

**XV. *Family Office Regulation Act of 2021: Response to Archegos Scandal***

**A. Introduction**

The recent collapse of Archegos Capital Management (“Archegos”) in March 2021 spurred lawmakers to introduce the Family Office Regulation Act of 2021, or the House of Representative 4620 (“H.R. 4620”), which would change how family offices are regulated.<sup>1</sup> On July 22, 2021, Alexandria Ocasio-Cortez, a member of the House Financial Services Committee, introduced the Family Office Regulation Act of 2021, House of Representatives 4620 (“H.R. 4620”).<sup>2</sup> H.R. 4620 would limit the use of the family office exclusion from the definition of investment adviser under the Investment Advisers Act of 1940 to certain covered family offices. This includes family offices with \$750 million or less in assets under management that are not barred or subject to final orders for conduct constituting fraud, manipulation, or deceit.<sup>3</sup> Under this new exemption, family offices managing over \$750 million in assets would be exempted from registering with the Securities and Exchange Commission (“SEC”) as investment advisers.<sup>4</sup> However, family offices would be required to file reports as “exempt reporting advisers” in accordance with the SEC guidelines.<sup>5</sup>

H.R. 4620 would also annul a “grandfathering clause” of the Dodd-Frank Act (section 409) that permitted family offices to qualify for the family office exclusion even if they included non-members of the family.<sup>6</sup> Finally, the bill would authorize the SEC to exclude family offices that have less than \$750 million assets under management from “covered family office” if they are highly leveraged or engage in high-risk activities.<sup>7</sup>

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<sup>1</sup> *What Family Offices Should Know About HR 4620, A Bill Requiring More Family Offices to Register with the SEC*, DENTONS (Aug. 6, 2021), <https://www.dentons.com/en/insights/alerts/2021/august/4/what-family-offices-should-know-about-hr-4620-a-bill-requiring> [https://perma.cc/UW58-77UH].

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

This article will examine in detail the Archegos scandal, explore the relevant SEC regulations of hedge funds and family offices, and assess the newly introduced H.R. 4620. In Section B, this article explains the Archegos scandal in detail. Section C discusses the current SEC regulations for (i) non-family office hedge funds in general, and (ii) family offices and how they might have allowed such scandals to happen. Section D focuses on the procedural status of the H.R. 4620 and the considerations family offices must make in light of this newly proposed bill. Finally, Section E concludes with a summary of the main points.

## **B. Archegos Scandal**

### *1. Brief History*

Archegos was a private investment firm and family office that primarily invested in the United States, Chinese, and Japanese stock markets.<sup>8</sup> Archegos provided investment or wealth management services for ultra-high net worth investors, generally those with over \$100 million in investment assets.<sup>9</sup> Archegos was founded in 2013 by Bill Hwang, a former equity analyst at Tiger Management.<sup>10</sup> In 2001,

Hwang established the former Tiger Asia Management, which became a multi-billion-dollar hedge fund and one of the largest investors in the Asian financial market.<sup>11</sup> However, in 2012, the SEC charged Hwang and Tiger Asia Management with insider trading and manipulation of Chinese stocks.<sup>12</sup> Hwang pleaded guilty and agreed to criminal and civil settlements of over \$60 million.<sup>13</sup> In 2013, Hwang converted Tiger Asia Management into a family office and named it Archegos Capital Management, which has reportedly grown to become larger than even many well-known hedge funds.<sup>14</sup>

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<sup>8</sup> Cherian Varghese, *The Collapse of Archegos Capital: Explained*, MARKETFEED (Apr. 1, 2021), <https://marketfeed.news/the-collapse-of-archegos-capital-explained/> [<https://perma.cc/UC5Y-FYB2>].

<sup>9</sup> *Id.*

<sup>10</sup> *Who is Archegos' Bill Hwang?*, FINNEWS.ASIA (Mar. 29, 2021), <https://www.finews.asia/people/34136-who-is-bill-hwang> [<https://perma.cc/XW9V-7R48>].

