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ICYMI: Commissioner Quintenz in Bloomberg: Family Offices Don’t Need New Regulations

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Excerpts from Commissioner Brian Quintenz's Op-ed with the Securities and Exchange Commission’s Commissioner Hester Peirce on the Collapse of Archegos (http://www.cftc.gov/exit/index.htm?https://www.bloomberg.com/opinion/articles/2021-06-24/archegos-collapse-doesn-t-necessitate-new-family-office-rules)

Bill Hwang’s family office, Archegos Capital Management, failed in spectacular fashion in March as investments in complex derivative products — specifically, total return swaps on individual stocks — rapidly accumulated losses too large for the firm to cover. As a result of Archegos’s default on these positions, large investment banks that were counterparties to the trades were left holding the bag. Some banks suffered large losses as they unwound those positions.

Many policy makers and commentators have used the Archegos event to fault current systemic-risk safeguards and call for increased scrutiny for, or even direct regulation of, family offices. Yet the systemic impact on the financial system of the Archegos-fueled losses was zero. Indeed, even the most directly affected firms easily weathered the event. Morgan Stanley and Goldman Sachs Group Inc., for instance, still posted record quarterly earnings. Only Credit Suisse Group AG, which also suffered from the Greensill Capital implosion, was compelled to raise a small amount of equity, and it did so smoothly and quickly.

Beyond hyperbolizing the event’s systemic risk, these sentiments misunderstand the rationale underpinning the Commodity Futures Trading Commission and Securities and Exchange Commission’s investment firm regulatory regimes.

First, family offices are organizations set up and overseen by wealthy individuals to manage their own money. Generally only family members or key employees of the family office are allowed to co-invest, which means the fund’s investors are also insiders. Family offices, regardless of their size, generally are not required to register with either the SEC or the CFTC. The investment adviser registration and regulatory regimes focus on investor protection, with a specific emphasis on protecting outside investors through disclosures, fiduciary-duty obligations and reporting requirements. Such protections are unnecessary when the investors are all in the family.

Regardless, investment adviser regulatory regimes are not designed to prevent investors — particularly sophisticated investors — from the consequences of their poor investment decisions. Events like this one are useful reminders of the importance of risk management for Archegos and other market participants. Rather than looking to their regulators to tell them how to avoid such losses in the future, sophisticated market participants should take an introspective look at their own risk-management systems, firm cultures and incentive structures.

Second, calls for revamped family office regulation also ignore the prudential-like swap dealing and reporting rules mandated by the Dodd-Frank Act to address Archegos's specific problem: a large and concentrated position spread out across the financial marketplace unknowable to anyone except financial regulators. These rules, a cornerstone of Dodd-Frank, were designed to provide regulators insight into the opaque over-the-counter swaps markets after the 2007-2009 financial crisis.

After Dodd-Frank, federal oversight of banks' derivatives activities depends on the products being traded. The CFTC received jurisdiction over banks' swaps activity that involves interest rates, broad credit or equity indices, foreign exchange, and commodities (which amount to around 95% of total notional traded swaps). In 2012, the CFTC adopted and implemented its swap dealer registration, capital, margining and reporting rules, pursuant to which the CFTC now receives real-time data on banks' trading activities and their clients' portfolio-level holdings in the cleared swaps market. The CFTC can aggregate, net and examine this information across financial markets.

Dodd-Frank gave the SEC jurisdiction over banks' activities in single-stock swaps, such as those dealt to Archegos. But it was only in the last few years, under the chairmanship of Jay Clayton, that the SEC finalized its rules around security-based swaps reporting requirements, which will come into full effect later this year. If the SEC's rules had been completed earlier, the trades and positions of various banks related to Archegos could have been aggregated and flagged.

Any large loss to banks from a single investment firm always provokes thoughtful debate around the adequacy of existing prudential and financial market regulations and the efficacy of market participants' risk-management programs. Given the lack of systemic impact from the Archegos losses, the misalignment of family office structures with the rationale for investment firm regulation, and the swaps oversight regimes currently in place or being brought online by market regulators, absent additional information, the Archegos case does not justify new regulation for family offices.

Read the full op-ed here (http://www.cftc.gov/exit/index.htm?https://www.bloomberg.com/opinion/articles/2021-06-24/archegos-collapse-doesn-t-necessitate-new-family-office-rules).

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