STANDARDS BOARD FOR ALTERNATIVE INVESTMENTS

Archegos and Counterparty Disclosure – April 2021

SBai
Standards Board for Alternative Investments

Introduction

At the end of March, the non-regulated family office Archegos Capital Management ("Archegos") could not meet margin calls on highly leveraged swap positions. This led to a fire sale of assets by prime brokers and resulted in significant losses to most of these banks. The fall-out from the losses has put the risk management practices at various prime brokerage counterparties into the spotlight. There were no serious systemic consequences this time as the banks were able to absorb these losses. Other issues, however, came to light including the delayed implementation of Dodd-Frank disclosure rules for derivatives and the disparity in regulation between hedge funds and family offices in the US.

Media accounts of the events frequently inaccurately describe Archegos as a hedge fund. Archegos is a family office and while most US based hedge funds are required to register with the SEC, family offices (regardless of size) are exempt from SEC oversight. Despite this, the event has still resulted in increased focus on the hedge fund industry due to its use of leverage and total return swaps through prime brokers.

To facilitate counterparty risk management at prime brokers and other counterparties, the SBAI's Alternative Investment Standards (which do not apply to family offices) require confidential reporting from asset managers to counterparties to improve risk transparency and enable ongoing counterparty risk monitoring. This requirement was introduced in 2008 to prevent the excessive build-up of risk such as that seen in the Archegos situation.

What Happened

Archegos built up significant and highly leveraged positions almost exclusively via total return swaps[1] (which do not require public disclosure), through at least six different prime brokers. Following a fall in the share price of a concentrated Archegos position, the family office could not meet its margin calls and the prime brokers were forced to dispose of the assets quickly to reduce their exposure. This led to Credit Suisse announcing losses of USD 5.5bn, Nomura of USD 2.8bn, Morgan Stanley of USD 911m, UBS of 811m and others with less significant losses. The impact does not stop at the financial losses, Credit Suisse and Nomura both had their credit rating outlook downgraded citing concerns over "the quality of risk management" and many senior executives at some of these banks have been dismissed.

What do the SBAI Alternative Investment Standards Say?

Disclosure to Prime Broker Counterparties

Like the Archegos family office, alternative investment managers also rely on investment banks and other counterparties to provide financing for their investments. This business has evolved over time and now

[1] Total Return Swaps are derivatives that allow investors to obtain synthetic long or short exposure, including leverage if desired, to an underlying security, index or other reference asset. The swap dealer may elect – but is not required – to hedge its exposure to the swap by buying or shorting the underlying security, index or reference asset (depending on whether the swap is long or short).

includes traditional prime brokerage (margin lending and stock borrowing), synthetic and derivative instruments, and fixed and long-term credit facilities.

The type of credit extended to these funds depends on many variables, and the amount of credit risk counterparties will assume is a function of a bilateral agreement which will include collateralisation of positions. To assess credit risk, counterparties require information about the fund and its positions. Based on public commentary, it does not appear in the case of Archegos that the banks knew about mirror swap positions held with other counterparties and internal investigations at two of the banks are trying to identify whether the family office withheld vital information (no formal investigations by regulators have been announced).

Lenders typically take responsibility for requiring specific transparency to enable well-informed lending decisions; however, there are conflicts that need to be assessed. Regulators and other parties have suggested that provision of this information may be impeded by some managers having concerns about confidentially protections within lending institutions, although these can be mitigated through the use of NDAs. It is therefore essential to recognise the importance of addressing these potential conflicts to facilitate the flow of relevant information to support effective risk management and informed lending decisions at the counterparty.

For these reasons, in 2008, the Counterparty Risk Management Policy Group II (CRMPG II) recommended disclosure practices to improve transparency and counterparty credit assessments[2]. CRMPG II stated that, when determining how much information to provide on a confidential basis to counterparties, market participants should recognise that provision of relevant credit data increases the level of counterparties' comfort and improves the likelihood that access to credit will continue during periods of systemic and institutional stress. The SBAI endorses the breadth and direction of these recommended practices which are also reflected within the SBAI Alternative Investment Standards.