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

## 2. *Total Return Swaps*

Archegos used a complex financial instrument called “total return swaps.”<sup>15</sup> A total return swap is “a swap agreement where one party makes payments based on a set rate, either fixed or variable, while the other party makes payments based on the return of an underlying asset, which includes both the income it generates and any capital gains.”<sup>16</sup> Total return swaps are favored by hedge funds because they allow access to a large amount of assets with only a minimal cash outlay.<sup>17</sup> Moreover, such trades do not have to be reported to the public.<sup>18</sup> Thus, Archegos never had to disclose to its banks any of the other total return swap transactions it had with other banks. As a result, Archegos could form a portfolio of \$100 billion without disclosing any information regarding its leverage or total return swap related information.<sup>19</sup> In a total return swap, the stock positions are not held in the holder’s name but rather in the bank’s name before the swap agreement is written and sold to a client.<sup>20</sup> This system and process allow the holder of the total return swap to anonymously and artificially trade stocks without actually owning them.<sup>21</sup> Apparently, the banks that dealt with Archegos couldn’t know Hwang was piling on leverage in the same stocks via total return swaps with other banks.<sup>22</sup>

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<sup>15</sup> Quentin Webb, Alexander Osipovich & Peter Santilli, *What Is a Total Return Swap and How Did Archegos Capital Use It?*, WALL ST. J. (Mar. 30, 2021), <https://www.wsj.com/articles/what-is-a-total-return-swap-and-how-did-archegos-capital-use-it-11617125839> [<https://perma.cc/JHQ4-J2QQ>].

<sup>16</sup> Lucas Downey, *Total Return Swap*, INVESTOPEDIA (Mar. 25, 2021), <https://www.investopedia.com/terms/t/totalreturnswap.asp> [<https://perma.cc/2ACU-YUVV>].

<sup>17</sup> *Id.*

<sup>18</sup> Erik Schatzker, Sridhar Natarajan & Katherine Burton, *Bill Hwang Had \$20 Billion, Then Lost It All in Two Days*, BLOOMBERG BUSINESSWEEK (Apr. 8, 2021), <https://www.bloomberg.com/news/features/2021-04-08/how-bill-hwang-of-archegos-capital-lost-20-billion-in-two-days> [<https://perma.cc/B6AF-J7ES>].

<sup>19</sup> *Id.*

<sup>20</sup> James Williams, *Archegos Collapse Shows What Can Happen When Leverage Is Misapplied*, HEDGEWEEK (May 5, 2021), <https://www.hedgeweek.com/2021/05/05/299729/archegos-collapse-shows-what-can-happen-when-leverage-misapplied> [<https://perma.cc/HY8H-A875>].

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

### 3. *High Leverage*

For investing in swaps, financial institutions often borrow millions of dollars from banks— known as leverage.<sup>23</sup> By late March 2021, Hwang’s portfolio in Archegos grew to \$100 billion, and this would equate to five times or more leverage in a cash portfolio.<sup>24</sup> At the time, Archegos heavily invested in a portfolio consisting of GSX Techedu (a Chinese ed-tech company), Discovery Inc., VicaomCBS, iQUIVI, Farfetch, Vipshop Holdings, Tencent Music Entertainment, and Baidu.<sup>25</sup> It is important to note that the relevant U.S. rules limit individual investors to have borrowed less than 50 percent of the money on margin when buying securities.<sup>26</sup> When such leveraged transactions are conducted, a portion of stocks that a firm intends to buy are often pledged in the form of collateral with banks.<sup>27</sup> The investor has to immediately bring in additional money as collateral as soon as the stock prices begin to fall.<sup>28</sup> This is because a decline in share prices leads to a fall in the value of margin with the broker/bank.<sup>29</sup> This demand for additional money or collateral is referred to as “margin calls”, which are triggered when the value of shares falls below a certain requirement.<sup>30</sup>

Total return swaps often increase the size of investments in stocks by enabling investors to infuse only a limited amount of money and providing them with a safe haven of anonymity.<sup>31</sup> However, when the underlying investments show a decline in value, banks and brokers usually sell the shares they hold on behalf of their clients.<sup>32</sup> If a client is unable to pay when a margin call is made, lenders begin to sell the shares

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<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> Matthew Fox, *These are the 8 Stocks That Plummeted as Archegos Capital Margin Call Led to \$20 Billion Liquidation*, MARKETS INSIDER (Mar. 29, 2021), <https://markets.businessinsider.com/news/stocks/archegos-capital-margin-call-20-billion-liquidation-8-stocks-plummeted-2021-3> [<https://perma.cc/HZ8K-WM37>].

