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Reproposed Rule 18f-4—Leveraged/Inverse Funds vs. Margin Accounts

We previously explored the treatment of "leveraged/inverse investment vehicles" under SEC's reproposal for regulating how funds use derivatives in compliance with Section 18 of the Investment Company Act of 1940 (proposed Rule 18f-4), and related proposed Rule 15l-2 under the Securities and Exchange Act of 1934 and Rule 211h-1 under the Investment Advisers Act of 1940. In this post we consider the options available to retail investors for leveraged trading and whether a more consistent approach may make sense.

Comparison of Margin Accounts to Leveraged Funds

Regulation T regulates extensions of credit by broker/dealers to their customers for purposes of margin trading. To oversimplify things, Reg T limits the amount of credit to 50% of the value of the securities held in a margin account. If, for example, I have $10,000 in my margin account, I could purchase $20,000 of indexed ETF shares by financing the additional $10,000 through a margin loan from my broker. The resulting leverage ratio would be 2:1; my results (good or bad, and ignoring interest and other costs) would be twice that of investing without a margin loan. This would be the limit of the initial leverage permitted in a margin account; brokers may, and many do, impose more stringent limitations. By contrast, under proposed Rule 18f-4, I could purchase a Leveraged Fund that seeks returns equal to 300% of the same index. This Leveraged Fund would have a leverage ratio of 3:1, half again as large as a margin account. But wait, a Leveraged Fund is also an eligible margin security, so I could buy it through my margin account. This means that I could turn my $10,000 into $20,000 of the 300% Leveraged Fund, obtaining an effective leverage ratio of 6:1.

Should Leveraged Funds Be Treated Differently?

If the SEC's proposal would permit retail investors to purchase Leveraged Funds with a 3:1 leverage ratio, why won't the SEC permit retail investors to achieve the same leverage in their margin accounts? The answer is that the Federal Reserve Board, not the SEC, is responsible for Reg T. Parity between margin accounts and Leveraged Funds would require coordination by two very different financial regulators. The difference between the limitations of Reg T and proposed Rule 18f-4 could push a retail investor seeking more leverage than permitted in a margin account to adopt a maximally leveraged strategy. To illustrate why this might happen, suppose Reg T were amended to permit a 3:1 leverage ratio. I could take $10,000 and invest in $30,000 of an unleveraged S&P 500 Index fund. If the index rose 1% the next day, I would be ahead $300. Technically, I could use the $300 gain for another $300 margin loan and buy more shares of the index fund, increasing my leverage as compared to my initial $10,000 investment. But I wouldn't—I just want to stake $10,000 on my bullish view of the index, not double down every time I'm ahead. But this is exactly what many Leveraged Funds do—trading at the end or beginning of each day to maintain a constant 3:1 leverage ratio. The constant releveraging of gains and deleveraging of losses by a Leveraged Fund can produce different results from a simple margin investment. In my oversimplified example, in 2017, when the S&P 500 rose 19.4%, the gains in my margin account (ignoring costs) would have been $5826, whereas the gain in 2017 on a $10,000 investment in an actual 300% S&P 500 ETF would have been about $7100 as a result of using unrealized gains to increase the ETF's leverage each day back to a 3:1 ratio. The Leveraged Fund may underperform as well as outperform an equally leveraged margin account.

What Should the SEC Do?

I have no idea what the "right" leverage ratio would be for retail investors, but I think the goal of investor protection would be better served by allowing investors to achieve the same result through a margin account, over which they have complete control, as they might attempt by investing in a Leveraged Fund. Without the cooperation of the Federal Reserve Board, however, the SEC cannot raise the leverage ratio for margin accounts. Unless the SEC lowers to 200% the leverage ratio permitted in the final version of Rule 18f-4, we will have to live with the inconsistency. In any event, the SEC could prevent retail investors from using a margin account to double the effective leverage of a Leveraged Fund. If the SEC has authority to require broker/dealers and investment advisers to elevate their oversight of how retail investors use Leveraged Funds, they should also have the power to prohibit broker/dealers from holding Leveraged Funds in a retail investor's margin account. This would limit the potential leverage a retail investor might obtain by combining the Reg T and proposed Rule 18f-4 limits.

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