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Family Office Regulation in Light of the Archegos Fallout

In late March 2021, Archegos Capital Management and its investment bank financiers started liquidating huge stock positions, causing significant turbulence in capital markets. The stock sell-offs led to pronounced declines among a number of stocks and left various investment banks with large losses. The developments sparked an array of responses from financial regulators. Some scrutiny has turned to Archegos's regulatory status as a *family office*—a lightly regulated entity with numbers in the thousands.

What Happened?

Archegos, a family office managing assets for investor Bill Hwang, reportedly had \$20 billion in net worth immediately before its collapse. Its entire investment portfolio, assembled by borrowing from multiple investment banks, reportedly totaled \$100 billion. In March 2021, Archegos defaulted on its loans after losses on a concentrated portfolio of risky stocks. As a result, Archegos's \$20 billion in net worth disappeared, and the losses spread to several lenders and counterparties to the firm. Credit Suisse, Nomura, Morgan Stanley, and UBS accumulated collective losses reportedly estimated to be about \$9.5 billion.

The event came as a surprise not only because of the size of the losses but also because of how Archegos was able to conceal its investment positions. Archegos invested heavily in a handful of stocks using financial instruments called *equity total return swaps*. These instruments allowed Archegos to receive economic exposure to the relevant stocks without directly owning them, thus avoiding direct-ownership-based disclosure requirements.

With losses of this magnitude tracing back to a single family office, policymakers have voiced concerns. Federal Reserve Chair Jay Powell said the agency was monitoring the event carefully. The Securities and Exchange Commission (SEC) indicated that it would examine the development, and Congress may hold related hearings.

How Was Archegos Formed?

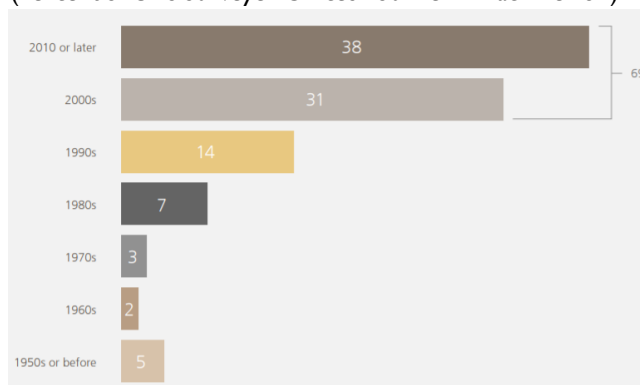
The origins of Archegos began in 2001 when Bill Hwang launched hedge funds Tiger Asia Management and Tiger Asia Partners. In 2008 and 2009, the SEC alleged that Hwang committed insider trading and attempted to manipulate the markets. In 2012, the SEC arranged a settlement with Hwang in which he and the two hedge funds agreed collectively to pay \$44 million. It also prohibited Hwang from associating with brokers, dealers, municipal securities dealers, municipal advisors, transfer agents, or credit rating agencies. This effectively banned Hwang from managing hedge funds. Later, in April 2020, the SEC commissioners voted to vacate the ban. In 2013, the same year the ban was imposed, Hwang reportedly

converted one of the former hedge funds into a family office, Archegos.

What Are Family Offices?

Family offices are investment firms that solely manage the wealth of family clients or the manager's own money. Surveys say that they primarily invest in stocks, fixed income instruments, private equity, and real estate and do not offer their services to the public. Robert Casey, a consultant, estimates that as of 2020, there were 3,500 family offices with more than \$2.1 trillion in assets under management in the United States. Historically, family offices have largely focused on family wealth preservation and management for wealthy families. That landscape has shifted in recent years as the offices have grown in number and size. A report from investment management firm UBS found that around 70% of the largest family offices globally were formed in the past two decades (**Figure 1**). Through the years, various hedge fund founders and traders such as Hwang have transitioned to founding family offices. Unlike earlier generations of family offices, some of these firms are said to employ aggressive investment strategies.

Figure 1. Founding Year of the Largest Family Offices
(Percent of UBS Surveyed Offices Founded in Each Period)



Source: UBS, *Global Family Office Report 2020*.

Notes: UBS survey of 121 of the world's largest single family offices covering \$142 billion in net worth.

Some Proposed Policy Solutions

Some observers propose to subject family offices to regulation as investment advisers under the Investment Advisers Act of 1940 (Advisers Act, P.L. 76-768). Others argue for enhanced disclosure requirements for family offices and other market participants through Sections 13(f) and 13(d) of the Securities Exchange Act (Exchange Act, P.L. 73-291) to address perceived loopholes.

