the expansion of dividend-arbitrage trades, people who were there at the time say. Known by the nickname "Fab," he hired and promoted former colleagues from Morgan Stanley to lead the push.

One of the managers whose power and prestige rose was Sylvan Chackman. He had been pushed aside in a management shuffle in 2011. Mr. Gallo told other managers that Mr. Chackman was "the best div-arb trader" and created a new job for him in London, people close to the business say.

But the trades sometimes didn't produce the returns that clients wanted. For example, a Dubai investment firm called Lycalopex expected to make tens of millions of dollars on dividend-tax trades with Bank of America, according to documents and people familiar with the plans.

Those people say the bank arranged to loan Lycalopex as much as $1 billion from its federally insured U.S. deposit-taking unit. Lycalopex was named after a jackal-like animal. Its financial backers included billionaire hedge-fund manager Paul Tudor Jones.

Andrew Devonald, the computerized-trading strategist managing Lycalopex, claimed Bank of America senior manager Rajeev Patel, who worked closely with SEFT in London, said the trades would produce at least $15 million in profits, according to a 2012 email from Mr. Devonald to Mr. Chackman.

"Do you think that we would spend the considerable time, effort and money setting up the trades we entered into with Raj with no conversation or assurance that the transactions were likely to be profitable?" Mr. Devonald wrote.

Instead, Mr. Devonald and his partner at Lycalopex, Stephen Diggle, claimed that Bank of America owed them about $10 million, had improperly altered the trading strategy and kept too much of the profits for itself.

Mr. Devonald also accused the bank of using mobile phones to text trading instructions to avoid detection by regulators and outside brokers to line up the trades to look like arm's-length transactions, rather than closely coordinated and essentially risk-free. Bank executives believe the transactions were appropriate and arm's length, according to a person familiar with the matter.

Regulators typically are leery of coordinated trades because they want securities prices to reflect actual supply and demand in the market.

Mr. Devonald threatened to go to regulators and complained all the way up the ladder at Bank of America to Thomas Montag, the No. 2 executive, according to people familiar with the matter.

Mr. Chackman and other Bank of America executives responded that changes in European regulations had forced the bank to adjust trades done on behalf of Lycalopex, according to people familiar with the matter.

At Lycalopex's request, the bank's own head of equities in Asia at the time, Peter MacDonald, pressed Mr. Gallo and other Bank of America officials in London to show Lycalopex how the trades were done and profits divided.

Those officials declined and said they would take care of the dispute, according to people familiar with the matter. Bank of America executives don't believe the bank guaranteed a minimum profit to Lycalopex.

Mr. Diggle says Lycalopex still is seeking payment from the bank. "We feel we have a legitimate grievance," he says. His partners in Dubai no longer pursue the investment strategy and instead sell packaged, halal-certified meals to refugee-aid organizations and supermarkets.

At a 2013 meeting with Thomas Montag, Bank of America's chief operating officer, executives debated the possible risks from dividend-tax trades. *PHOTO: JONATHAN FICKIES/BLOOMBERG NEWS*

At times, some Bank of America officials objected to tax trades created by SEFT—and even blocked them.

In 2012, an up-and-coming trader in the group's London office spent months putting together a tax-minimization trade for Advanzia Bank SA, a credit-card issuer in Luxembourg.

The trader, Rurik Jutting, oversaw the structuring of a transaction that called for Advanzia to trade more than $200 million of shares in French utility Électricité de France SA around the same time that the utility was scheduled to pay dividends to its shareholders, internal bank documents show.

Former colleagues of Mr. Jutting, who came to Bank of America from Barclays PLC in 2010 when he was in his mid-20s, say he told them that Advanzia would probably do more business with SEFT if the trade worked well.

The trade was approved by Advanzia's board of directors and was similar to a series of previous trades arranged by SEFT that helped other clients avoid millions of dividend-withholding taxes on European stocks, according to bank documents reviewed by the Journal.

But Bank of America lawyers and other employees in London grew concerned about the mechanics of the transaction, say people who were there at the time. The trade was structured so a bank subsidiary would buy the utility-company shares, sell them to Advanzia and then repurchase them, all within a few days.

The sequence was designed to ensure that Advanzia would reap tax savings from the trade without exposing the credit-card issuer to any actual risk, according to the documents and people familiar with the proposed transaction.

