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MARKETS

# What Is a Total Return Swap and How Did Archegos Capital Use It?

The common Wall Street derivative has for years faced scrutiny from regulators and some well-known investors

Bill Hwang's Archegos Capital used total return swaps instead of simply buying shares of companies.

PHOTO: EMILE WAMSTEKER/BLOOMBERG NEWS

*By Quentin Webb, Alexander Osipovich and Peter Santilli*

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Archegos Capital Management's investments were partly concentrated in a common Wall Street derivative, called a total return swap, that has for years faced scrutiny from regulators and even some well-known investors.

Here's how the use of swaps figures in Archegos's problems.

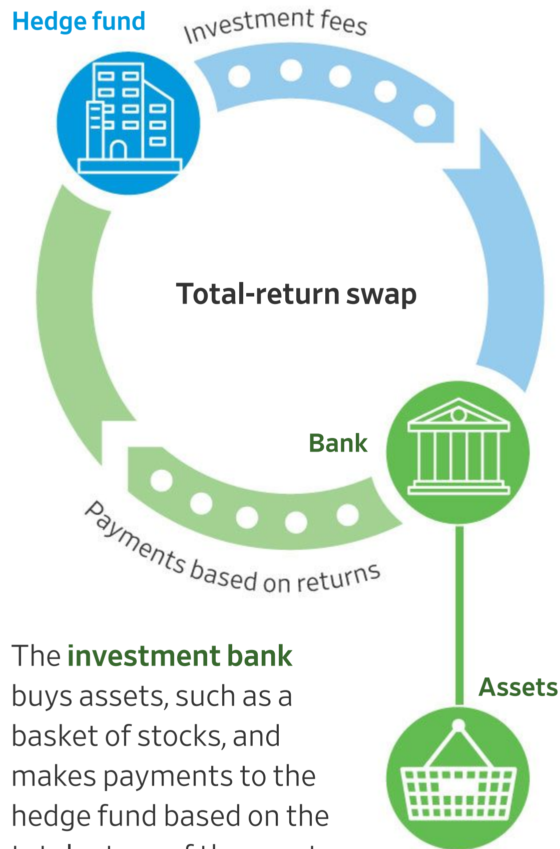
**What is a total return swap?**

Total return swaps are contracts brokered by Wall Street banks that allow a user to take on the profits and losses of a portfolio of stocks or other assets in exchange for a fee. Swaps allow investors to take huge positions while posting limited funds up front, in essence borrowing from the bank.

Investor Bill Hwang of Archegos rattled markets in the past week after his firm and its banks began liquidating huge positions in blue-chip companies, according to people familiar with the transactions. Archegos is estimated to have managed about $10 billion of its own money, according to people familiar with the fund. Its total positions that were unwound approached $30 billion thanks to leverage Archegos obtained from banks.

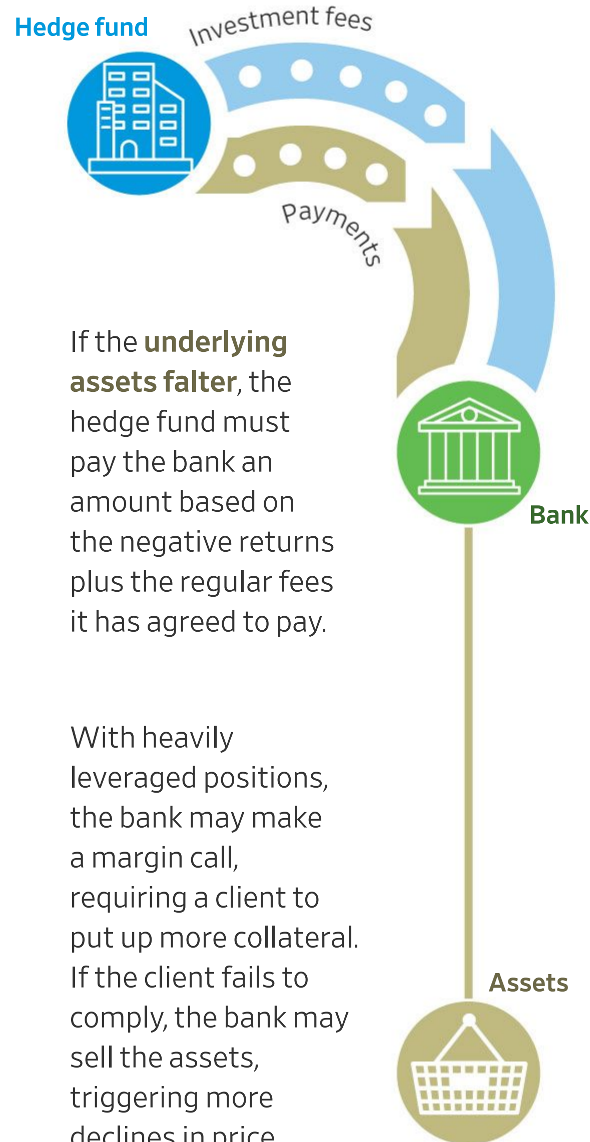
**How total-return swaps work**

A total return swap allows an investor, such as a **hedge fund**, to invest in assets without owning them. In the deal, the fund makes payments to an investment bank based on fees and an interest rate such as Libor.