The Investment Advisers Act

Congress passed the Advisers Act to codify a fiduciary duty of investment advisers to their clients and to mitigate or

eliminate adviser conflicts of interest that might bias their advice. Under the act, an investment adviser is an entity that provides advice or issues reports or analyses regarding investment in securities for compensation. Central to being a SEC-registered investment adviser is completing a registration form providing information about an adviser's business, ownership, clients, employees, and disciplinary record and the private funds they advise.

The central role of a family office is advising its family clients, which is also arguably the role of an investment adviser. Before the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act, P.L. 111-203), family offices were not statutorily defined. During this time, family offices avoided regulation under the Advisers Act under the former "private adviser" exemption—which was available to advisers with fewer than 15 clients—or by obtaining a special exemptive order from the SEC.

The Dodd-Frank Act amended this regime to explicitly provide that certain family offices, as to be defined by the SEC, are not "investment advisers." The carve-out applies only to single family offices, which pool the wealth of a single family, not multifamily offices, which pool the wealth of several families. The carve-out for single family offices is in contrast to Dodd-Frank Act's placement of hedge funds and private equity funds with at least \$150 million in assets under management under the act.

A 2010 Senate Committee on Banking, Housing, and Urban Affairs report that accompanied the Dodd-Frank Act argued that large hedge funds and private equity funds—which, like family offices, were exempt from registration under the Advisers Act—should be made subject to registration under the act to provide information about their trades and portfolios and help regulators assess systemic risks. By contrast, the committee also explained that it was removing family offices from the act's jurisdiction because the act was not designed to regulate the interactions of family members and would intrude on their privacy.

Policy proposal—subjecting family offices to the Investment Advisers Act. In the aftermath of the Archegos failure, some have advocated for more family office regulatory oversight by putting them under the ambit of the Advisers Act. One observer, Tyler Gellasch, is head of the market reform group Healthy Markets. A former SEC counsel, Gellasch argues that the absence of such regulation has helped to make some family offices a financial stability concern. However, pushing back on the costs of such reform, in a 2012 report, *To Register or Not? SEC Investment Adviser Guidance for Family Offices*, business lawyers Ryan Harding and Elise McGee argue, "For most family offices, the information disclosure and compliance expense make registration an unattractive outcome." The share of very large family offices appears to have grown since 2012. Institutional Real Estate reports that most family offices currently have over \$250 million in assets under management.

The Exchange Act's 13F and 13D Disclosures

Form 13F. Section 13(f) of the Exchange Act requires disclosure of information regarding securities holdings by

institutional investors. The policy intention was to increase investor confidence through transparency. Institutional investors' investment activities and holdings in 13F reports could also help the SEC to assess the investors' influence and impact on fair and orderly securities markets.

An institutional investor must file a 13F report if it exercises investment discretion over an aggregate of more than \$100 million in securities specifically designated by the SEC as Section 13(f) securities. The SEC has broad rulemaking authority to determine the eligibility thresholds for 13F reporting. Archegos reportedly never filed form 13F in its eight years. Some inside the industry reported to the *New York Times* that it is unusual for offices the size of Archegos not to file and that smaller ones routinely file.

Form 13D. Section 13(d) of the Exchange Act specifies that, when an investor acquires beneficial ownership of more than 5% of a voting class of a company's equity securities, the investor must file a 13D report with the SEC. The form discloses the investor name, ownership amount, and purpose of transaction, among other information. Depending upon the individual circumstances, the investor may be eligible to file the more abbreviated 13G in lieu of 13D. Filings of 13D are particularly important for investors and company issuers to detect early signs of unsolicited takeover from hedge funds and others. In many situations, 13D filings can show when investors begin to accumulate large blocks of equity holdings of publicly traded companies. The filings provide transparency for large equity positions that trigger the 5% threshold. Archegos reportedly never filed a 13D despite its large *economic* exposure via total return swaps.

Policy proposal—enhancing 13F and 13D requirements.

Some observers argue for enhanced disclosure for family offices and other asset managers. Among other things, they advocate subjecting them to more confidential filings with the SEC to identify potential threats to market stability. For example, Americans for Financial Reform, a coalition group, has called for an SEC review of 13F filings and whether gaps in the disclosure process exist for family offices. Specifically, the group recommended the SEC expand the reporting frequency and types of financial products subject to 13F reporting to include total return swaps and short-selling positions. Opponents of the proposed changes argue that increased disclosures may reveal investors' proprietary trading strategies. They say disclosed positions may harm the market by deterring some investors from engaging with poorly run companies or expose fraud. Critics also argue that more disclosure may not be necessary, because market participants already know the level of trading activities even though they may not know who was making the trades. A previous legislative proposal (the Brokaw Act, S. 1744 in the 115th Congress) would have required the disclosure of certain derivatives—such as the ones used by Archegos—that would give investors economic exposure to stocks.

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