<sup>26</sup> Schatzer, Natarajan & Burton, *supra* note 18.

<sup>27</sup> Jean Folger, *What Happens If I Cannot Pay A Margin Call?*, INVESTOPEDIA <https://www.investopedia.com/ask/answers/12/what-happens-cannot-pay-margin-call.asp> [<https://perma.cc/XJV6-ES4D>].

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

to recover what is owed to them. If the stock prices continue to fall, these lenders would start to incur huge losses.<sup>33</sup>

#### 4. *Impact*

In late March 2021, the stock prices of ViacomCBS, Baidu, and Tencent plummeted because of a large scale selling.<sup>34</sup> The shares of other companies Hwang had bet on, such as GSX Techedu and RLX Technologies, also fell.<sup>35</sup> To cover the losses, Archegos Capital initiated a fire sale—the selling of a security or other product at a price that is well below market value—of the stocks in their portfolio.<sup>36</sup> However, the lenders called for more collateral to secure equity swap trades they had partly financed, and the firm was unable to supply.<sup>37</sup> Most of the firm’s prime brokers such as Goldman Sachs and Morgan Stanley quickly offloaded the stock in all of Archegos’ investments.<sup>38</sup> As shares of the companies mentioned above were being sold or simply dumped, its stock price plummeted.<sup>39</sup>

It is unclear how big Archegos’ total losses were, but one can infer the magnitude based on the losses several banks have reported.<sup>40</sup> For example, Switzerland-based Credit Suisse alone lost \$4.7 billion from Archegos’ collapse. Wall Street Journal reported that the \$2 billion loss of Japan’s Nomura Holdings is tied to Archegos.<sup>41</sup> Other large institutions such as Goldman Sachs and Morgan Stanley also reportedly exited quickly to minimize losses as soon as Archegos collapsed. This is because the value of the collateral they were holding in the form of stocks was losing value very quickly.<sup>42</sup> The stocks of all major banking and financial services firms that had exposure to Archegos Capital saw

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<sup>33</sup> *Id.*

<sup>34</sup> Hayley McDowell, *The Collapse of Archegos Capital Management*, THE TRADE (Jul. 16, 2021), <https://www.thetradenews.com/the-collapse-of-archegos-capital-management/> [<https://perma.cc/23P3-XYQB>].

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> Talyor Telford & Hamza Shaban, *How Credit Suisse Got Tangled in the Archegos Wall Street Chaos*, WASH. POST (Apr. 6, 2021), <https://www.washingtonpost.com/business/2021/04/06/credit-suisse-archegos-capital/> [<https://perma.cc/6YK9-XX22>].

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

a huge fall on March 29, 2021.<sup>43</sup> Morgan Stanley shares fell 2.6 percent and Goldman Sachs Group took a hit of 1.7 percent.<sup>44</sup> The shares of Nomura posted a record one-day decline of 16.3 percent. Credit Suisse shares dropped 14 percent, its biggest fall in a year.<sup>45</sup>

In response to this scandal, SEC and Commodity Futures Trading Commission (“CFTC”) pointed to the need to tighten the regulation of family offices and the need for introspective look at their own risk-management systems: “The collapse of Archegos Capital Management and the billions of dollars in losses to investors and other market participants is a vivid demonstration of the havoc that errant large investment vehicles called ‘family offices’ can wreak on our financial markets,” said Dan M. Berkovitz, a commissioner of the CFTC.<sup>46</sup>