The **investment bank** buys assets, such as a basket of stocks, and makes payments to the hedge fund based on the total return of the assets.

The bank owns the assets, not the hedge fund. So while a hedge fund may have heavy exposure to a stock through swaps with multiple banks, it isn't subject to disclosure laws that a very large shareholder would be.




If the **underlying assets falter**, the hedge fund must pay the bank an amount based on the negative returns plus the regular fees it has agreed to pay.

With heavily leveraged positions, the bank may make a margin call, requiring a client to put up more collateral. If the client fails to comply, the bank may sell the assets, triggering more declines in price.

**How did Archegos use total return swaps?**

The firm's positions were either in big, concentrated positions in companies' shares or held in total return swaps.

Using total return swaps instead of simply buying shares of companies provided two main benefits for Archegos.

The use of these types of derivatives helped enable the firm to increase its leverage, in essence owning more of an asset or assets than its cash would have otherwise allowed it to. In addition, these swaps allow investors like Mr. Hwang to maintain their anonymity.

**Why do investors like total return swaps?**

Many investors say swaps are a useful tool that allows them to access markets they would otherwise struggle to participate in, and lets them bet on moves in a stock or other asset without tying up as much capital as buying shares.

"Total return swaps are just part of the derivatives tool kit," said Stephen Howard, chief executive officer of Howard Trading Ltd. in Hong Kong. "What is probably questionable at the moment is, was too much leverage extended to one counterparty by the banks, and is there a lack of transparency about the reporting requirements on total return swaps?"

It could be useful to require investors to report large positions held through derivatives, he said.

**What are the risks of total return swaps?**

How risky a swap is for a broker depends on a range of factors, including the collateral it holds, the size of the position, the creditworthiness of its counterparty, and how easy it is to trade in the underlying shares, Mr. Howard said. "The total return swap has a variety of valid uses, it is flexible and allows people to achieve their investment objectives," he said.

ARCHEGOS ROLE IN MARKET TURMOIL

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- Who Is Archegos Fund Manager Bill Hwang?

Total return swaps can also be a cost-effective way for smaller investors to place a range of bets without, for example, going to the trouble of setting up in different markets, said David Rogers, a partner at Quinlan & Associates, a Hong Kong-based financial consulting firm.

"Total return swaps have proven now for a long time that they're a very effective way for end-investors to get exposure to global markets, specific stocks, sectors, and products," said Mr. Rogers.

**Why do some people believe total return swaps are problematic?**

The types of swaps used by Archegos and hundreds of other firms are among the most controversial products on Wall Street. Proponents say these types of derivatives increase market access and improve liquidity. Critics have said they increase leverage past the point of acceptable, adding risks to other investors in the market.

In his 2003 letter to investors, Warren Buffett explored the risk of total return swaps and concluded that the product and derivatives like it were "financial

weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."

### What do regulators think?

The Securities and Exchange Commission has so far taken the position that investors aren't required to disclose positions in equity derivatives like total return swaps unless they have voting power over related shares. If an investor doesn't have voting power, they aren't deemed to be the ultimate owner of the shares—or what U.S. law calls the "beneficial owner." Investors who become the beneficial owner of more than 10% of a company's shares are also deemed to be corporate insiders, and thus must report changes in their holdings through other public filings.

So, even as Archegos was estimated to have had exposure to the economics of more than 10% of multiple companies' shares, it didn't have to report those positions.

### What is happening with total return swaps now?

In 2011, the law firm Wachtell, Lipton, Rosen & Katz asked the SEC to require disclosure of any derivatives that grant an investor a "profit or share in any profit derived from any increase in the value of the subject security."

The SEC hasn't acted on the request, but it is close to implementing a broad set of new regulations governing security-based swaps, including the type of swaps that Archegos is said to have used. Under rules taking effect in coming months after years of delays, banks and other firms that trade large quantities of such swaps must comply with a variety of requirements, including reporting each trade to

giant databases that regulators can use for surveillance. The SEC was required to implement such rules under the Dodd-Frank Act of 2010 but took nearly a decade to finish writing them.

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*What do you think the near future holds for Archegos? Join the conversation below.*

It is unclear whether those rules would have led the Archegos situation to play out differently.

"We have been monitoring the situation and communicating with market participants since last week," an SEC spokesperson said.

*—Dave Michaels contributed to this article.*

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