Glossary of Common Derivatives Terms

American Depository Receipts (ADRs). ADRs are receipts issued by a U.S. bank or trust company evidencing its ownership of underlying foreign securities. Most ADRs are denominated in U.S. dollars and are traded on a U.S. stock exchange.

Asset-Backed Security (ABS). An asset-backed security is a security the payments on which are derived primarily from the cash flow of a discrete pool of self-liquidating assets that by their terms convert to cash within a finite period of time. The underlying assets are usually financial assets, such as mortgage, automobile or student loans or credit card receivables.

Call Option. A call option is a financial contract that gives the holder the right (but not the obligation) to buy the underlying asset at a specified price (strike price) during a specified period for a premium. Conversely, the writer of a call option is obligated to sell the underlying asset to the holder at the strike price upon its exercise at any time prior to the expiration date. European call options differ from American primarily insofar as they must be exercised on a specified date rather than at any time before expiration.

Call Option on Futures Contract. A call option on a futures contract is a financial contract that gives the holder the right but not the obligation to purchase a particular futures contract at the strike price up to the expiration date. For this right, the buyer pays a premium to the seller. Writing a call option on a futures contract obligates the writer to sell the particular futures contract to the holder at the strike price up to the expiration date.

Cap. A cap is an upper limit on an interest or payment rate.

Collar. A collar is an investment strategy that uses options to limit to a specific range the possible range of positive or negative returns on an investment in an underlying asset. To establish a collar, an investor simultaneously purchases a put option and sells (writes) a call option on an asset.

Collateralized Debt Obligation (CDO). A CDO is a debt security issued by a trust, the payments on which are based on the cash flow of underlying assets such as a portfolio of bonds, loans, or similar assets. CDOs are similar to ABS in that the payments are based on a portfolio of financial assets but differ from ABS in that the portfolio is actively managed. Like ABS, CDOs use credit and time tranching to obtain credit enhancement for senior classes of securities and can tailor the cash flows to obtain the payment characteristics required by investors.

A CDO that has an underlying portfolio composed of bonds is called a collateralized bond obligation or CBO. A CDO that has an underlying portfolio composed of loans is called a collateralized loan obligation or CLO. CDOs backed by ABS or MBS are called structured finance CDOs or SF CDOs. When a CDO is backed by a combination of corporate bonds, loans, ABS, or MBS, it is called a multisector CDO. Some CDOs are backed by classes of securities from other CDOs, which are called CDO squared or CDO\(^2\).
Collateralized Mortgage Obligations (CMO). A CMO is a special purpose entity that owns pools of mortgage loans or mortgage-backed securities and issues classes or tranches of bonds with different principal balances, interest rates, average lives, prepayment characteristics and final maturities. CMOs allow investors with different investment horizons, risk-reward preferences and asset-liability management requirements to purchase mortgage-backed securities tailored to their needs. In order to issue CMOs without the issuing entity being taxed as a corporation, the issuing entity must make a tax election to be treated as a real estate mortgage investment conduit, or REMIC, and must be structured to meet the REMIC requirements. By making the REMIC election, tax will not be imposed on the issuing entity even though it issues securities, the payments on which are not pro rata. Because of the pervasiveness of the REMIC structure, the terms “CMO” and “REMIC” are used interchangeably.

Commercial Mortgage-Backed Securities (CMBS). A CMBS is a mortgage-backed security the payments on which are derived from a discrete pool of commercial mortgage loans.

Convertible Debt Security. A convertible debt security is a security that can be converted into another security at the option of the issuer and/or the holder. A convertible bond is a type of bond that can be converted into shares of stock in the issuing company, usually at some pre-announced ratio. A convertible bond will typically have a lower coupon rate because the holder is also compensated by the value of the holder’s ability to convert the bond into shares of stock. In addition, when it is first issued, the bond is usually convertible into common stock at a substantial premium to its market value.

