

The Enlightenment that Archegos Defaults Event to Our Country Finance Supervises

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Abstract: At the end of March 2021, the default of Archegos, an American hedge fund, led to a total loss of more than 10 billion dollars for a number of investment banks, which exposed the absence of supervision in the United States financial regulators. Based on the publicly disclosed information in the market, this paper analyzes the main process and key links of the incident in detail, summarizes and summarizes the defects and problems in the supervision of family office as a financial subject and derivatives trading in the United States, and puts forward opinions and suggestions on the supervision of family office and derivatives for financial institutions and regulatory departments in China.

Keywords: Archegos, Financial supervision, Family office, Derivative

1. Archegos and Its Investment Strategy

1.1. Archegos Founded

Archegos is a family fund founded by Korean-born Bill Hwang, formerly known as Tiger Asia. In 2001, Mr. Robertson, the founder of Tiger Fund as famous as Mr. Soros, shut down Tiger Fund and founded a group of hedge funds known on Wall Street as "Tiger boys," including Mr. Huangbill's Tiger Asia. Since its inception in 2001, Tiger Asia has delivered annualized returns of approximately 15.8% per year for its investors. In 2007 alone, Tiger Asia generated a return of about 40.4% for investors. By the end of 2007, Bill had a record \$8 billion under management.

The year 2008 was a turning point in the fortunes of Yellow Bill. Tiger Asia was one of many hedge funds that took a big hit when the financial crisis suddenly hit. After betting heavily against the market in the first half of 2008, Tiger Asia was net long by more than 50 per cent in the fourth quarter. Tiger Asia, however, was hit hard by overly optimistic market judgments. Moreover, Tiger Asia's bets on Lehman Brothers and Volkswagen ended in losses. In the cold winter of the financial crisis, Tiger's performance fell to -23% and investors withdrew en masse. In retrospect, Tiger Asia's net short strategy in 2009, just as the global stock market rally, the fund's performance is only 3%, since then, Tiger Asia has been flat. Tiger Asia's assets under management fell sharply after 2008 as a result of poor performance. In July 2008, Tiger Asia had \$9.25 billion in assets under management. By July 2009, that figure had shrunk to \$4.1 billion. In July 2010, it fell further to \$3.14 billion. In July 2011, Tiger Asia managed just \$1.02 billion in assets with a return of 1% and returned 9% in 2011.

In addition to the fund's declining performance, Tiger Asia has also crossed a legal line. In 2008, Yellow Bill and Tiger Asia were accused by the US Securities and Exchange Commission of insider trading and stock market manipulation in connection with shorting Hong Kong shares of Bank of China and China Construction Bank, making more than \$17m in illegal profits. On December 12, 2012, Yellow Bill pleaded guilty to wire fraud and was ordered to pay a \$44 million fine.

In addition, the SEC banned Yellow Bill from continuing to manage hedge funds. So, after shutting down Tiger Asia and withdrawing outside funds, he set up Archegos, a family office, to manage his personal fortune.

1.2. Archegos Investment Strategy

Archegos continues the Tiger Asia era with a fundamental research-driven long/short equity strategy focused on long-term value investments of 18 months to 3 years in the financial services, telecom and Internet sectors. The long/short equity strategy is one of the most common strategies used by hedge funds, in which fund managers buy stocks they believe are relatively undervalued and sell those that are relatively overvalued, benefiting by taking both long and short positions in stocks or derivatives. This hedge fund strategy can be applied broadly to the market, or it can be specific to a specific industry. The long/short stock strategy has proven to be a very successful trading strategy. After 2012, Archegos' net asset value grew steadily to \$3.865 billion in 2016. Archegos' excellent market performance has lasted for a long time, but the investment strategy behind it has completely changed to aggressive.

