FedFin Client Report

Thursday, April 1, 2021

FedFin Assessment: Archegos Aftermath – Enforcement Now, Bank Rules to Come

Client Report: HEDGE59

Executive Summary

The stunning collapse of the leveraged family office, Archegos, and its impact on the financial system has renewed calls for an array of regulatory initiatives. In this report, FedFin assesses the options readily at hand in the U.S. in the context of the broader rewrite of financial regulation already under way at the Treasury, FRB, SEC, and other federal agencies. Leveraged funds have been a financial-stability priority since the March 2020 dash for cash (see *Client Report* **SYSTEMIC89**); this case will only confirm those demanding action as evidenced yesterday as FSOC prioritized both open-end and hedge funds for immediate systemic review. In the near term, the banks directly involved in Archegos will be asked uncomfortable questions by examiners and Congress. Thereafter, we expect hedge-fund standards to emerge principally as adjuncts to broader efforts to stabilize short-term bond markets, with work initially focusing on transparency and expanding to direct leveraged-fund standards as events and political realities warrant. However, the role of banks – U.S. and foreign – as Archegos' counterparty in high-risk swaps, the controls to absorb risk, the processes that permitted the customer relationship in the first place, and the impact on equity-market volatility will be immediately assessed in light of longstanding concerns about bank interconnectedness with leveraged funds. Controversial rules on "covered funds" (see FSM Report **COVEREDFUNDS2**) and the broader Volcker construct will also come under renewed scrutiny, with Sen. Merkley (D-OR) finding a ready ally in Senate Banking Chairman Brown (D-OH) for tough hearings as events unfold. Senate Permanent Subcommittee on Investigations hearings akin to those surrounding the "London Whale" incident (see *Client Report* **PROPTRADE16**) may also ensue. As a result, banks face an array of new legal and reputational risks at a time when the Administration and Senate are eager to show a "zero-tolerance" stand on anything that could be characterized as market "rigging."

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

© 2021. Federal Financial Analytics, Inc. All rights reserved.

Analysis

We have assessed the following options in response to facts known so far about Archegos and regulatory discussions. Any subsequent revelations or continuing market volatility would alter forecasts. At present, we conclude:

- Systemic Designation: We do not expect funds such as Archegos to be considered for systemic designation. First, as previously noted, U.S. preference has moved from firm-specific designations to those for activities and practices. Much in this area is now under way with regard to open-end and hedge funds and the broader bond market. Systemic standards governing certain activities – e.g., highly-leveraged swaps such as those at Archegos – could well be implemented as a result, but firms with concentrations in them would not on their own be designated unless one or another comes to be far larger than any now evident in the U.S. market.
- Swap Regulation: After the 2008 crisis, there was strong demand for derivatives regulation, including bank-specific standards focused on credit derivatives and total return swaps. Focus instead shifted to creation of CCPs and resulting margin requirements, with regulators of the view that this provided sufficient market stability by isolating OTC products and adding cost to them. SEC rules on securities-based swaps were also mandated by Dodd-Frank but come into effect only later this year. Archegos will lead to renewed review of the SEC's rule and the extent to which it suffices, especially with regard to market transparency. Banking agencies will also reconsider higher risk-based capital standards and single-counterparty limits that include not just the counterparty (i.e., Archegos), but also exposures (i.e., equities) linked to it.
- Coordinated Asset Disposition: Press reports indicate that banks with large Archegos exposures held extensive discussions about how best to dissolve positions without undue loss. We expect Senate and perhaps Justice Department inquiry to focus on whether such discussions constitute undue collusion and thus pose an antitrust or similar market-integrity concern. The SEC may well also investigate this in light of continuing concerns about dark pools and Chairman-nominee Gensler's particular aversion to them.
- Governance: Press reports also assert that at least one large bank decided to waive longstanding bans on doing business with persons such as Archegos' controlling party due to insider-trading and other allegations. Supervisors will surely explore the extent to which Archegos relationships and exposures comported with internal governance, due-diligence, and risk-

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

© 2021. Federal Financial Analytics, Inc. All rights reserved.

tolerance restrictions. Companies found to have violated internal controls will face enforcement actions and large banks more generally will likely face a new round of supervisory inquiry to ensure that they are also not exposed to Archegos-like risk.

- Volcker Rule: As noted, we expect this case to lead to renewed Congressional calls to tighten the final version of the Volcker Rule (see Client Report **PROPTRADE26**) finalized in 2019 over strong objections from FRB Gov. Brainard and FDIC Director Gruenberg. The extent to which these swap exposures touch on the Rule's proprietary-trading restrictions is uncertain given the Rule's exemptions for customer transactions, but the actions by banks to protect themselves at what some may view as the expense of the broader market will spark inquiry and, we would expect hearings. Whether any of this leads to substantive changes in the Rule will be clearer only after inquiry proceeds and the leadership of federal financial agencies is reshaped under the Biden Administration.

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

© 2021. Federal Financial Analytics, Inc. All rights reserved.