Investment manager Stephen Diggle claims Bank of America owes his firm about $10 million after improperly altering dividend-tax trades. *PHOTO: JENNY STRASBURG/THE WALL STREET JOURNAL*

Critics of the trade inside Bank of America worried that regulators might see the deal as "circular," a potential violation of rules in multiple countries requiring that trades involve some financial risk.

Some people at the bank also believed Mr. Jutting was "aggressively pushing" the transaction before other Bank of America officials were comfortable enough with it, according to an email sent by a bank employee in London.

The week that the Advanzia trade was supposed to happen, lawyers at Bank of America said it couldn't go through. Mr. Gallo, the executive in charge of the bank's equities business, also disapproved of the trade's structure, size and choice of client, says a person familiar with the matter. An Advanzia executive confirms that the transaction wasn't done.

In 2013, though, Mr. Jutting helped Bank of America arrange similar trades with a different Luxembourg bank, according to internal documents and people familiar with the matter.

Later that year, the trader was transferred to Hong Kong, promoted to vice president from associate, and began trying to help SEFT expand its fledgling business in Asia. He jointly reported to managers there and in London, internal organizational charts show.

Mr. Jutting couldn't be reached for comment. He is in jail in Hong Kong awaiting trial on murder charges related to two women found dead in his apartment in 2014. One of the bodies was in a suitcase on his balcony.

He has said he would fight the charges and is no longer employed by the bank. Mr. Jutting's lawyer declined to comment.

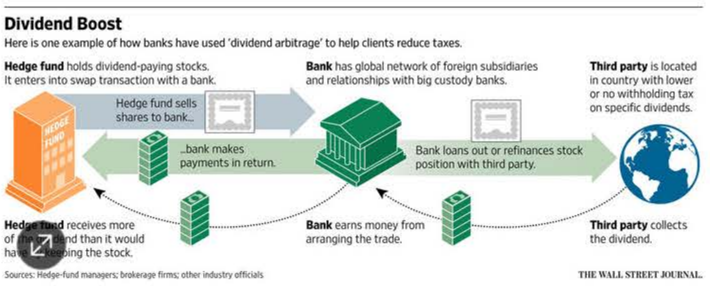
Executives spar

By mid-2013, a deep split had formed inside Bank of America about the possible risks from dividend-tax trades. At a meeting in the same Manhattan building where SEFT employees worked, executive Stuart Hendel said the bank should stop doing the trades, say people familiar with the meeting.

Mr. Hendel headed the bank's business with hedge funds, a lucrative source of potential clients for SEFT, but said its tax trades were "sleazy" and put Bank of America's reputation at risk. Mr. Hendel is a lawyer who previously was chief operating officer at hedge-fund firm Eton Park Capital Management LP and joined Bank of America just before Mr. Gallo in 2011.

At the same meeting, Messrs. Gallo and Chackman presented a report to Mr. Montag that acknowledged the trades carried "reputational risks" and "could be portrayed as facilitating tax avoidance." The report cited the "current trend to vilify banks," according to a copy reviewed by the Journal.

Nevertheless, Messrs. Gallo and Chackman assured Mr. Montag, now Bank of America's chief operating officer, that the bank was carefully vetting clients and adhering to international tax law. The report cited Lycalopex as a past client without mentioning the dispute.



The meeting ended with no major changes to SEFT's strategy. The group continued arranging tax-minimizing trades. Mr. Hendel left Bank of America in early 2014.

The Richmond Fed, which is the primary regulator of Bank of America, first expressed concern about SEFT's dividend-arbitrage trades in the spring of 2014, according to people familiar with the matter.

Fed officials are broadly examining the tax trades, other elements of SEFT's overall strategy and the group's controls and accounting, say people familiar with recent communications with the regulator. The Securities and Exchange Commission has been questioning current and former bank employees for more than a year as part of an investigation into whether SEFT trades violated customer-protection rules.

The bank has said that transactions in question "received extensive review" and that the bank "fully complied with the rules designed to safeguard client funds." Bank of America also has overhauled procedures for safeguarding customer accounts.

As scrutiny of SEFT intensified, the bank banished the group's name from organizational charts as part of a broader restructuring. "Don't refer to SEFT anymore," a London manager said last summer when employees kept using the acronym in meetings and email, according to people familiar with the remark.

Bank of America employees still structure tax trades but far fewer of them. They now are part of a unit called the Inventory Management Group.

Write to Jenny Strasburg at jenny.strasburg@wsj.com