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THE JOINT AUDIT COMMITTEE IN THE POST-ARCHEGOS RISK MANAGEMENT REGULATORY LANDSCAPE

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Regulators—including the Federal Reserve, the U.S. Securities and Exchange Commission, the Commodity Futures Trading Commission and the Joint Audit Committee—are increasingly focusing on the terms and conditions of account agreements under which banks, broker-dealers and futures commission merchants' contract with their customers, and in particular on terms and conditions relating to limits, the right to call for margin, limited recourse, and grace periods that may toll the right to exercise remedies upon a default. This focus derives from legitimate risk management concerns. The market crash in March 2020 and the ensuing weeks of volatility, and then, a year later, the default of Archegos Capital Management, spurred regulatory and supervisory assessments and reviews of risk management practices across the industry.[1]

For many firms, this process has cast a spotlight on practices around documentation of trading and clearing arrangements with institutional clients. There was a time, before the 2008 financial crisis, when dealers, for the most part, exerted most of the leverage in document negotiations with those clients. (The template forms of the ISDA Master Agreement and Credit Support Annex attest to this fact.) In the wake of the crisis, however, the balance began to shift and dealers increasingly faced the choice between conceding risk points to top-tier clients, and losing the business. Of course, at the same time non-market and market risk management functions at the dealers were becoming more robust, more fully staffed, and more intensively regulated. So, dealers were able to get comfortable that they could manage the risk entailed by concessions around key documentation terms.

Now, in the wake of the March 2020 volatility and the Archegos default, dealers are experiencing something of a regulatory reckoning around these risk management practices. In this article I examine three recent examples of this new vigilance: SR 21-19, issued by the Fed's Division of Supervision and Regulation with specific reference to Archegos;[2] a March 2022 Statement by the SEC's Division of Trading and Markets[3]; and the Joint Audit Committee's recent practice in the conduct of annual financial and operations audit of the industry's largest FCMs. After an overview of SR 21-19 and the TM Statement, I look at the history of the

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JAC's audit practice around the issues raised by those regulatory releases. My objective is to reveal what the three regulatory initiatives have in common, and suggest ways that the JAC's initiative might look to the Fed and the SEC actions as instructive precedents to action they should consider as well in addressing a matter of common concern, among not just the regulators, but among the market participants as well (on both the sell-side *and* the buy-side).

SR 21-19

Last December the Fed's Division of Supervision and Regulation issued an SR Letter, SR 21-19, summarizing a supervisory assessment undertaken by Fed staff of counterparty credit risk management in light of the Archegos Capital Management Default in March 2021.[4]

SR 21-19 identifies several risk management practices of concern for banks and dealers entering into leveraged derivatives transactions:

- **Diligence at onboarding and in periodic credit reviews.** Firms may "accept incomplete and unverified information from" counterparties, particularly with regard to the fund's strategy, concentrations, and relationships with other market participants. These concerns are "heightened where a fund client has a history of concentrated positions and losses."
  - **Remediation.** Onboarding and ongoing monitoring diligence should include "information regarding size, leverage, largest or most concentrated positions," as well as information about the counterparty's other prime brokers "with sufficient detail or frequency" to permit the firm to determine the counterparty's ability to meet its obligations on outstanding transactions.
- **Control Functions.** Firms should be vigilant to how "poor communication frameworks and inadequate risk management functions, as well as fragmented systems and ineffective governance, may hamper their ability to identify and address risk."
- **Reputation Risk.** Firms should "consider reputational risk in making risk assessments; when they do so, they should establish a clear connection between such factors and specific financial decisions made by the firm with regard to a specific client."
- **Documentation.** Finally, firms should ensure that there is comprehensive review by internal stakeholders (sales, market risk, non-market risk, credit, finance) of "contractual terms and practices relating to internal limits," since those terms can materially affect the risk a counterparty presents.
  - SR 21-19 specifically calls out the risk of acceding to "inappropriate margin terms," which may include "failing to provide for adequate margin levels or sufficient risk-sensitivity." Contractual terms "that prevent a firm from improving its margin position or closing out positions quickly if a fund misses margin calls, even when presented with an increasing risk profile at the fund, may be inconsistent with safe and sound practices."
  - Firms should "ensure that margin prac-

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tices remain appropriate to the fund's risk profile as it evolves, avoiding inflexible and risk-insensitive margin terms or extended close-out periods with their investment fund clients."