Archegos has been shifting from a long/short stock strategy to a pure long strategy since 2017, and there are two main ways to increase its long holdings:

a. Heavy holdings

Starting in 2017, Archegos' portfolio is focused on U.S. technology sector companies with market capitalization of more than \$10 billion. After 2019, Yellow Bill added media groups Viacom CBS, Discovery Channel and a number of Chinese concept stocks to its portfolio. According to Archegos' trading records with Credit Suisse, its top 10 long block trades accounted for 75% of Credit Suisse's total prime brokerage market capitalization in 2019, and only the top four long prime brokerages accounted for 50%.

b. Use derivatives

Yellow Bill is an expert in the use of derivatives. He leveraged his portfolio by five to six times using derivatives contracts such as total income swaps, giving him control of \$80 billion, given the fund's net asset value of \$15 billion. In addition to increasing leverage, another important reason he

chose derivatives trading was to avoid regulation. Derivatives transactions such as total income swaps are not included in the SEC's 13F report (Institutional Investor position report) requirements, so Archegos fund can use derivatives to indirectly hold shares without actually owning the relevant stocks, thus avoiding the U.S. securities regulation that requires 5% of a single company's shares to be reported. Through this regulatory loophole, Archegos has remained outside the rules of the game.

2. Archegos Transaction Structure

If Archegos had traded only with his own money, even a blowout would not have caused such a huge loss on Wall Street. But Archegos took advantage of the opacity of derivatives to sign derivatives agreements with six major investment banks with essentially the same positions and directions, which led to a spiral out of control. The main one involved is the Total Return Swap (TRS).

Total income swaps are Archegos' main over-the-counter financial derivatives. Swaps are the most common form of product in the interest rate market, with the total market value of OTC interest rate swaps globally exceeding \$8 trillion as of June 2021. Most interest rate swaps are for hedging purposes, but equity swaps are generally for speculation. The total income swap realizes the exchange of the underlying asset income and interest rate between the two parties to the transaction, namely the payer of the total income swap and the recipient of the total income swap. The payers of total income swap are usually investment banks, insurance companies and other institutions with large amounts of capital. The recipients of total return swaps are mostly hedge funds, private equity funds, pension funds and other institutions that want to make leveraged investments. We can simply understand the operation mechanism of the total income swap as "purchasing", and we can assume a simple scenario: the recipient of the total income swap wants to invest in an underlying asset, but it cannot make large-scale investment due to capital or procedure restrictions, while the payer of the total income swap has a large number of underlying stocks, but it wants to obtain a more stable cash flow. So an agreement was reached. During the term of the Agreement, the payer transfers to the receiving party the gross proceeds of the underlying asset, which may include principal, interest, prepaid expenses, and capital gains resulting from favorable changes in the price of the asset; In exchange, the recipient promises to pay the other party a specific percentage of the appreciation of the agreed assets, usually LIBOR plus a margin, and capital losses due to adverse changes in the asset price. In the event of this explosion, the target of the total income swap between Archegos and the investment banks is Tencent Music, Baidu, Who to learn, Viacom Columbia Broadcasting, Discovery Channel and other stocks.

3. Archegos Explosion Warehouse

Archegos used over-the-counter derivatives, such as total income swaps, to borrow money from investment banks with limited funds and pay interest to take bigger stock positions. Archegos' trading leverage typically ranged from 4 to 7 times, according to the SEC complaint. According to the U.S. Treasury Department's Office of Financial Research, Archegos family offices had about \$10 billion in net assets under management by the end of 2020, while using leverage to increase its total asset exposure to about \$120 billion may

have been leveraged more than 10 times. With high leverage, Archegos' aggressive investment strategy has also created considerable returns for it. In the fourth quarter of 2020, for example, the S&P 500 was up nearly 12% over the same period, while seven of Archegos' 10 holdings were up more than 30%, with Baidu and Vipshop up more than 70%. At the time, Archegos was working with six major investment banks at the same time, and it was paying tens of millions of dollars a year in fees to Wall Street banks, which could total more than \$100 million.

However, the good times did not last long, and the risks gathered and finally erupted.

