Statement of Senator Carl Levin (D-Mich.)
Before
U.S. Senate Permanent Subcommittee on Investigations
On
Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits

July 22, 2014

In recent years, this Subcommittee has devoted significant time and effort to exposing complex financial arrangements that profitable corporations and wealthy individuals employ to avoid their obligations to pay all their U.S. taxes. We also have examined reckless behavior that has put the stability of the financial system – and by extension, the U.S. economy – at risk. Today's hearing brings those two themes together.

Our focus today is on how two banks and a handful of hedge funds developed a complex financial structure to engage in highly profitable trades while claiming an unjustified lower tax rate and avoiding limits on trading with borrowed money. This structure worked well for the banks, which earned hundreds of millions of dollars in fees. It worked well for the hedge funds, which made billions of dollars in profits. But it didn't work for average taxpayers, who had to shoulder the tax burden these hedge funds shrugged off with the aid of the banks. And it didn't work for the financial system, which is still recovering from a devastating crisis brought on by excess risk, and remains ill-equipped to withstand another shock from over-leveraged financial institutions.

In essence, today's hearing is about a series of fictions, one piled on top of another, fictions that major banks and their hedge fund clients used to avoid taxes and federal leverage limits.

The key financial product involved in these fictions is called a "basket option." The basket options examined by the Subcommittee were developed and sold by two banks, Deutsche Bank AG and Barclays Bank PLC, to more than a dozen hedge funds. Together, the banks sold 199 basket options to hedge funds that used them to make over $100 billion in trades. Two of the largest basket option users were Renaissance Technologies LLC, known as RenTec, and George Weiss Associates.

Although there were minor differences in specifics, the basket option basics worked like this. The bank sold its hedge-fund client a structured financial product, labeled an "option," whose payoff equaled the profits generated by a "basket" of securities held in a designated account at the bank. The basket, here, is key. It was an open account with ever-changing contents. Technically, the account and the securities it contained were held in the name of the banks in its own trading account. The hedge fund put up 10% of the cash needed to buy the securities, and the bank lent the other 90%.

This arrangement included a number of fictions which defied reality, but resulted in big profits for the hedge funds and the banks.

First, though the structure was designed to create the appearance that the bank owned the assets in the basket option account, the hedge fund made all the trading decisions for those accounts – and in fact, used the bank's computerized trading system to execute trades in the account. RenTec estimates its trading through basket option accounts averaged more than 100,000 trades each day, or about 30 million trades a year. Also, the hedge fund reaped all of the trading profits, even though the financial structure created the illusion that the bank owned the assets. The beneficial owner, the real owner, was the hedge fund.

Second, the hedge fund's control of all the trading for the basket option account demolishes the fiction of a legitimate option. So the hedge funds set up new entities, which they controlled, to serve one function, and that was to act as the option holder. The hedge funds would then claim that their control of the option holder was totally independent of their role in making the trading decisions for the basket option account. Documents we will explore today show the extraordinary lengths to which RenTec and the banks went to perpetuate the illusion that the option holder and trader were somehow independent, when in fact the hedge fund, RenTec, played both roles.

The fictional option was structured so that it could be exercised more than one year after it was created. Under that structure, the hedge funds claimed that trading profits from the account were long-term capital gains and thereby qualified for the reduced long-term capital gains tax rate.

The tax code gives long-term capital gains a reduced rate on the theory that it provides an incentive for investors to risk their capital on the kind of long-term investments that grow the economy and create jobs. The high-volume trading that, for example, RenTec conducted through its basket options doesn't meet that test. When securities are held for weeks or days or even seconds, it's surreal to characterize those trading profits as long-term capital gains.

But that's what the hedge funds did. The banks and hedge funds used the fictional option structure to collapse millions of individual trades into one transaction, the execution of an option. As if by magic, the option structure transformed what would be short-term capital gains from an ordinary trading account into long-term capital gains subject to lower taxes. Subcommittee staff estimates, based on basket option profits that RenTec reported from 2000 to 2013, that RenTec avoided paying more than $6 billion in taxes.

That's a lot of money even by Washington standards. It would, for example, pay for almost two-thirds of the cost to replenish the Highway Trust Fund so that it doesn't run out of money next month and create havoc in road projects around the country.

This isn't the first time options have been abused to try to convert short-term trading profits into long-term capital gains. That's why, in 1999, Congress passed a law in part to stop that practice, Section 1260 of the tax code. The basket options at issue here were written to skirt Section 1260's prohibitions. In 2010, the IRS warned that the type of basket options used here could not claim the lower long-term capital gains tax rate. Despite that IRS warning, Barclays continued to sell basket options to RenTec for another two years, before finally revising its option product in 2013, so that the options expired in less than a year and couldn't be used to game the tax code. Deutsche Bank suspended its issuance of new basket options after the 2010 IRS warning, but continued to administer multiple basket option accounts already in existence.