Credit Default Swap. A credit default swap is a contract whereby the parties agree to isolate and separately trade the credit risk of a third party. In a credit swap agreement, the buyer agrees to make one or more payments in exchange for the agreement of the seller to pay an amount equal to the decrease in value of a specified bond or a basket of debt securities upon the occurrence of a default or other “credit event” relating to the issuer of the debt. In such transactions, the buyer effectively acquires protection from decreases in the value of the securities relating to the creditworthiness of the debt issuer. The seller agrees to provide credit protection in exchange for the premium payments.

Derivative. A derivative is a security whose price is dependent upon, or derived from, one or more underlying assets. The derivative itself is merely a contract between two or more parties. Its value is determined by fluctuations in the underlying assets. The most common underlying assets include stocks, bonds, commodities, loans, currencies, interest rates and market indexes.

Exchange-Traded Option. An exchange-traded option is one with terms that are standardized by the exchange on which it trades. The exchange acts as an intermediary to all transactions, and takes an initial margin from the option writer to act as a guarantee. Over-the-counter options are contracts that are traded directly between two parties, without going through an exchange or other intermediary.

Floating Rate Securities (Floaters). Floating rate securities are debt securities that pay an interest rate which is reset periodically based on the movement of a representative interest rate index.
**Floor.** A floor is a lower limit on an interest or payment rate.

**Forward Contract.** A forward contract is an agreement to purchase or sell an asset at a pre-arranged future point in time at a pre-determined price. Forward contracts do not have standardized terms. They are traded over-the-counter.

**Futures Contract.** A futures contract is a standardized contract, traded on a futures exchange, to purchase or sell an underlying asset, such as a physical commodity or a financial instrument, at a certain date in the future at a specified price. Some futures contracts may call for physical delivery of the asset, while others may be settled in cash. The contracts are executed through a clearinghouse, which is an agency or separate corporation of a futures exchange responsible for settling trading accounts, clearing trades, collecting and maintaining margin monies, regulating delivery and reporting trading data.

**Index Option.** An index option is a call or put option on a financial index (e.g., the S&P 500). It is cash settled.

**Interest Only (IO) Tranche.** An IO is a security with cash flows derived from the interest payments on underlying mortgages, bonds or other debt securities.

**Interest Rate Swap.** An interest rate swap is an agreement whereby one party exchanges a stream of interest for the other party’s stream of interest. Typically, one party agrees to make payments that are equivalent to a fixed rate of interest on the specified notional amount in exchange for payments from the other party that are equivalent to a variable rate of interest (based on a specified index) on the same notional amount.

**Market Neutral Strategy.** A market neutral strategy is a trading strategy that involves the purchase of securities long and the sale of securities short in order to protect a portfolio from exposure to broad market moves. The goal is to profit from relative mispricings between related instruments – going long on those that are perceived to be underpriced while going short on those perceived to be overpriced – while avoiding systematic risk.

**Mortgage-Backed Securities (MBS).** A mortgage-backed security is an asset-backed security, the payments on which are derived from a discrete pool of first-lien mortgage loans. The security represents an undivided beneficial ownership interest in the pool of assets. The most basic type of MBS is a simple “pass-through” security that entitles the holders to receive a pro rata share of the principal and interest payments on the underlying mortgage loans.

**Naked Option.** A naked option is an uncovered option, *i.e.*, a put option purchased or a call option written where the seller does not own the underlying security.

**Participation Loans.** A participation loan is a single loan made by multiple lenders to one borrower. The lenders share profits and losses in proportion to the amount of the loan each owns.

**Pay-in-Kind Securities.** Pay-in-kind (or PIK) securities are bonds, notes or preferred stock that pay interest or dividends in securities, rather than cash. The securities used to pay the
interest or dividends are usually identical to the underlying securities, but occasionally they have different terms.

**Planned Amortization Class (PAC).** A PAC is a class of a CMO security that is structured to be partially protected from prepayment risk. A PAC is designed with an amortization schedule that can be maintained provided that actual prepayments do not experience severe fluctuations. The protection comes from the issuance of one or more related “companion classes” that absorb fluctuations in mortgage loan cash flows to stabilize the cash flow to the PAC.

