Provisional Translation

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Financial Services Agency

Supervisory Focus Points and Actions in Light of the Losses Resulting from the Default of a U.S. Investment Fund

1. The Objective of This Letter

Archegos Capital Management[1], a U.S. investment fund, defaulted in March 2021, causing losses totaling more than 1 trillion yen at multiple large firms, including Japanese ones.

The Financial Services Agency ("FSA") worked closely with regulators in the U.K., U.S., and other jurisdictions to analyze the causes that led to Archegos' failure and the deficiencies in the risk management and governance of firms that were counterparties to Archegos.

This letter sets out the observations on the firms' practices that were identified through these monitoring and analysis, as well as the FSA's future actions. The identified issues are not necessarily unique to this case, but can be applied broadly to transactions with hedge funds or family offices and other relevant transactions. It is of great importance to draw lessons from the shortcomings of the firms' practices observed in this incident in order to prevent similar cases from happening in the future.

Accordingly, the FSA expects firms to be aware of the issues described in this letter and implement better practices. While the issues presented in this letter are not necessarily relevant to all firms, the FSA expects that this letter will serve as a guide for firms—regardless of the types of entities or businesses—to improve their governance and risk management framework, as well as an aid to foster a sound risk culture.

2. The Issues Identified in Firms' Practice

While multiple types of transactions were observed in relationships with Archegos, the main source of the losses was a derivative transaction (total return swaps[2]) referring to stocks. The examination of the causes that had led to the losses identified cross-firm deficiencies in:

[1] Archegos Capital Management is a fund called a family office, which invested in a small number of technology or media companies in the U.S. and China.

[2] Specifically, it was a transaction in which a financial institution would pay an amount equal to the return on the reference stock, and Archegos would pay a predetermined rate.

(1) Business strategy

i. Clearly articulating the business strategies and associated risk tolerance—in promoting business with hedge funds and institutional investors, what types of transactions and risks are acceptable for what types of clients.

ii. Reviewing, prior to the execution of the business strategy, whether the governance and risk management framework are commensurate with the strategy, and making changes to the strategy and risk tolerance accordingly.

(2) Governance

i. Senior management's responsibility and involvement in formulating business strategies, setting and complying with risk tolerances, ensuring an adequate risk management framework, and responding to the risk event.

ii. Developing a governance and risk management framework at the global level to ensure group-wide soundness. This includes developing a framework to promote the functioning of appropriate monitoring, control, check/challenge, and coordination by the parent company with respect to overseas subsidiaries or among overseas subsidiaries, as well as ensuring the effectiveness of the framework.

iii. Clarifying roles and responsibilities, including those of senior management, in arrangements where business divisions and risk management divisions reside in multiple locations due to an arrangement such as remote booking[3].

(3) Risk management

i. Sufficient understanding of the nature of counterparty credit risk in equity derivative transactions with hedge funds and family offices.

ii. Risk measurement, limits[4] and margining that are suitable for the characteristics of the counterparty and the transaction.

iii. Ensuring an appropriate framework of due diligence, ongoing monitoring, contingency planning for risk events, and escalation to senior management, as well as the allocation of sufficient resources to those processes.

iv. Sufficiency of the business division’s awareness of its own risks and roles and responsibilities in managing risk, and the effectiveness of review and challenge by the

[3] Remote booking is an arrangement in which a transaction is booked at a location in a different jurisdiction from the location where the transaction is conducted.

[4] A risk limit is a transaction limits or maximum risk tolerance.

risk management division to the business division (which includes ensuring risk reporting by the business division to the risk management division).

3. The FSA's Actions

In light of these observations, the FSA will, with the viewpoints stated in (1) and (2) below, pay close attention to development, improvement, and enhancement of effective governance and risk management framework of firms, specifically for the firms operating securities business globally.

To promote effective group-wide supervision of these firms with global business operations, the FSA will also work more closely with other global regulators, by actively engaging in dialogues, as well as carrying out joint reviews where warranted.

(1) Development of governance and risk management framework commensurate with business strategy (focus applicable to all businesses)

i. Firms should appropriately analyze and assess the risks it faces through its business operations, and develop necessary frameworks commensurate with the materiality of the risks. Specifically, firms should, in line with the risks in each business, clearly define the roles and responsibilities of business and risk management divisions in managing risk, as well as allocating necessary resources and ensuring review and challenge (including allocation of authorities to effectively exercise review and challenge).

ii. For major businesses (including core businesses, focused businesses, and businesses with a potential of loss at a certain scale), senior management should clearly define risk tolerance, and set appropriate limits to ensure that the firm remains within the tolerance when a risk event occurs. Firms should also thoroughly review the appropriateness of their risk measurement methods.

iii. Firms should have a framework to ensure compliance with the limits. For example, firms should have a framework where, at the time of a limit breach or an increased likelihood of a limit breach, it is reported by the business divisions to risk management divisions (and to senior management where warranted) and appropriate actions are taken in a timely manner.

iv. Firms should have a framework that enables swift responses to risk events. This includes clearly defined responsibilities (including those of senior management) and decision making process, to ensure appropriate reporting and actions in a risk event (including cases where business divisions and risk management functions reside in multiple locations due to an arrangement such as remote booking).

v. These frameworks should be periodically reviewed, and where changes are made, discussed and approved by senior management.

vi. To promote group-wide soundness, firms should ensure that its group entities have an appropriate governance and risk management framework. Firms should also put in place a framework to adequately monitor, manage, and challenge the governance and risk management of overseas subsidiaries and other group entities. To achieve this, firms should also clearly define roles and responsibilities, including those of senior management. In addition, where firms carry out business spanning across different jurisdictions, they should have a framework to promote appropriate communication between senior management in the relevant overseas subsidiaries and cooperation and coordination among those subsidiaries.

(2) Counterparty credit risk management [5] (focus applicable to derivative transactions)

i. When a firm enters into a derivative transaction, it should have a thorough understanding of the counterparty credit risk specific to the nature of the counterparty and the product.

ii. Firms should establish an appropriate counterparty credit risk management framework. Examples of the focuses include:

- Firms should set appropriate contractual terms, such as those for collateral, guarantees, and a grace period, suitable for the characteristics of the counterparty and the transactions and the materiality of risk.
- Firms should have an understanding of the characteristics and limitations of the exposure measurement methodologies they use for internal controls, and manage counterparty credit risks holistically by utilizing multiple risk metrics as necessary, such as gross metrics that capture the scale of the transactions. In addition, firms should appropriately consider wrong way risk.
- Firms should manage risk dynamically employing stress tests.
- Firms should have a framework to take swift actions in the event of a counterparty's default (including coordination among the legal division and other relevant departments).

iii. For a transaction where the counterparty is a hedge fund or a family office, examples

[5] Counterparty credit risk is defined as the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows.

of the focuses include:

- Firms should have a framework to frequently and appropriately analyze and assess the risk of the client, through receiving information on an ongoing basis, such as the fund's investment strategy, transaction scale, level of leverage, concentration of underlying assets, and relationships with other financial institutions, both at the time of transaction initiation and throughout the transaction period.
- Firms should have a framework to take necessary risk mitigation measures for counterparties on an ongoing basis, such as setting contractual terms to mitigate the risk and reviewing them as necessary.
- Firms should have a framework to evaluate the reputational risk of a transaction, not only money laundering/terrorist financing risk and credit risk. In doing so, firms should ensure that senior management is appropriately involved in assessing the risk of the counterparty and making decisions on the transaction—for example, review and approval of a transaction by senior management as necessary.