### C. Relevant SEC Regulations and Their Developments

#### 1. *Non-Family Office Hedge Funds*

In December 2004, the SEC issued a controversial rule mandating hedge fund advisors to register under the Investment Advisers Act.<sup>47</sup> The controversy stemmed from the hedge fund advisors’ reluctance to comply with the new act in addition to the existing SEC inspections and bookkeeping and record keeping requirements to which they were already subjected.<sup>48</sup>

In 2010, the Dodd-Frank Act mooted the oppositions by authorizing explicitly the SEC to require registrations of hedge fund advisers.<sup>49</sup> The advisors’ reluctance was mooted in 2010 by the Dodd-Frank Act, which explicitly authorized the SEC to require hedge fund advisers to register. Title IV of the Dodd-Frank Act, also known as the

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<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> Dan M. Berkovitz, *CFTC Oversight of Family Offices Must be Strengthened*, CFTC (Apr. 1, 2021), <https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement040121> [<https://perma.cc/BQ3C-ZLGR>].

<sup>47</sup> Wulf Kaal & Dale Oesterle, *The History of Hedge Fund Regulation in the United States*, THE CLS BLUE SKY BLOG (Feb. 29, 2016), <https://clsbluesky.law.columbia.edu/2016/02/29/the-history-of-hedge-fund-regulation-in-the-united-states/> [<https://perma.cc/7RS6-5P94>].

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

Private Fund Investment Advisers Registration Act of 2010 (“PFIARA”) authorizes the SEC to supervise hedge funds’ compliance with regulations.<sup>50</sup> Under the Dodd-Frank Act, the SEC is authorized to issue rules compelling registration and enhanced disclosure private equity and hedge fund managers.<sup>51</sup> The SEC issued rules that would mandate “the disclosure of strategies and products used by the investment adviser and its funds, performance and changes in performance, financing information, risks metrics, counterparties and credit exposure, positions held by the investment adviser, percent of assets traded using algorithms, and the percent of equity and debt, among other matters.”<sup>52</sup>

The Dodd-Frank Act “mandates hedge fund adviser registration to increase record keeping and disclosure.”<sup>53</sup> Under PFIARA, hedge funds managing more than \$150 million assets are “required to register as investment advisers and to disclose information about their trades and portfolios to the SEC.”<sup>54</sup> Under the Dodd-Frank Act, the SEC is also empowered to establish rules for registration and reporting by hedge fund managers previously exempt from registration.<sup>55</sup> By registering hedge fund advisers, the SEC may “collect necessary information to curtail those who operate in the unregulated areas of the markets, prevent fraud, limit systemic risk, and provide information to investors.”<sup>56</sup>

Title IV of the Dodd-Frank Act also includes record keeping requirements for investment advisers, as well as any other information that may be “necessary and appropriate to avoid systemic risk” by the SEC and other systemic risk regulators.<sup>57</sup> Advisers must provide confidential reports on certain information related to systemic risk, such as: “trading practices; trading and investment positions; the amount of asset under management; valuation policies; side letters; the use of

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<sup>50</sup> *SEC Adopts Pay-To-Play Rule for Investment Advisers*, O’MELVENY (Jul. 15, 2010), <https://www.omm.com/resources/alerts-and-publications/publications/pay-to-play-july-alert/> [https://perma.cc/R59P-24QU].

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

leverage; including off-balance sheet leverage; counterparty credit risk exposures; and other information deemed necessary.”<sup>58</sup>

## 2. *Family Offices*

Until recently, the situations were a little different with family offices. In June 2011, the SEC adopted Rule 202(a)(11)(G)-1, which states that “a family office is excluded from the investment adviser definition if it: (1) manages the wealth and other affairs of a single family; (2) provides investment advice only to family clients; (3) is wholly-owned by family clients and exclusively controlled by family members and/or certain family entities; and (4) does not hold itself out to the public as an investment adviser.”<sup>59</sup> Under present law, a family office is not disqualified from the exemption by any of the following: “total asset under management, ... the amount of leverage utilized for the assets or the exposure of any counterparties to its positions, ...[or] the number of family members participating are disqualifying factor for the exemption.”<sup>60</sup>

In the Archegos collapse, Hwang kept anonymity regarding multiple total return swap deals he had with different banks, took advantage of extreme leverage, and invested heavily with relatively small capital. All this could have happened only if Bill Hwang’s investment strategies were protected under the lack of transparency in the family offices and swap markets.

