# Explained: Why regulators failed to spot the ticking time bomb at Archegos

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Last week, [a fire sale of shares](https://www.cnbctv18.com/market/stocks/explained-archegos-margin-call-bill-hwang-credit-suisse-goldman-sachs-nomura-8757301.htm) held in family office Archegos Capital Management's name rattled equity investors globally even though the impact was restricted to a handful of stocks. Complicating matters for the market and for regulators was the lack of information about the stocks in Archegos’s portfolio. Despite owning huge positions in stocks in Discovery, ViascomCBS, and many US-listed China stocks, the fund was able to keep those a secret from the market. That begs the question: How did the Bill Hwang-owned Archegos manage to do that. Let us break it down for you

**How did Archegos manage to get away by not disclosing its positions?**

According to reports by Bloomberg and The Wall Street Journal, Archegos built up these positions through a derivative instrument called total return swaps. According to [this](https://www.forbes.com/sites/antoinegara/2021/03/29/the-firm-behind-the-30-billion-yardsale-shaking-financial-markets-disclosed-almost-nothing/) Forbes report, family offices are required to report stock and derivative positions above $100 million in 13-f filings on the Securities Exchange Commission’s EDGAR website. However, swaps are excluded from 13-f filings

**So what exactly is a total return swap?**

A total return swap [is a swap agreement](https://www.investopedia.com/terms/t/totalreturnswap.asp) in which one party (Archegos, in this case) makes payments based on a set rate, while the counterparty (Normura, Goldman, Credit Suisse, in this case) makes payments based on the return of an underlying asset(shares in this case), This includes both the income it generates (dividend) and any capital gains (appreciation in share price).

So Archegos borrowed money from investment banks like Goldman, Morgan Stanley, Credit Suisse, Nomura, and got them to buy a basket of stocks. It paid the banks a fixed pre-decided fee at regular intervals, plus the interest cost for the borrowed money. In return, the banks paid Archegos the capital gains on the basket of stocks, at pre-decided intervals, and also dividends if any.

**How does this arrangement benefit the buyer of the swaps?**

The buyer can build a huge position without the market knowing about it. Plus, the buyer has put up very little of his own capital upfront. According to a WSJ report, Archegos was putting up $15 of its capital, and borrowing $85 against it.

**Give an example**

Say a fund house based out of Singapore wants to bet on Rs 100 crore worth of Tata Steel shares for six months. It would get in touch with an investment bank in India, put up Rs 15 crore and borrow Rs 85 crore from the investment bank. This Rs 100 crore would then be used to buy Tata Steel shares. The fund house would pay the investment bank a fixed fee as well as interest on the borrowed money, every month. If the value of the Tata Steel shares were to rise to Rs 110 crore at the end of the month, the investment bank would have to pay Rs 10 crore to the fund house. The fund house’s profit will be the capital gain minus the fixed fee and interest charges.

But if the value of Tata Steel shares is lower at the end of the month, the investment bank will ask the fund house to either reduce its position or put up more capital. This is known as a margin call. Throughout the tenure of the swap contract, the shares sit in the books of the investment bank.

**What happened in the case of Archegos?**

Archegos had total return swap arrangements with multiple investment banks for the same set of stocks. The banks were not aware of this. As a result, Archegos managed to build huge positions without having to make the required disclosure. In doing so, Archegos ended up overextending itself without enough capital to fall back on.

As long as the share prices in Archegos’s swap portfolio kept rising, the fund profited hugely. Trouble started when the share prices began to slip. Archegos was inundated with margin calls from the banks which were holding the shares. Once it became clear that Archegos did not have the capital to honour the margin calls, the investment banks started dumping the stocks.

**What do regulators plan to do?**

Treasury Secretary Janet Yellen said at the Financial Stability Oversight Council (FSOC) that top US regulators will re-establish an Obama-era working group to scrutinise hedge funds in particular and study their risks and vulnerabilities. Last year, the Donald Trump administration had shuttered the working group.

Yellen said heightened scrutiny was required after the COVID-19 pandemic showed hedge funds can increase market instability at times.