**Principal Only (PO) Tranche.** A PO is a security with cash flows derived from the principal payments on underlying mortgages, bonds or other debt securities.

**Put Option.** A put option is a financial contract that gives the holder the right (but not the obligation) to sell the underlying asset at a strike price during a specified period for a premium. Conversely, the writer of a put option is obligated to buy the underlying asset from the holder at the strike price upon its exercise at any time prior to the expiration date. European put options differ from American insofar as they must be exercised on a specified date rather than at any time before expiration.

**Put Option on Futures Contract.** A put option on a futures contract is a financial contract that gives the holder the right, but not the obligation, to sell a particular futures contract at the strike price up to the expiration date. For this right, the buyer pays a premium to the seller. Writing a put option on a futures contract obligates the writer to buy the particular futures contract from the holder at the strike price up to the expiration date.

**Repurchase Agreement.** A repurchase agreement is an agreement whereby a seller sells a financial instrument or securities at one price and simultaneously agrees to repurchase, at a later date, the same financial instrument or securities at a higher price. Under the Investment Company Act of 1940, it is treated as a loan.

**Reverse Floater (Inverse Floater).** A reverse or inverse floater is a floating rate security that pays an interest rate which fluctuates inversely with an interest rate index – increasing when the index decreases and decreasing when the index increases.

**Reverse Repurchase Agreement.** A reverse repurchase agreement is an agreement whereby a buyer purchases a financial instrument or securities and simultaneously agrees to sell back to the seller, at a later date, the same financial instrument or securities at a higher price.

**Short Sales.** An investment strategy whereby an investor sells securities that the investor does not own and borrows the securities from its broker to deliver to the purchaser. The investor believes that it will be able to purchase those same securities in the future at a lower price, the difference being the expected profit. Short sellers make money if the stock goes down in price by more than the cost of borrowing the securities.

**Structured Note.** A structured note, which is sometimes referred to as “hybrid debt,” is a debt security whose interest payments are linked to the movement of an interest rate, stock, stock index, commodity, or currency.
**Swap.** A swap transaction is an agreement between two parties to exchange different streams of cash flows based on a specified or “notional” amount. The cash flows exchanged in a specific transaction may be, among other things, payments that are the equivalent of interest on a principal amount, payments that would compensate a purchaser for losses on a defaulted security or basket of securities, or payments reflecting the performance of one or more specified securities or indices.

**Subordinated Debt.** Debt that is junior in claim on assets to other debt and, therefore, is repayable only after other debts with higher claim have been satisfied.

**Targeted Amortization Class (TAC).** A TAC is a security that provides protection against rapid prepayments by diverting prepayments, if prepayment rates increase, to the corresponding support classes.

**Total Return Swap.** A total return swap is a contract whereby a buyer agrees to make payments that are the equivalent of interest on a specified notional amount in exchange for the right to receive payments equivalent to any appreciation in the value of an underlying security, index or other asset, as well as payments equivalent to any distributions made on that asset. If the value of the asset underlying a total return swap declines over the term of the swap, the buyer may also be required to pay an amount equal to that decline in value to its counterparty.

**When-Issued Security.** A when-issued security transaction involves the pre-purchase of securities that will be issued at a future date. These transactions are made conditionally because issuance of the underlying securities, although authorized, may not always take place.

**Zero Coupon Securities.** Zero coupon securities are debt obligations that do not entitle the holder to any periodic payment of interest prior to maturity or specify a future date when the securities will begin to pay current interest. Zero coupon securities are issued and traded at a discount from their face amount. The discount varies depending on prevailing interest rates, the time remaining until cash payments begin, the liquidity of the security and the perceived credit quality of the issuer. At maturity, the holder of a zero coupon security receives the face amount, which represents principal plus accrued interest.

**Z Tranche Securities.** Z tranche securities, which are often the last tranche in a CMO, receive no cash payments for an extended period of time until the previous tranches are retired. While the other tranches are outstanding, the Z-tranche receives credit for periodic interest payments that increase its face value but are not paid out. When the other tranches are retired, the Z-tranche begins to receive cash payments that include both principal and continuing interest.