It also resumed offering them in 2012, although with a term of less than one year and a requirement that the option holder treat the profits as short-term capital gains.

Tax avoidance through financial engineering is not the only problematic element here. These banks and hedge funds also used basket option accounts to circumvent regulations designed to limit systemic risks to the banking system posed by excessive leverage – that is, excessive lending to finance stock trading.

The stock market crash of 1929 devastated the U.S. economy, not just by the collapse of thousands of stock speculators, but also by the failure of thousands of banks that had lent them money and couldn't collect on the loans. In the aftermath of the Great Depression, Congress enacted laws limiting the use of borrowed money to trade securities. Those limits are included in a set of "margin rules" that essentially prohibit U.S. broker-dealers from lending more than $1 to brokerage clients for each $1 of the client's own money in the account – in other words, for every $2 in a brokerage account, only $1 of that $2 can be borrowed from the broker.

Had the hedge funds involved in these transactions been using normal brokerage accounts, they would have been subject to the 2-to-1 leverage limit. But because the basket option accounts were opened in the name of the banks in their own proprietary trading accounts, it looked as though the money placed into those accounts was the banks' own proprietary money rather than money they were loaning to a customer. This is another fiction. The banks and hedge funds pretended the bank funds were not loans, even though the hedge funds paid financing fees and posted collateral.

So instead of complying with the 2-to-1 leverage ratio, the banks offered their hedge-fund clients leverage as high as 20-to-1. RenTec used the increased leverage to borrow billions of dollars for its trading strategies, which produced huge profits for RenTec, while the lending generated huge additional fees for the banks.

But as we've learned over and over – in the Depression, in the 1990s collapse of the hedge fund Long Term Capital Management, and in the financial crisis from which we're still recovering – excessive leverage doesn't always produce profits. Sometimes it produces losses. And when huge losses happen, they can bring down not just a reckless borrower, but the financial institution that lent it money, and that failure can ripple throughout the entire financial system. While it appears the two banks the Subcommittee has examined have stopped selling basket options as a way to claim long-term capital gains rates, they are still selling these products as a way to avoid leverage limits – meaning our financial system and economy still face unnecessary risk.

RenTec, through its Medallion Funds, used basket options to produce profits from 1999 to 2013 totaling more than $30 billion. The banks charged financing, trading, and other fees that, over the same period, produced revenues totaling about $570 million for Deutsche Bank and $655 million for Barclays. Basket options were clearly a lucrative line of business for the participants.

But this money-maker was built on an interlocking series of fictions. The key fiction is the option itself – the idea that this structure was really an option, when in fact what it did was give hedge funds the profits from buying and selling assets in accounts that the hedge funds

themselves controlled. It was fiction to treat the banks as the true owners of the basket option assets, when the hedge funds controlled and executed all of the millions of trades in the accounts, the hedge funds paid the daily trading costs, and the hedge funds reaped the profits. It was fiction to suggest that the borrowed money that financed the trades was considered proprietary funds of the banks, rather than loans to the hedge funds. It was fiction to treat the profits from trades lasting days or even seconds as long-term capital gains deserving a reduced tax rate. And it was a fiction to pretend that hedge funds were not acting both as option-holder and as trade decision-maker. These were all fictions, but fictions with real-world consequences: they shifted billions of dollars in tax burden onto the backs of ordinary taxpayers, and they added billions of dollars in hidden risks to our financial system.

Congress and financial regulators can and should work together to stop these abuses.

The IRS should seek to collect taxes owed on billions of dollars in basket option profits unjustifiably claimed as long-term capital gains.

Federal financial regulators should make clear to banks that participating in abusive structures designed to avoid leverage limits and taxes is unacceptable, and penalize the banks that do.

The Financial Stability Oversight Council, working with other agencies, should establish reporting and data collection requirements to detect and stop abuse of structured financial products to circumvent leverage limits that safeguard our economy.

Finally, Treasury, and the IRS should remove impediments to audits of large partnerships, like hedge funds, 99% of which today escape IRS audits – meaning we are largely blind to how many other hedge funds may be using these structures to avoid risk limits and taxes.

These measures would help protect the interests of ordinary Americans who pay their taxes and must pay the price for tax avoidance schemes. It is these same Americans who would bear the burden of economic devastation that unaddressed systemic risks can cause.

I want to thank Senator McCain and his staff for their hard work in making today's hearing and our bipartisan report possible. The staff of this Subcommittee, majority and minority, through the years have been able to work together as one team. I'm very proud of them.

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