On March 22, shares of Viacom (VIAC.O), in which Archegos is heavily invested, fell sharply. On the same day, the share price of fog core Technology (RLX.U), the parent company of electronic cigarette giant Yueke, suffered heavy losses and halved. This was followed by a sharp fall in many Chinese stocks on March 24th. On the evening of March 25, Archegos told Credit Suisse that his remaining stake was only \$9 billion to \$10 billion, according to Credit Suisse. The brokers then issued a default notice to Archegos and began to liquidate Archegos' positions in the bank. At this point, brokers are caught in a situation similar to the prisoner's dilemma. They had long the spot market for the risk of short total income swap contracts, and now Archegos defaulted and needed to sell their shares. The problem is that more than one broker needs to sell, and all the big brokers have positions in the same direction. If multiple brokers sell shares in the market together, the stock market will fall sharply, and each will have a huge loss. According to reports, on the evening of March 25, 2021, Archegos convened a number of investment banks to discuss a solution, hoping to avoid large-scale liquidation of investment banks. If each family chooses to sell slowly, then the overall loss can be minimized, but if everyone rushes to sell, the loss of the first person off the boat will be much smaller than the loss of the whole slow sell. Goldman Sachs was the first to sell shares on March 26th in an effort to minimize losses, followed by UBS, Mitsubishi UFJ and Morgan Stanley. By the time Credit Suisse reflected, it was too late. In the end, Credit Suisse lost \$5.5 billion, Nomura Securities lost \$2.85 billion, Morgan Stanley lost \$911 million, UBS lost \$861 million and MUFG lost \$300 million. Goldman retreated in time and suffered less damage.

4. There is a Serious Lack of Supervision

Archegos default caused such a huge loss, reflecting that the existing laws and regulations of the US regulatory agencies are difficult to fully restrict the nature of this family office investment entity; In other words, the shell of the family office has the bonus of light regulation for investment firms.

4.1. Family Office Regulation in the United States

In 1940, the United States Congress passed the Investment Advisers Act, which clarified the fiduciary obligation of investment advisers to their clients as trustees of investment advisory management business, that is, the way of "entrusted by others to manage money on behalf of others". The introduction of the act aims to regulate the professional ethics of investment advisers and mitigate or eliminate some conflicts of interest. Under the Act, an investment adviser is

required to register with the Securities and Exchange Commission and provide information about the investment business, asset ownership, and clients, and when the number of investment advisers is less than 15, the investment adviser is exempt from this section. Although the exemption clause for investment advisers with less than 15 clients facilitates small investment firms, high-risk investment companies such as hedge funds and private equity funds can also use the exemption clause to avoid the information disclosure requirements of registration with the SEC. The Dodd-Frank Act, enacted after the 2008 financial crisis, removed that exemption and required hedge funds and private equity funds to register to provide information about their trades and portfolios and to help regulators assess systemic risk. At the same time, the Dodd-Frank Act amended this system, requiring the SEC to formally define a family office to exempt a single family office from regulation under the Advisers Act, provided that: (1) only provide investment advice on securities to "family clients" as defined by the statute; (b) wholly owned by the "family customer" and controlled exclusively by a "family member" and/or a "family entity" as defined by the regulations; (3) and does not present itself to the public as an investment adviser.

In 2010, a Senate Committee on Banking, Housing, and Urban Affairs report released at the same time as the bill explained that family offices were exempted from Dodd-Frank's regulatory reach because the primary purpose of the act was not to regulate individual family wealth management.

4.2. Us Derivatives Disclosure Requirements for Family Offices

The Securities Exchange Act of the United States has certain information disclosure requirements for institutional investors' positions. The regulation aims to increase investor confidence by increasing information disclosure and enhancing the transparency of the securities trading market. In addition, regular information disclosure reports of institutional investors on their investment activities and holdings help the CSRC to track and assess the impact of investors on a fair and orderly securities market. Archegos took advantage of the "invisibility cloak" of the family office to hide its holdings through derivatives, taking advantage of regulatory loopholes.

Section 13 (f) of the Securities and Exchange Act requires investment firms to file quarterly 13F reports detailing their portfolios when the combined market value of stocks, options and convertible bonds traded on U.S. exchanges reaches or exceeds \$100 million. But the law only requires investment firms to disclose their holdings of stocks, options and convertible bonds that trade on U.S. exchanges. Short positions, derivatives and transactions in foreign stocks are not required. That's how Archegos, a multibillion-dollar family office, was able to evade oversight and never made the 13F report public.

