10/09/2020 08:40:13 [BN] Bloomberg News

Father of VIX Warns Options Glitch Is Costing Investors Millions

- **Robert Whaley is researching impact of ETP strategy tweaks**
- **'Windfall wealth transfers' may be happening more, study shows**

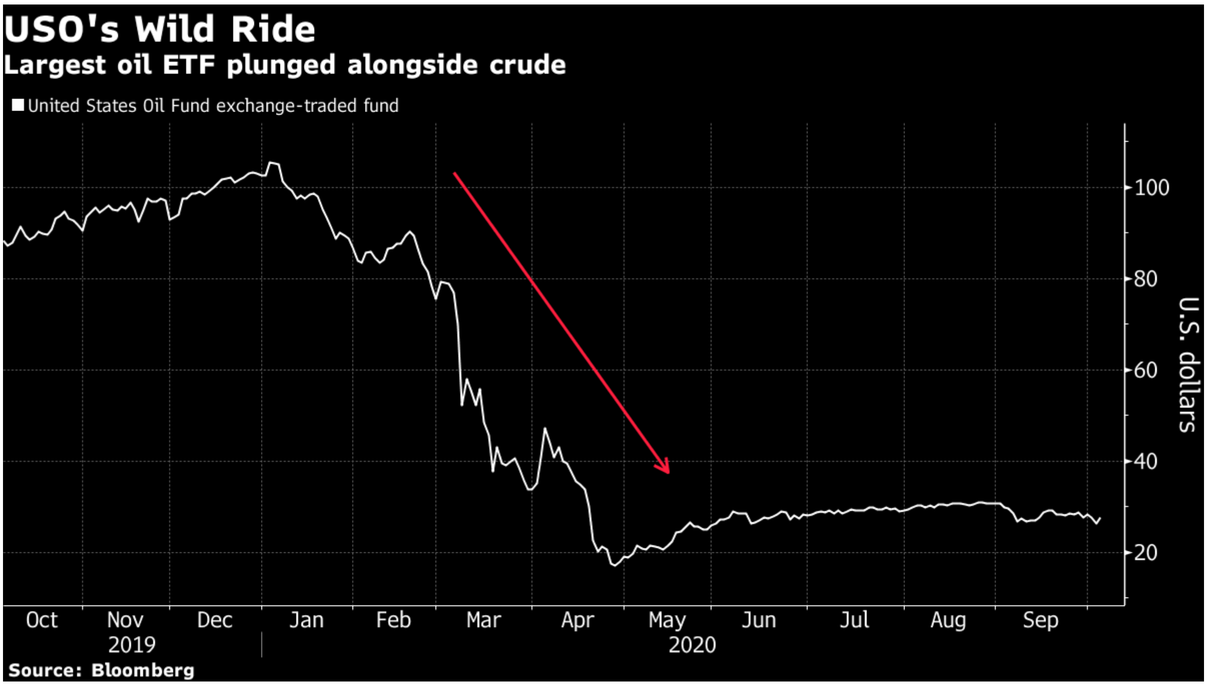
By Alex Longley and Katherine Greifeld

(Bloomberg) -- Options on tech stocks may have dominated the headlines, but one of the leading minds in finance reckons this year's crazy markets have been stirring up trouble elsewhere in the system.

Robert Whaley, the man who created the VIX Index, is investigating a major problem in the market for derivatives of exchange-traded products.

It shows up when certain ETPs adjust their investment strategies, a previously rare event that has happened multiple times in 2020's extreme turbulence. Options holders have lost hundreds of millions of dollars as a result.

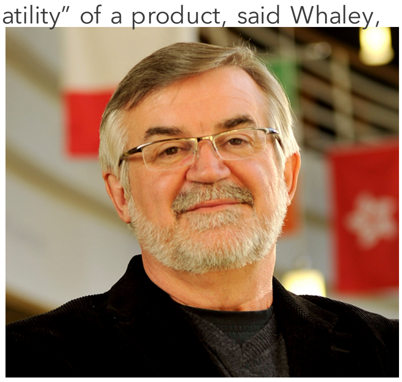
"These things don't occur that often, but at the same time they have occurred with increasing frequency in past months," said Whaley in an interview. "I'm interested in issues of market integrity, and this is the antithesis to me."



When an ETP alters its leverage or what it invests in -- like when the United States Oil Fund (USO) started buying longer-dated oil futures as prices crashed -- it can radically alter the profile of the product. But unlike with other corporate actions such as share sales or splits, options aren't adjusted to compensate.

In other words, anyone who bought options to bet USO would drop likely saw the value of their wagers plunge because the fund's actions meant it was better placed to ride out the turmoil.

"As they're making these changes, what they're doing is they're reducing the volatility" of a product, said Whaley, the Valere Blair Potter Professor of Finance at Vanderbilt University in Nashville. "That reduces the value if you bought an option."

