The Collapse of Archegos Capital Management

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The collapse of family office Archegos Capital Management ("Archegos" or the "Firm") highlights the inherent risks of investing in concentrated, highly levered equities and derivatives. However, the failure of Archegos can primarily be attributed to poor risk management of the investment portfolio within the Firm itself and is not related to any systemic issues within the financial markets or hedge fund industry. The fallout from the drastic fall in value of the Archegos portfolio resulted in significant losses to several of the Firm's prime brokers, currently estimated to be at least $4.7 billion for Credit Suisse. This research report serves to highlight the services offered by a prime broker and its rights under a margin default, potential industry repercussions, and Cliffwater's due diligence approach related to evaluating and monitoring portfolio and counterparty risk.

Prime Brokerage and Margin Calls

Many large international investment banks have prime brokerage divisions that provide various portfolio and trade related services including financing, custody, clearing, reporting and other operational functions to clients such as hedge funds and select family offices. Of most relevance to Archegos is the ability of a prime broker to provide margin financing to its clients using the underlying fund assets as collateral. Prime brokers monitor the valuation fluctuations of each client portfolio daily to ensure the valuation of the collateral maintained in custody is sufficient to cover the contractual margin requirements. In the event of a dramatic drop in the valuation of a client's portfolio, the prime broker may issue a margin call, whereas the client will need to either liquidate positions or transfer in additional cash to satisfy the margin shortfall. If the client cannot collectively liquidate securities or provide additional cash and defaults on the margin call, the prime brokers have the right to manage or sell the underlying fund assets to mitigate their losses.

Credit Suisse, Nomura, MUFG, Goldman Sachs, Deutsche Bank, Morgan Stanley, and Wells Fargo all reportedly served as prime brokers to Archegos. On or around March 25, due to a significant drop in the values of Archegos' concentrated, highly levered exposure to media and China based companies, primarily via total return equity swaps, Archegos' prime brokers realized the underlying collateral needed to be sold or liquidated to avoid significant losses at each respective bank. The financial impact to each prime broker primarily depended on how quickly each prime broker was able to sell the Archegos securities held in custody as collateral to generate cash proceeds. As of April 19, 2021, losses at Credit Suisse, Nomura and Morgan Stanley were estimated to be $4.7 billion, $2 billion, and $1 billion, respectively. No material losses at Goldman Sachs, Deutsche Bank and Wells Fargo were reported.

Potential Industry Repercussions

The fallout from the collapse of Archegos has already attracted the scrutiny of regulators. A primary concern relates to Archegos' usage of total return swaps and the lack of transparency of the levered swap exposure in totality across its multiple prime brokers. Archegos' usage of total return swaps allowed the Firm to avoid public filing requirements around significant company ownership such that there was no public disclosure regarding the Firm's actual concentrated economic exposure to each individual security. The billions of losses incurred by Credit Suisse and Nomura can primarily be attributed to the delayed liquidation of the collateral held by these banks compared to the other prime brokers, as the earlier block sales by Goldman Sachs and Morgan Stanley significantly impacted the prices of the collateral not yet liquidated. The SEC, or organizations such as The International Swaps and Derivatives Association ("ISDA"), may consider changes that enhance the collective disclosure of swap exposure to one hedge fund or family office client. Currently, ISDA agreements are independently negotiated between the client and each prime broker. Such disclosure would allow for enhanced risk management at each prime broker related to a client's overall derivative exposure and usage of leverage, which would help determine appropriate margin lending parameters.

Another expected area of focus is related to the lack of a regulatory regime regarding most family offices. Unlike hedge funds that manage outside capital, family offices that have no external investors are generally exempt from registration with the U.S. Securities and Exchange Commission. As unregulated entities, these family offices are therefore not required to report assets under management and select portfolio data via quarterly form 13F and annual form PF filings with the SEC. The SEC may reconsider the current exemptions for family offices if such disclosure would have identified the inherent risks in the portfolio, or at least the existence of a family office managing reportedly at least $10 billion of unlevered assets.

Evaluating and Monitoring Portfolio and Counterparty Risk

The failure of Archegos can primarily be attributed to poor risk management of the investment portfolio within the Firm itself and is not related to any systemic issues within the financial markets or hedge fund industry. The Archegos portfolio comprised of long concentrated, highly levered equities and derivatives significantly increased the potential risk of loss. Cliffwater's investment due diligence on all approved hedge funds includes a thorough review and understanding of each fund's risk profile including usage of leverage, individual position concentration, fund liquidity, and various exposure metrics. Post an investment in a hedge fund by a Cliffwater client, monthly monitoring is conducted to evaluate any material changes in risk profile and drivers of performance. It is important to note that unlike the Archegos family office, Cliffwater's approved hedge fund managers are regulated by the SEC or other local jurisdictions and have external institutional investors which inherently allows for enhanced overall transparency of the portfolio and oversight of the manager.

The significant financial losses incurred by some of Archegos' prime brokers, in particular Credit Suisse and Nomura, highlights the need for hedge funds to maintain multiple prime brokerage relationships. Counterparty diversification is necessary in the event a hedge fund needs to transfer assets or reduce exposure to a particular prime broker due to material concerns regarding its business viability or potential changes to service offerings or financing terms. For example, after its disclosure of an expected $4.7 billion loss, Credit Suisse fired the head of its investment bank and head of risk and compliance, announced its co-heads of prime brokerage will step down, and suffered credit rating downgrades and reputational damage, which may lead to hedge funds reducing prime brokerage exposure to the bank. Counterparty risk management is assessed as an important component of Cliffwater's operational due diligence process for every approved hedge fund manager. Cliffwater's approved hedge funds that have historically retained Credit Suisse or Nomura also maintained relationships with alternative prime brokers which mitigates the risk of reliance on only one prime broker to provide custody, settlement, and financing services.

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