Section 13 (d) of the Securities and Exchange Act requires any investment company that holds more than 5% of the shares of a single company by voting rights to file a 13D report with the Securities and Exchange Commission within 10 days of the threshold date. The 13D report contains the amount of investment and the purpose of trading, which can show when investors began to accumulate a large number of shares of listed companies, which is of great significance for ordinary investors and the original controlling shareholders of

the company to detect the malicious takeover and stock price control behaviors of institutional investors such as hedge funds as early as possible. Similarly, due to Archegos' equity swap transactions with brokers, Archegos' concentrated holdings in shares of companies such as Victrom are not reflected in its ledger of transactions and thus Archegos has never filed a 13D report. Archegos owns stocks indirectly through stock-swap derivatives deals with brokers, which allow it to benefit from rising underlying asset prices while avoiding CSRC disclosure requirements.

In addition, there is no regulatory oversight of derivatives trading in family offices. Although family offices can participate not only in the U.S. securities market but also in the U.S. commodity derivatives market, the U.S. Commodity Futures Trading Commission (CFTC) does not believe that family offices will cause significant disruption to financial markets. For example, the CFTC mandated in 2020 that a family office operator or principal with a defective qualification need not register with the CFTC to work as a commodity fund manager (CFO). In addition, because family offices do not have to raise funds publicly, they are not subject to the CFTC's investor protection rules, and the derivatives holdings of large family offices like Archegos are not fully known to regulators.

There is no doubt that Dodd-Frank's exemption space for family offices is a double-edged sword. On the one hand, the Act gives the traditional family wealth management office with the investment goal of mild preservation and appreciation a wide space for self-care of investment, reflecting the protection of private property by law; On the other hand, the law's white space has also become a regulatory arbitrage space for hedge funds like Archegos dressed up as "family offices", through which Archegos circumvents regulation by taking indirect stakes in OTC derivatives.

5. Implications for the Supervision of Family Offices in China

Along with the rapid development of China's economy, the family and social wealth have achieved rapid growth. It can be said that China is facing a wave of large-scale inheritance of wealth, and the family office, an important tool, will play an indispensable role in the intergenerational inheritance. Archegos warehouse explosion alerted financial supervision, if the lack of relevant supervision policies for family offices, it is easy to lead to financial risk events, which will have an adverse impact on financial stability.

a. Adopt the principle of classified supervision on the regulatory objects and access

First of all, regarding the definition of regulatory objects and access supervision, it is suggested to adopt the principle of classified supervision. On the premise of strictly defining a single family office, it is suggested that the regulatory authorities maintain a loose regulatory standard for the access of a single family office, in order to encourage entrepreneurs to set up family offices on their own, promote the standardization, specialization and institutionalization of the inheritance of private enterprises in China, and increase the source of long-term capital for the capital market. For joint family offices, the regulatory authorities can conduct access supervision according to the asset management industry, without setting additional access conditions. Among them, the definition of single family office can refer to the practice

of SEC family office rules; for the definition of joint family offices, reference can be made to the practice of regulatory classification from a behavioural perspective.

b. Integrate the regulation of asset management practices into the existing regulatory framework

Secondly, regarding the supervision of asset management behaviors, it is proposed to incorporate the existing regulatory framework. According to the classification of asset management business activities of family offices, it is suggested that based on the existing regulatory framework, starting from the securities industry, fund industry, trust industry, insurance industry and other industries, the existing regulatory departments of each industry should conduct corresponding behavioral supervision. Thirdly, regarding the supervision of transaction consulting behavior, it is recommended to consider professional qualification norms. For legal institutions, consulting business scope generally do not need to obtain a special license; However, when the family affairs consulting services provided by the family office involve professional fields such as law and taxation, the regulatory authorities may consider formulating corresponding regulations, requiring the family office to have qualified practicing lawyers, certified public accountants, tax agents, etc., or purchasing outsourcing services from professional organizations without having to provide them themselves, so as to ensure that professional consulting services are carried out by professionals. Avoid investor losses due to non-compliance.

c. Set up industry associations and institutes for self-regulation

Finally, regarding self-regulation, it is suggested to guide the establishment of industry associations and societies. It is suggested that the regulatory authorities guide the construction of domestic family office industry self-regulatory organizations, further regulate and guide the family office industry, and help the smooth succession of China's private enterprises and the healthy development of the wealth management industry.

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