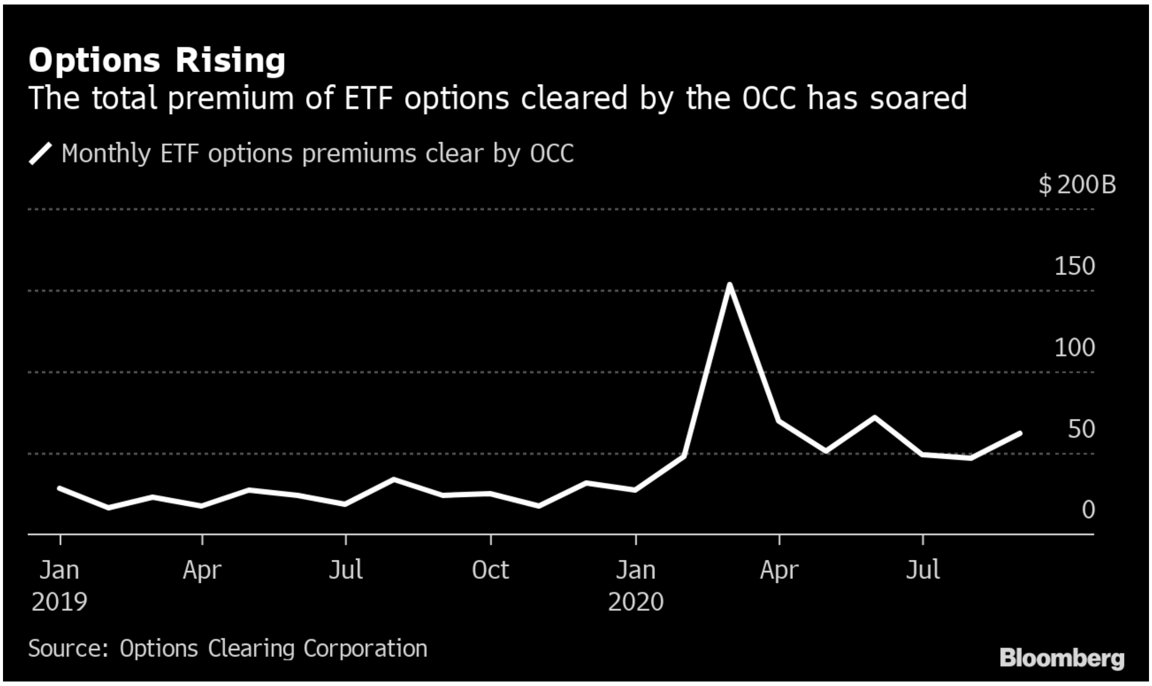


Robert Whaley

Source: Vanderbilt University

At first blush, this may seem like an esoteric concern. The type of products making these adjustments tend to be leveraged or specialized and not meant for a broad audience, and investing in their derivatives should theoretically be a niche practice.

Nonetheless, the market for ETP options is booming. Some $47 billion worth of ETF derivatives traded in August alone, according to Options Clearing Corporation data, compared with $34 billion a year earlier. Whaley thinks regulators and most market players have yet to realize the full consequences of the situation.



In a draft paper co-authored with Angel Tengulov, a research scholar at Vanderbilt, Whaley uses the volatility explosion of February 2018 to document two major examples of the phenomenon.

Amid the turmoil, ProShares made large reductions in the leverage ratios of its Ultra VIX Short-Term Futures fund (UVXY) and its Short VIX Short-Term Futures ETF (SVXY). Whaley and Tengulov estimate the combined market value of options on the pair dropped by more than $116 million as a result of the move, a decline of 16%. A spokesperson for ProShares declined to comment.

While the paper doesn't really delve into this year's events -- it doesn't mention USO, though it references leverage ratio changes by 10 Direxion funds -- Whaley says the same process has been at work.

In the case of USO, multiple changes were made in a bid to save the ETF and at one point in response to regulator concerns. The fund survived, but anyone betting against it -- whether via options or just a vanilla short position -- was probably burned.

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United States Commodity Funds, the company behind USO, said in a statement the ETF had not changed its strategy but used longer-dated contracts because of position limits. The ETF's prospectus "expressly authorized" those actions and the longer-dated contracts had a high degree of correlation to the fund's benchmark, it said.

No one at Direxion responded to a request for comment.

Reductions of leverage in some products, or a commodity fund lowering volatility by shifting to longer-dated contracts, is a new type of corporate event, Whaley and Tengulov argue. But because options aren't adjusted when they occur, the result is "windfall transfers of wealth from outstanding long to outstanding short option holders," they write.

Their paper proposes a shift in OCC procedure to address the issue by altering contracts when ETPs make these kinds of changes. A spokesperson for the OCC declined to comment.

For Whaley, it all feeds into broader concerns about a segment of ETPs which he believes shouldn't exist.

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Products using leverage are doomed by nature, in his opinion. ETPs are also giving investors easy access to types of futures contracts that would normally have stringent rules for who could buy them.

"Most retail customers wouldn't satisfy most of that set of criteria," he said.

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