THE TM STATEMENT

In March 2022, Staff of the Division of Trading and Markets issued a statement in the same vein. Without naming Archegos, the Statement urges broker-dealers and other market participants

- to remain vigilant to market and counterparty risks that may surface during periods of heightened volatility and global uncertainties and to maintain strong risk management practices;
- to collect margin from counterparties "to the fullest extent possible in accordance with any applicable regulatory and contractual requirements;"
- to monitor concentrated positions of prime brokerage counterparties and to seek sufficient information to determine counterparties' aggregate positions in any markets that may experience liquidity concerns and work with the counterparties to mitigate risk;
- to stress test positions with the proper severity in light of current events and potential market movements, and act to manage the risk of the positions, particularly those that are concentrated, appropriately; and
- to monitor risk management limits, calibrated to the financial resources of the broker-dealer, closely intraday and escalate any breaches promptly to senior management.

THE JOINT AUDIT COMMITTEE

In 1984, a number of futures exchanges, acting in their capacities as self-regulatory organizations, and the National Futures Assocation, entered into a Joint Audit Agreement, under which any FCM that is a member of more than one self-regulatory organization would have a single designated SRO. Under the Agreement, the DSRO would be primarily responsible for periodic financial examinations, the results of which would be shared with the other SROs of which the FCM is a member.[5]

The CFTC endorsed the Joint Audit Agreement when it adopted Regulation 1.52, which permits DSROs to enter into such agreement subject to the CFTC's approval after public notice and comment.[6] Under Regulation 1.52 an SRO may delegate responsibility for regulatory oversight over a member FCM to a designated SRO with respect to

- minimum financial and related reporting requirements and risk management requirements, including policies and procedures relating to the customer funds, adopted by such SRO and the CFTC; and
- financial reports and notices necessitated by such minimum financial and related reporting requirements.

The current Joint Audit Program assigns each FCM to either CME or NFA as the FCM's DSRO (specifically, all FCM clearing members of CME are assigned to CME, all other FCMs to the NFA). Accordingly, only the CME and NFA cur-

rently engage in routine, periodic on-site examinations of FCMs pursuant to the Joint Audit Agreement.[7]

THE JAC AND CFTC STAFF ON CFTC REGULATION 1.56

In 2019 the JAC issued a Regulatory Alert[8] asserting that "certain clauses in FCM account agreements with their customers and noncustomers" were in violation of CFTC Regulation 1.56.[9]

Specifically, JAC 19-03 interprets CFTC Regulation 1.56 to

- require that FCM customer (and non-customer) account agreements give the FCM *the absolute right at all times* "to look to funds in all accounts" of the customer, including accounts that are under different control, as well as the right to call the customer for funds required by the FCM under the agreement, and
- prohibit "limited recourse and nonrecourse clauses" in any account agreement.

Twice since its issuance, CFTC staff has addressed the JAC's interpretation of Regulation 1.56, appearing, in part, to endorse it, but also to clarify and expand on it as well. In both cases, Staff framed its guidance on Regulation 1.56 within the broader context of guidance on how an FCM should manage the separate margining of accounts established by a customer that maintains more than one separately managed account with the FCM.

In CFTC Letter 19-17, Staff states:

"The Division of Swap Dealer and Intermediary Oversight confirms that, in accordance with Regulation 1.56, FCM customer agreements or other documents must not: (i) preclude the FCM from calling the beneficial owner of an account for required margin; (ii) in the event the beneficial owner fails to meet the margin call, preclude the FCM from initiating a legal proceeding to recover any shortfall; or (iii) otherwise guarantee a beneficial owner against, or limit a beneficial owner's, loss.

