CONVERGENCE

OPTIMAL PERFORMANCE

Archegos Capital Management
Another Sad Day in our Financial Village
It's Time to Wake-Up!

The Archegos financial fiasco reminds me of the phrase coined by French writer Jean-Baptiste Alphonse Karr, "plus ça change, plus c'est la même", "the more things change, the more they remain the same." In his latest investor letter, hedge-fund titan David Einhorn calls out the SEC for its lack of action on what he considers the "real story" of the Archegos Capital implosion. However, we believe the real and perhaps ugly story is our industry's collective failure to call out suspicious activity. Once again, our "financial village" ignored, overlooked or failed to understand "signals" suggesting that not all was quite right about Archegos. The result, poof, another $8-$20 billion goes-up in smoke. Until our "village" members wake-up to these signals, the losses and finger pointing will continue. It is time for a different approach.

According to media reports Einhorn slammed the SEC for not seeing the poor risk management of banks and excessive leverage assumed by Archegos. He says that caused people to miss how Archegos "cornered the market" and drove a massive gain in a stock that short sellers say faked sales. The New York Times points to Archegos' failure to file Form 13F which would have signaled its large positions in securities, including derivatives, that is of course, if anyone pays attention to what is in these filings. And just think that 6-months ago the SEC considered increasing the 13F reporting thresholds from $100mm to $3bn! Just imagine if that was ratified! This all sounds remarkably familiar. Who remembers LTCM?

Archegos failure to file a 13F is an interesting angle to explore. Convergence has studied 10-years of 13F filings. They are one of many filings within the regulatory filing "tool-kit" that banks, investors, service providers and regulators can use to supplement their risk management oversight, yet they do not. So why? Well, the SEC makes it clear that they do not check regulatory filings for accuracy, consistency or frequency. And since they are not checking them for accuracy it is unlikely they are attempting to identify those who fail to file it. As many of our colleagues know, regulatory filings are often inaccurate, incomplete and inconsistently produced making comparisons difficult. And on top of this, the filings are loaded with "technical jargon" making them impossible for mere mortals to understand. So, why would they bother?

While Mr. Einhorn's investors and others may agree with his criticism of the SEC, Convergence does not agree because it is simply too easy to blame them in this case and the problem is beyond the SEC's ability to police it on their own. Let's be honest, the business of regulatory arbitrage is booming in our rules-based system and while there is much more the SEC can improve, there are plenty of others involved in our "financial village" who were in a position to "smell this particular rat."

Let us do a quick rollcall of those in our "financial village" and point out a few of the opportunities to keep this from happening in the future:

1. Banks – were in a good position to identify Archegos' 13F disclosure failures. After all, they finance the securities that Archegos should have reported in a Form 13F filing. Archegos failure to file their Form 13F should trigger some level of additional inquiry as to why. Are they failing to comply for a reason?
2. Investors – were in a good position to reconcile the positions reported to them by Archegos in portfolio updates and investor letter to Archegos' 13F filings. After all, the SEC publishes them so investors can follow the investment activity of large managers. Investors pay lots of money to investment consultants to help them identify "questionable" entities.
3. Investment Consultants – were in a good position to identify Archegos failure to file 13F if they perform due diligence on behalf of investors
4. SEC – are not in a good position to unilaterally detect Archegos-like 13F filing failures. The SEC clearly states "they do not review what is filed in 13F" nor many other regulatory filings submitted. They have committed to improving the quality of selective financial disclosures within regulations like S-K, yet the industry and taxpayers deserve improvements across all regulatory filings, including Form 13F, Form ADV, Form D and Forms 3&4. All of these Forms suffer from similar neglect.

How did Archegos avoid being on the SEC radar screen and how did it avoid filing a 13F?

1. Not on The SEC Radar Screen - The old "Family office" loophole exists so they did not need to "register" as an adviser with the SEC. This means no transparency into the entity and its business via Form ADV analysis.
2. Failure to File a Form 13F – Archegos either believed they did not have to file, or simply decided not to file. Lawyers will debate the nuances of this question well after the next scandal hits us.

This is why the "village approach" is so desperately needed. Had the banks been aware that Archegos may not have been meeting their 13F reporting requirements they could have dug deeper into the reasons. If investors and their agents replaced "blind-trust" with "informed trust" and attempted to reconcile the positions reported to them to Archegos 13F, they would have detected that no 13F was on file. And if the SEC plugged loopholes that exists for family offices and pay more attention to existence and quality then perhaps these issues can be identified earlier. And for public companies, such as Viacom whose stock price plunged 27% as Archegos liquidated its holdings, they would have had more transparency into who owned their shares and what was driving the stock market fluctuations. No one has a crystal ball, so it is a question for the ages.

Convergence calls for all in our "financial village" to improve their ability to detect "risk signals" and use the power they have to minimize the wreckage created by the Archegos in the market.

It does not need to be this way. The technology and tools are there to detect the very signals that can save so many for the bad acts of so few. So why do we continue being victimized by the Archegos'? And then I woke-up to the reality that within our "financial village"……..“plus ça change, plus c'est la même."

If you want to learn how to use "risk signals" to reduce your risk of being victimized by bad actors, email me at jphinney@convergenceinc.com.