Standard 4.1 discusses the disclosure to counterparties:

> ***Standard 4.1*****: A fund manager should, subject to obtaining the consent of the fund's governing body, provide, or do what it reasonably can to enable and encourage the fund's administrator to provide, any agreed information reports to the fund's counterparties in a timely manner.**

When the SBAI (at the time the Hedge Fund Working Group) proposed this standard in its consultation paper in 2007, some respondents felt that no separate standard was required for lending banks or prime brokers, as they could request relevant information to make adequate risk assessments themselves. While the SBAI agrees that counterparties can request the required information, the SBAI continues to believe that this topic is important from a financial stability perspective (as demonstrated by recent events).

Asset Manager and Investor Counterparty Risk Management

In addition to enabling robust risk management at counterparties (including prime brokers), it is crucial for alternative investment managers and their investors to be able to accurately determine their exposure to counterparties and any associated risk to a stress event. The SBAI Alternative Investment Standards cover counterparty risk management in detail, including putting processes in place to monitor news on the fund's counterparties, changes in share prices, credit spreads and credit ratings on an ongoing basis as part of a sound counterparty risk management process.

Standard 14 discusses the management of counterparty risk:

[2] http://www.crmpolicygroup.org/docs/CRMPG-III.pdf

***Standard 14.1*: A fund manager should have a process for setting up trading relationships on behalf of the fund, including the assessment of creditworthiness and the setting of risk limits.**

In setting up such trading relationships, a fund manager may, where relevant and appropriate, wish to consider putting netting agreements and appropriate collateral arrangements in place. For example, it may be possible for certain funds to agree two-way collateral posting with a trading counterparty.

***Standard 14.2*: Creditworthiness of the fund's trading counterparties should be monitored periodically, and risk limits adjusted, if required.**

Investors will also need to understand the aggregate exposure to counterparties in their portfolios (which may comprise several investments to different external alternative investment funds). The SBAI has two transparency tools that can facilitate this aggregation.

Open Protocol Risk Reporting:

The Open Protocol Risk Reporting tool contains a counterparty exposure tab providing transparency to investors covering prime brokers, ISDA counterparties, clearing counterparties and others by entity, geography, and relationship.

The SBAI Administrator Transparency Report (ATR):

The SBAI's ATR is a widely used tool that allows fund administrators to provide transparency to investors on the fund's counterparty exposure in an independent manner. An example of this reporting is shown below.

Example Counterparty Exposure Reporting from ATR[3]:

Counterparty Reporting (to be named directly below, or left blank and separate Counterparty List below to be completed)	Net (USD)	% NAV	% NAV Range
Counterparty 1	55,000,000	46	40-50
Counterparty 2	38,000,000	32	30-40
Counterparty 3	11,000,000	9	5-10
Counterparty 4	6,000,000	5	5-10
Counterparty 5	2,078-740	2	0-5
Counterparty 6	3,565,900	3	0-5
Counterparty 7	0	0	0-5
Counterparty 8	0	0	0-5
Counterparty 9	0	0	0-5
Counterparty 10	0	0	0-5
… add lines for additional counterparties / or aggregation of other	0	0	0-5

[3] In cases where the individual counterparty is not named alongside the relevant exposure percentage, the manager should discuss exposure to the impacted counterparties with the investor at their request.

Counterparty Reporting (to be named directly below, or left blank and separate Counterparty List below to be completed)	Net (USD)	% NAV	% NAV Range
Non-Custodied Assets 1 (Name if applicable)	0	0	0-5
Non-Custodied Assets 2 (Name if applicable)	0	0	0-5
Non-Custodied Assets … (add lines if needed)	4,313,800	4	0-5
Non-Trading Balances (Accruals and Prepayments) including pending	41,560	0	0-5