"To address any shortfall, the FCM ***must retain the ability to ultimately look to funds in other accounts of the beneficial owner***, including accounts that may be under different control, as well as the right to call the beneficial owner for additional funds."[10]

And again in 2020:

"There is no specific or express language that must be contained in customer agreements in order for an FCM to meet the requirements of Regulation 1.56. As Letter 19-17 made clear, Regulation 1.56(b) prohibits an FCM from agreeing to (1) guarantee the beneficial owner against loss, (2) limit the loss of the beneficial owner, or (3) prohibit the FCM from calling for or attempting to collect initial and maintenance margin as established by the rules of the applicable board of trade. Separately, Regulation 1.56(c) provides that no person may represent that an FCM will engage in any of the acts or practices described in 1.56(b). ***An FCM agreement that does not contain (or incorporate by reference) language that can be construed as a representation that the FCM agrees to any of those three points would meet the requirements of Regulation 1.56; an FCM need not have additional provisions regarding its rights against the beneficial owner under such an agreement.***

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"An FCM and its client (and the client's asset manager) can, consistent with Regulation 1.56, agree to a protocol to address rare occasions where margin calls in one account of the beneficial owner at the FCM are not timely met. Pursuant to such a protocol, on such an occasion, the FCM would promptly follow a specific series of defined steps before resorting to liquidation or accessing the funds in the other accounts of the beneficial owner held at the FCM. ***Nonetheless, the FCM must retain, at all times, the discretion to determine that the facts and circumstances of a particular shortfall are extraordinary and therefore necessitate accelerating the timeline and relying on the FCM's protocol for liquidation or for accessing funds in the other accounts of the beneficial owner held at the FCM.***"[11]

THE JAC'S EVOLVING INTERPRETATION OF CFTC REGULATION 1.56

JAC Alert 19-03, read in light of CFTC Letters 19-17 and 20-28, presents a critical interpretive question, for FCM legal and compliance personnel and JAC examiners alike: namely, under this guidance, when is an FCM account agreement in violation of CFTC Regulation 1.56?

Although the answer to this question is not as free from ambiguity as such personnel and examiners might wish, this much is clear:

- An agreement that does not contain provisions agreeing to the prohibited terms enumerated in 1.56(b) need not contain additional provisions affirmatively detailing unlimited recourse. So a "standard" FCM agreement that simply provides for the right to call margin and for the customer's obligation to pay, does not also need to state (for example) that the FCM retains the absolute right at all times to look to funds in all accounts of the customer.
- Where a customer maintains separately margined accounts with an FCM, the FCM may agree with the customer to "a protocol" that would specify a "series of defined steps" constraining the FCM's right to access funds in one separately managed account to cover a margin shortfall in another separately margined account. Nonetheless, where the FCM has agreed to such a protocol, it must retain, at all times, the discretion to determine that the facts and circumstances of a particular shortfall are extraordinary and therefore necessitate accelerating the timeline set forth in that protocol.

What is much less clear is whether the JAC and CFTC guidance on Regulation 1.56 prohibits an FCM from agreeing to cure periods or grace periods all together—that is, for any customer (or non-customer), without regard to whether it maintains separately margined accounts with the FCM and without regard to whether the relevant account agreement includes a "protocol" for how to address shortfalls in any such separately margined accounts.[12]

CONCLUSION

The JAC has a broad remit under CFTC Regulation 1.52 to examine FCMs for compliance with CFTC and SRO "risk management requirements, including policies and procedures relating to the customer funds." But an indispensable precondition to the effective execution of that mission is clarity about what those requirements are. Absent that clarity, the JAC risks creating

confusion and informational asymmetries within the industry, through exam and disciplinary findings that are not transparent on the face of guidance issued to date and which are applied inconsistently and without sufficient transparency.

The Fed's SR 21-19 and the TM Statement may offer the CFTC and JAC a framework within which to provide clarity on this topic. After all, most clearing member FCMs also operate as broker-dealers and many are also affiliates of bank and financial holding companies or are otherwise subject to regulation by the Fed. And the CFTC and JAC should welcome the opportunity to harmonize their risk management guidance with the Fed's and SEC's.

To that end, the CFTC and JAC should issue guidance aligning their guidance to date on Regulation 1.56 with SR 21-19 and the TM Statement. Specifically, the CFTC and JAC should clarify that FCM customer account agreements (whether or not entered into with customers that maintain separately managed and separately margined accounts), when construed in their entirety under applicable contract law, should not include terms that would prevent the FCM from "improving its margin position or closing out positions quickly" upon a default or in the event of an "increasing risk profile," or that provide the customer with risk-insensitive margin terms or extended close-out periods." Subject to those general standards (and the DSRO's power to examine for compliance with those standards), an FCM should otherwise be free to contract with its customers within the constraints of its risk management program and its risk management policies and procedures.

