

July 22, 2014

**TESTIMONY OF BARRY BAUSANO, PRESIDENT, DEUTSCHE BANK SECURITIES INC. AND SATISH RAMAKRISHNA, GLOBAL HEAD RISK & PRICING FOR GLOBAL PRIME FINANCE, DEUTSCHE BANK SECURITIES INC. BEFORE THE U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS**

Chairman Levin, Ranking Member McCain, and Members of the Subcommittee:

On behalf of Deutsche Bank Securities Inc., we respectfully submit the following joint written statement by Barry Bausano and Satish Ramakrishna.

Barry Bausano is currently the President of Deutsche Bank Securities Inc. and Co-Head of Deutsche Bank's Global Prime Finance Business. Mr. Bausano is based in the New York office of Deutsche Bank and has worked at Deutsche Bank for approximately twelve years.

Satish Ramakrishna is currently Managing Director and Global Head, Risk & Pricing for Global Prime Finance, Deutsche Bank Securities Inc. Mr. Ramakrishna is based in the New York office of Deutsche Bank and has worked at Deutsche Bank for approximately sixteen years.

This testimony is submitted in response to the Subcommittee's invitation to provide a written statement regarding barrier option contracts, which Deutsche Bank called MAPS, an acronym for Managed Account Products. MAPS was an option with the advantages of providing clients with increased leverage, limitations on downside risk, and market anonymity. Derivative financial instruments are a critical component of global finance as they allow participants to alter risk and the distribution of returns relative to holding the underlying investments. For the reasons discussed below,

Deutsche Bank strongly believes that it acted at all times responsibly, indeed proactively, in its ongoing consideration of MAPS in the light of evolving views regarding the regulatory landscape surrounding derivative products, and that its conduct demonstrates the Bank's strong commitment to be well within the bounds of the law.

We further understand, however, that the IRS has expressed concerns with a particular type of barrier option contract and the potential for associated long-term capital gain treatment as set forth in an IRS Generic Legal Advice Memorandum, or GLAM, issued November 12, 2010. Importantly, in 2010, Deutsche Bank was not entering into barrier option contracts as described in the GLAM. Indeed, Deutsche Bank had ceased offering a product based on agreements similar to the ones described in the GLAM in 2008, when Deutsche Bank, in consultation with outside counsel, independently restructured its MAPS product. Despite having no knowledge of any IRS intention to release the GLAM, or that the IRS was even auditing barrier option contracts, Deutsche Bank proactively addressed virtually every factor considered in the GLAM approximately two years before the issuance of the GLAM. The restructured Deutsche Bank product is referred to in this testimony as New MAPS.

It is important to note the limited scope of the use of New MAPS at Deutsche Bank. From 2008 through today, Deutsche Bank has entered into New MAPS options with only one client, Mosel LP, a Renaissance Technologies LLC affiliate. And even with that one client, Deutsche Bank has entered into only one long-term option since the IRS's issuance of the GLAM. That option was negotiated prior to the GLAM and entered into on the business day following the GLAM's issuance—and only after Deutsche Bank conferred with outside counsel to confirm that New MAPS was not the

same structure as the product described in the GLAM. Indeed, and importantly, shortly after issuance of the GLAM, Deutsche Bank reassessed its participation in barrier option contracts. Despite its belief that New MAPS was in compliance with applicable laws and regulations, Deutsche Bank decided that it did not wish to risk being associated with any controversy over the tax treatment of MAPS. Therefore, it decided to cease entering into any New MAPS transactions with a duration of more than one year.

We believe that Deutsche Bank acted appropriately at all times with respect to the barrier option contracts it offered. Deutsche Bank affirmatively and proactively undertook steps to ensure compliance with applicable tax and securities laws and regulations. While we understand the Subcommittee is studying tax policy in this area, and such issues are worthy of discussion, there should be no question that Deutsche Bank did its best to ensure compliance with the laws and regulations as written and understood by the subject matter experts at the time. We do note, however, that it is a widely accepted principle that tax consequences differ among various financial instruments. New MAPS, which was an option, was treated by Deutsche Bank in accordance with the tax rules relating to financial derivatives at all times.

The following is a more detailed description of Deutsche Bank's participation in MAPS.

#### The MAPS Product

In 1998, Deutsche Bank acquired certain business lines of National Westminster Bank, or NatWest. One such acquired business line offered MAPS to certain hedge fund clients of NatWest. MAPS continued as an important but limited offering of Deutsche Bank after the 1998 acquisition, as it safely met the demand for

increased leverage for a limited set of clients whose trading strategy was suitable for such a product. In MAPS, a client holds an option over a basket of securities, long and short, held by Deutsche Bank. The basket is traded by an affiliate of the option holder using the option holder's own trading strategy, but within strict parameters set by Deutsche Bank. Accordingly, MAPS was offered to and executed with only a limited group of institutional clients that followed balanced trading strategies that consistently fit within those parameters. Unlike many of its peers at that time, Deutsche Bank did not have a well-developed prime brokerage offering that met client need for increased leverage. MAPS allowed Deutsche Bank to compete for the business of those clients that wanted increased leverage and had trading strategies suitable for such a product.

