Blogs
May 02, 2016
Could the Use of Derivatives Create a “Toxic Brew?”

This post continues my consideration of some conceptual questions underlying the SEC's proposed Rule 18f-4. The following comment on the proposal caught my attention:

> Congress is stating [in Section 1(b) of the Investment Company Act] that there is a problem when leverage unduly increases the "speculative character" (what we now call risk) of the investments. This was particularly a problem back in the 1930s … [when the] combination of opaque products, complex capital structures, pyramiding, bad corporate governance, and leverage created a toxic brew that resulted in serious losses for unwary investors.

Although this wasn't the commenter's point, it struck me that derivatives have the potential to present today all of the problems that senior securities presented in the 1930. **Opacity** The SEC's Division of Economic and Risk Analysis released a companion white paper for proposed Rule 18f-4. The white paper catalogued the following challenges encountered when trying to use fund financial reports to determine the notional amount of derivatives used by mutual funds.

1. A significant percentage of funds do not clearly report the notional amounts for various derivatives or provide precise descriptions of notional amounts.
2. There is no standardized reporting of derivatives.
3. When notional amounts were reported, there were instances where they were not consistent with other parameters of the derivatives.
4. Many derivatives or underlying assets were denominated in foreign currencies.
5. For some types of derivatives, funds may enter into offsetting transactions in order to reduce or eliminate their economic exposure. In some cases, both initial and offsetting transactions continued to be reported on the fund's schedule of investments.

Complexity The terms of some derivatives, such as credit default swaps, can be quite complicated. The ability of derivatives to hedge, replicate or magnify portfolio risks adds to their complexity. Although derivatives do not complicate a fund's capital structure as such, if a derivative is booked as a single position, it may shift from being an asset to a liability as it moves in and out of the money. **Pyramiding** Proposed Rule 18f-4 recognizes that it is possible to invest in a derivative for which the underlying asset is a fund or account of other derivatives. **Governance** The Investment Company Act and related regulations regarding independent directors have greatly improved fund governance as compared to the 1930s. But the opacity and complexity of derivatives can also challenge the directors' ability to oversee portfolio risks. **Leverage** None of the previous factors would be troublesome but for the ability of derivatives to magnify a fund's returns, whether positive or negative. The challenge is that, while senior securities in the 1930s would invariable increase a fund's leverage, derivatives frequently do not. Many of the comment letters address the difficulty of separating derivatives used for leverage from other uses. This will be a critical aspect of any eventual reforms. **Derivatives Should Be Regulated, Not Banned** It's worthwhile to reflect that Congress's response to complex capital structures in 1940 was to ban them. Mutual funds may have only one class of common equity and borrowings are limited to bank loans. The comment letter from an investor advocate questioned whether the SEC should take the same approach to derivatives by prohibiting them altogether. Here it's important to keep the limitations of Section 18 in mind. Banning derivatives would probably drive funds to other leveraged investments that fall outside the scope of Section 18. Increasing investments in sticky jump Z-tranches in the name of reducing portfolio complexity would be self-defeating. On the other hand, it should be hard to object to the SEC doing what it can to prevent derivatives from ever becoming a "toxic brew."

Explore more in

Investment Management