Blogs
March 31, 2021
Asset Management ADVocate

What Risks May Be Associated with Derivatives Transactions

Having completed our review of derivatives transactions, we now consider the risks such transactions may pose. Rule 18f-4(a) defines "derivatives risks" to include "leverage, market, counterparty, liquidity, operational, and legal risks and any other [material] risks." The adopting release (the "Release") provides helpful descriptions of these risks and some examples.

Specific Risks

The Release provides the following description of the risks specified in the definition of derivatives risks.

Type of Risk	Description
Leverage	The risk that derivatives transactions can magnify the fund's gains and losses.
Market	The risk from potential adverse market movements in relation to the fund's derivatives positions; the risk that markets could experience a change in volatility that adversely impacts fund returns and the fund's obligations and exposures.
Counterparty	The risk that a counterparty on a derivatives transaction may not be willing or able to perform its obligations under the derivatives contract, and the related risks of having concentrated exposure to such a counterparty.
Liquidity	The risk involving the liquidity demands that derivatives can create to make payments of margin, collateral, or settlement payments to counterparties.
Operational	The risk related to potential operational issues, including documentation issues, settlement issues, systems failures, inadequate controls, and human error.
Legal	The risk from insufficient documentation, insufficient capacity or authority of counterparty, or legality or enforceability of a contract.

The Release cites other possibly material risks of an idiosyncratic nature, such as the "risk that a complex OTC derivative could fail to produce the expected result (e.g., because historical correlations change or unexpected merger events occur)" and "political risk (e.g., events that affect currencies)."

Examples

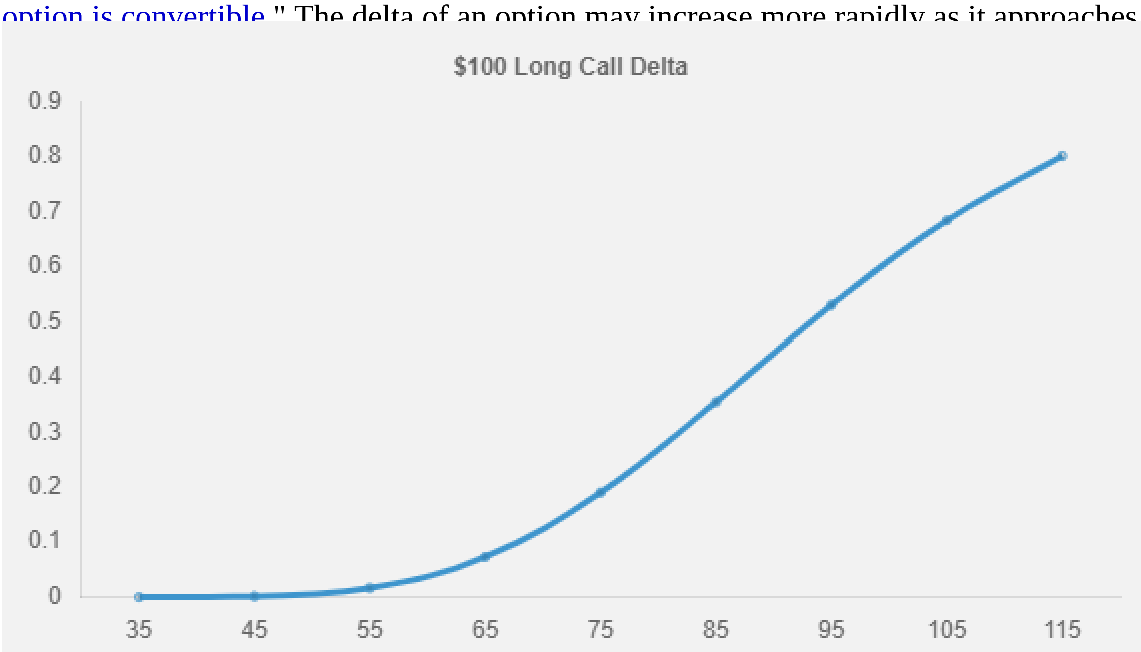
The Release acknowledged that not every derivatives transaction will entail every type of derivatives risk.

> [A] fund that uses derivatives to hedge currency risks would not be introducing leverage risk, but could still introduce other risks, including counterparty risk and a risk of selling investments to meet margin calls."

Even notionally small derivatives transactions may entail significant risks. For example:

> derivatives with non-linear or path-dependent returns, may pose risks that require monitoring even when the derivatives' delta-adjusted notional amount represents a small portion of net asset value. In such case, because of the non-linear payout profiles associated with put and call options, changes in the value of the option's underlying reference asset can increase the option's delta, and thus a fund's derivatives exposure from the option."

"Delta refers to the ratio of change in the value of an option to the change in value of the asset into which the option is convertible." The delta of an option may increase more rapidly as it approaches being "in the money," ... of the option. The ... lta and the x-axis is the



Now that we have identified the relevant risks, we will take a moment to revisit the big picture, namely, the alternative methods offered by Rule 18f-4 for managing derivatives risks.

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