ENDNOTES:

[1]Archegos Capital Management, an investment firm heavily concentrated in leveraged equity swap positions on a small number of U.S. and Chinese technology and media companies, defaulted in March 2021, causing over $10 billion in losses across several large banks that had been counterparty to those positions. In April 2022 federal prosecutors unsealed an indictment charging Bill Hwang, Archegos's founder, and Patrick Halligan, its CFO, with racketeering conspiracy, securities fraud, and wire fraud offenses in connection with schemes to manipulate the prices of securities in Archegos's portfolio and to defraud its prime brokers. Inevitably this complicates the post-mortems around apparent risk management issues, by casting into stark relief just how extraordinary a tail event the collapse of Archegos was. Risk managers might well question how they should control for the risk that a client is lying to them. That said, "fraud risk management is an intrinsic part of banking," and being "systematically misled," as the indictment states, is no less a risk management issue than permitting a client to breach risk limits. *See* Helen Bartholomew and Luke Clancy, "How banks got caught in Archegos's web of lies," Risk.net, 10 May 2022 (quoting an unnamed former regulator, and the federal indictment).

[2]See SR 21-19: The Federal Reserve Reminds Firms of Safe and Sound Practices for Counterparty Credit Risk Management in Light of the Archegos Capital Management Default (December 10, 2021), available here: https://bit.ly/3u2bFlQ The Fed's supervisory assessment was undertaken in consultation with other regulators, including the Bank of England and the Financial Conduct Authority, which released a similar notice the same day. See Dear CEO Letter, Supervisory review of global equity finance businesses (December 10, 2021), available here: https://bit.ly/36o9Uao

[3]See TM Staff Statement, SEC Division of Trading and Markets, March 14, 2022, available here: https://bit.ly/3we9jDo

[4]SR21-19 notes that "Archegos Capital Management, an investment firm heavily concentrated

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in a small number of U.S. and Chinese technology and media companies, defaulted on March 26, 2021, causing over $10 billion in losses across several large banks."

[5]The DSRO process "is intended to enhance the effectiveness and efficiency of the SROs' financial surveillance function by avoiding unnecessary duplicative financial examinations of FCMs that are members of more than one SRO." Commodity Futures Trading Commission, "Joint Audit Committee Operating Agreement," 73 FR 52832 (September 11, 2008).

[6]See CFTC Regulation 1.52(h).

[7]Commodity Futures Trading Commission, "Financial Surveillance Examination Program Requirements for Self-Regulatory Organizations," 84 F.R. 12882 at 12884 n. 22 (April 3, 2019).

[8]See JAC Regulatory Alert 19-03 ("JAC 19-03"), available here: https://bit.ly/3KMzRj5

[9]Regulation 1.56 prohibits an FCM or IB from "in any way" representing that it will, "with respect to any commodity interest in any account carried by the futures commission merchant for or on behalf of any person: (1) Guarantee such person against loss; (2) Limit the loss of such person; or (3) Not call for or attempt to collect initial and maintenance margin as established by the rules of the applicable board of trade."

[10]CFTC, Division of Swap Dealer and Intermediary Oversight, Division of Clearing and Risk, CFTC Letter 19-17, July 10, 2019 (emphasis supplied).

[11]CFTC, Division of Swap Dealer and Intermediary Oversight, Division of Clearing and Risk, CFTC Letter 20-28, September 15, 2020 (emphasis supplied). Both Letter 19-17 and Letter 20-28 are available in the CFTC's Letters archive, here: https://bit.ly/3ibdacb

[12]In some cases, DSRO examiners have taken the position that any contractual grace or cure period overlying a customer's failure to pay (that is not qualified by reference to administrative or operational reasons for the failure) is a violation of CME Rule 930.K.1, which requires clearing members to "maintain full discretion to determine when and under what circumstances positions in any account shall be liquidated." But this highlights all the more urgently why clearer guidance is needed. Why is it so clear that to "maintain full discretion" necessarily entails that an FCM may never conclude, in its reasonable risk management judgment, that an account is eligible for a contractual or grace period upon a payment fail (particularly in cases where the FCM has otherwise provided for limits and appropriate margin levels for the account)? If that is in fact what 930.K.1 means, the CME (and the JAC) should say so, in a Regulatory Alert that also explains their reasoning.