Significantly, MAPS was not marketed by Deutsche Bank as a means of helping clients avoid or minimize taxes. In fact, when Deutsche Bank initially sought legal advice in connection with offering MAPS as a product, it did so to ensure that the structure was an option under the securities laws, and not because of any questions about the tax treatment of the option.

As noted above, MAPS itself was fundamentally an option on a trading strategy. The option buyer and holder, a hedge fund, paid a premium to Deutsche Bank to purchase the option. If the strategy did not generate gains in excess of the initial premium, the buyer simply paid for the cost of the option and use of Deutsche Bank's capital and received the remaining value in the option at maturity. However, if the strategy generated positive returns, the buyer received the amount of those returns, less the costs and fees for the option paid to Deutsche Bank. The Bank engaged an investment advisor affiliated with the option holder to run the trading strategy within

strict parameters and to purchase in the Bank's own account the securities or positions that comprised the strategy as a hedge to the option.

While Deutsche Bank's exposure under the option was hedged, MAPS was not without risk to the Bank, particularly absent the controls we put in place. If the value of the securities held in the proprietary account fell below the barrier price of the option, the Bank bore all losses.

### New MAPS

In August 2007, hedge funds employing a statistical-arbitrage, market-neutral strategy experienced what has come to be known as the "quant quake." The quant quake occurred over four days when it is believed the liquidation of a single quantitatively constructed portfolio triggered a domino effect across numerous "quant funds" running similar leveraged, market-neutral strategies. Many of those funds suffered enormous losses, with some incurring double-digit losses within a single day. Deutsche Bank clients utilizing the MAPS product in August 2007 (a total of six clients at the time) largely employed a leveraged, statistical-arbitrage, market-neutral strategy and were among the affected funds. Historically, these funds – because of sophisticated algorithms to balance long and short positions – had not experienced significant swings in performance. Therefore, they were viewed as low risk. The quant quake demonstrated that such funds were riskier than believed because of the high correlation in positions held by the different funds employing similar strategies.

As a result, in late 2007, the Bank's risk managers began to consider ways to provide the Bank with better protection if the value of the portfolio of securities the Bank was holding relating to MAPS suddenly dropped. At the same time, those in the

Bank's control functions, including legal, tax, and compliance, were assessing MAPS in light of ongoing dialogue and observations concerning the regulatory landscape surrounding derivatives products. Those efforts were merged together as Deutsche Bank worked to restructure MAPS and develop "New MAPS" in 2007 and 2008.

The MAPS restructuring included the following changes:

- First, New MAPS included key risk-reduction terms that provided the Bank with certain rights at declining levels of account value—first to require the investment advisor to reduce its leverage, second to take over the management of the portfolio, and third to assume control and liquidate the positions being traded by the investment advisor in Deutsche Bank's proprietary account.
- Second, the New MAPS agreements further provided that the securities traded for each option would be held in separate subaccounts, and the options staggered. This reduced the risk that a loss in value in one account would de-value options in other subaccounts.
- Third, New MAPS was changed from an American to a European-style option, which could not be terminated early without forfeiting a significant portion of the premium.
- Fourth, the investment advisor's duties to the Bank, which were set forth in an Investment Advisory Agreement, were clarified under New MAPS, and the fee paid to the advisor was changed to conform to standard market practices for investment advisors.

- Fifth, in New MAPS, Deutsche Bank ensured that it expressly retained important rights relating to the underlying securities, including distribution rights and voting rights.

In addition to these changes to the product, the Bank took steps to improve internal controls and limit the Bank's risk under New MAPS. Performance of the securities traded in the subaccounts was monitored on an intra-day basis, allowing for almost immediate detection of subaccount changes in value. Such monitoring enabled Deutsche Bank to assume complete control of the relevant portfolio in the event of an applicable threshold breach.

Deutsche Bank also ensured that the revised option price calculation accurately compensated the Bank for its risks and costs, including the costs of utilizing the Bank's capital. Pricing was done through the use of traditional option-pricing methods and the strike price was adjusted so that the cost of the option and the financing cost of the portfolio were reflected in the strike price of the option. Specifically, the option was priced based on an analysis of the risk that the Bank was assuming by entering into the option, as well as the time value of the capital the Bank was using to purchase the securities that comprised the portfolio.

In sum, Deutsche Bank priced the MAPS option as an option, managed it as an option, and documented it as an option. It did so because MAPS was an option and the Bank was compensated, and managed its risk, accordingly.

Precisely because it was an option, MAPS offered a number of unique advantages to clients. As the Subcommittee is aware, one of those advantages is that gains on options with durations of more than one year are treated as long-term capital

gains. In this respect, MAPS was not different from any other long-dated option. However, the MAPS product offered many economic and other significant non-tax advantages for the option buyer.<sup>1</sup> Structuring financial products to meet client needs for risk and return is a necessary function of capital markets.