### **D. What Family Offices Should Learn from the Scandals**

Though family offices have historically catered to family wealth preservation and management,<sup>61</sup> the growth of family office in number and size in recent years has somewhat changed the exact capacities of the family office.<sup>62</sup> Though Archegos was exceptionally aggressive in its trading policies and practices, several firms have adopted high leverage and high risk, often called as “get wealthy” policies that are far more risky than the “stay wealthy” policies

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<sup>58</sup> *Id.*

<sup>59</sup> DENTONS, *supra* note 1; 17 C.F.R. § 275.202(a)(11)(G)-1 (2011).

<sup>60</sup> DENTONS, *supra* note 1.

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*



employed by most family offices.<sup>63</sup> “Yet, standing alone, the existence of some family offices with more aggressive investment strategies surely is not a sufficient reason to subject most family offices to the information disclosure, compliance expense and potential disclosure of proprietary trading strategies that comes with federal regulation.”<sup>64</sup>

While family offices must strive for comprehensive improvements in governance and risk management, they must also not forget about fraud risk management.<sup>65</sup> Although family office fraud is rarely publicized in the media, it is more common than banks and family office owners themselves appreciate.<sup>66</sup> reliance on familial loyalty can be catastrophic when pertaining to significant control over an ultra-wealthy family’s finances and investments.<sup>67</sup> “To supplement enhanced governance and risk management frameworks, family offices need more formal, sophisticated fraud prevention programs, with robust policies and procedures, and periodic fraud risk assessments — programs that can proactively prevent and detect fraud early, mitigating both reputational and monetary losses for the family office and their counterparties.”<sup>68</sup>

This can be a huge issue not only legally, but also culturally.<sup>69</sup> To combat family office related frauds, family offices must first admit there might be a problem within the current system.<sup>70</sup> Family offices must then be willing to train family members and employees about identifying, reporting, and responding to potential fraud risks.<sup>71</sup> Most importantly, sophisticated market participants, especially the family offices, must take initiative in reviewing their internal risk-management systems, firm cultures, and incentive structures, instead of depending on the regulators for guidance on how to avoid such losses in the future.<sup>72</sup>

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<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> Marie Gervacio, *Regulated or Not, Family Offices Should Start Behaving Like Regulated Entities*, ANKURA (Jul. 20, 2021), <https://ankura.com/insights/regulated-or-not-family-offices-should-start-behaving-like-regulated-entities/> [<https://perma.cc/8ZTM-TY2W>].

<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> DENTONS, *supra* note 1; Gervacio, *supra* note 67.

### E. Conclusion

The recent collapse of Archegos Capital Management reminds the regulators and especially the family offices of the grave dangers posed by family offices unknown transactions, often accompanied by anonymity and extreme leverage. Archegos scandal also reminds them of the importance of proper regulations as well as the need for introspective attention at family offices' own internal risk-management systems. The Family Office Regulation Act of 2021 is a response by regulators to cautiously investigate family offices and their transactions. Even if H.R. 4620 never becomes law, the family offices must not forget that the opinions of the bill's supporters in the Financial Services Committee could heavily influence how SEC and CFTC regulators monitor family office issues.<sup>73</sup>

However, significant changes to current regulations could result in more harm than benefit for family offices if such changes restrict the qualifications for exemption so far as to invade their privacy and impair their ability to fund startups and otherwise promote innovation.<sup>74</sup> Family offices, with the current exemptions in mind, must start to communicate with the regulators about the recently proposed modifications to relevant rules and exemptions.<sup>75</sup>

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<sup>73</sup> DENTONS, *supra* note 1.

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

<sup>76</sup> Student, Boston University School of Law (J.D. 2023).