We identify the following three non-tax advantages of New MAPS that we consider most significant for purposes of this statement. First, as discussed above, Deutsche Bank was comfortable providing the option buyer with greater leverage at the fund level than it would have allowed in a traditional prime brokerage relationship. This was because the Bank had greater visibility, control, and protections in place relating to the underlying trading activity than it did in a prime brokerage account. Indeed, MAPS provided the option holder with leverage of up to eighteen times the premium compared with what the Bank could safely provide in the closest prime brokerage alternative, enhanced prime brokerage. Second, the MAPS option limited the client's downside risk to the premium it paid to purchase the option. Third, the client could pursue its trading strategy anonymously, because any market transactions associated with the trading strategy were made by Deutsche Bank, in Deutsche Bank's own name.

On the leverage point, it is important to emphasize that, while MAPS permitted clients to obtain leverage greater than other products offered by the Bank, the risk associated with such increased leverage was managed pursuant to the transactional terms. As discussed above, those terms were revised in connection with the 2008

---

<sup>1</sup> Indeed, there were clients of Deutsche Bank that entered into MAPS trades that did not seek the long-term capital gain treatment of the option discussed in the GLAM, as those clients never traded a MAPS option with a tenor of more than one year.



restructuring to allow for improved management of the risk. MAPS, therefore, did not expose the Bank to excessive risk. In addition, unlike a traditional prime brokerage account, in MAPS the securities are owned and held by the Bank, providing the Bank with transparency into the portfolio and the ability to control the account's holdings, as well as the right to vote the securities. Moreover, New MAPS was entered into with only one hedge fund customer, Renaissance, a fund that pursued a market neutral investment strategy and that had historically consistent returns, thus reducing, albeit not eliminating, market risks.

DB Responds to the GLAM, and Discusses MAPS with its Regulators

Although discussed earlier in this statement, Deutsche Bank's actions after IRS's issuance of the GLAM on November 12, 2010, merit separate discussion and specific consideration.<sup>2</sup> Following the release of the GLAM, the Bank discussed the GLAM with its outside tax counsel, and counsel affirmed that the GLAM did not change their prior views on the New MAPS product. Nevertheless, and despite the Bank's view that New MAPS was outside the scope of the GLAM, the Bank decided it would no longer enter New MAPS options with its one remaining New MAPS client. It did so out of a desire to avoid being associated with any controversy over the tax treatment of MAPS that might result from the GLAM.<sup>3</sup> The Bank made this decision even though New MAPS was

---

<sup>2</sup> It bears noting that a GLAM, by its terms, is not to be cited or relied on as precedent.

<sup>3</sup> Renaissance subsequently expressed a desire to engage in New MAPS trades having a tenor of less than one year. Deutsche Bank agreed because such trades do not present the opportunity for the counterparty to claim long-term capital gains treatment for any gains and therefore do not present the same reputational risk. In addition, following the GLAM, Deutsche Bank briefly discussed with Renaissance an alternative to MAPS in the form of an option linked to the amount a trading strategy outperformed

entirely consistent with the requirements of the Bank's Non-Prosecution Agreement with the U.S. Department of Justice.<sup>4</sup>

### Conclusion

In sum, with respect to MAPS, Deutsche Bank affirmatively took steps, on its own initiative, to ensure that its conduct was well within the boundaries set by applicable legal requirements. Deutsche Bank: (1) ceased entering into the transaction described in the 2010 IRS GLAM two years before the GLAM was issued; (2) entered into New MAPS with only one client from the end of 2008 through the 2010 GLAM; and (3) completely stopped entering into New MAPS transactions with a duration of more than one year shortly after issuance of the GLAM. This is so, even though, as of today, neither the IRS nor any court or regulator has found that a New MAPS option (or indeed, any Deutsche Bank MAPS option) did not qualify as a derivative for tax, securities, or any other purposes. Deutsche Bank believes strongly that it acted appropriately in

---

the S&P 500 Index. Although this concept was discussed in good faith with Renaissance, it was widely recognized within Deutsche Bank that it was highly unlikely the revised structure would overcome the reputational risks that caused the Bank to cease entering New MAPS. In any case, the project was abandoned well before it reached a stage where the potential reputational impact would have been reviewed by the Bank's tax and legal functions.

<sup>4</sup> New MAPS was consistent with the requirements of the Non-Prosecution Agreement because it was supported by an appropriate legal opinion and because the transaction, to this day, does not appear as a listed transaction or in any category that is prohibited by the NPA or DB's internal policies. In addition, it bears noting that the Bank discussed the MAPS product with certain regulators as early as 2007, and it discussed the MAPS product with the Department of Justice, the IRS, the SEC, and the Independent Expert Deutsche Bank retained as part of the NPA. All of these discussions took place well before this Committee began its investigation. Indeed, the Bank communicated with the Independent Expert about MAPS at a meeting on February 3, 2011, and discussed the MAPS product with the Department of Justice and the IRS at several meetings in 2012 and 2013.

entering the New MAPS options when it did, and that it acted conservatively and responsibly when it decided to stop entering them for reputational reasons after the issuance of the GLAM.

Thank you for this opportunity to submit this written testimony, and we will be prepared at the hearing to address the topics raised in your letter of July 9, 2014.