Securitization, Hedge Funds and Private Equity: Systemic Risks in Organizational Financing

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Introduction

Ever since the credit crisis occurred in 2007 in the US, the lawsuits and settlements are taking place continuously, most of which were in relation to the use of alternative investment tools in financial market. The systemic risks[2] of securitization and hedge funds have drawn enough attention of scholars and lawmakers, meanwhile, with the promulgation of the US's Dodd-Frank Act in 2010, the authorities are also regulating private equity funds more strictly to mitigate the systemic risks of LBOs. In this essay, the author will compare the possibility of systemic risks in above types of alternative investment vehicles from an organizational law perspective.

1. Securitization: commercial trust model

Generally speaking, the securitization has been widely used in financial market in US for the purpose of diversifying the risks of illiquid assets from commercial banks to other institutional investors. The core legal mechanism of securitization is the 'bankruptcy remoteness' which is realized by transferring the financial assets to an independent entity, commonly is called 'special purpose vehicle (SPV)' in return for payment by holding the trust certificates. Meanwhile, SPV issues trust certificates to other investors in public markets. The interests of securitization are expected by the repayment from original debtors.

Compared with corporation, securitization does not only provide more stable residual claimant to their members but also more flexible funds for further investment[3], in other words, the owners of commercial banks can be sure that SPV's assets will not be traced by the creditors. At the same time, the payment of the assets will provide originators with more capital to make further interests by lending, and banks will also retain a portion of subordinate trust certificates in expectation of receiving cash flow from the assets in SPV. Therefore, banks have motivation to lend more money to the borrowers including those one whose credit record cannot provide sufficient and stable guaranty to the lending.[4]

Because of 'trustees', actually in most cases, the investment banks or securities brokers commit to provide higher return to public investors, therefore, like pension funds, hedge funds and insurance companies quite prefer the securitization. Moreover, in order to upgrade the rating of securitized assets, the 'trustee' would use some external warranty measurements like credit default swap

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[2] In this topic, the term 'systemic risk' is defined as the possibility of a series of correlated defaults among financial institutions that occurs over a short period of time, often caused by a single major event. See Chan, Nicholas T. and Getmansky, Mila and Haas, Shane M. and Lo, Andrew W., 'Systemic Risk and Hedge Funds' In Carey, Mark and Rene M. Stulz (eds) *The Risks of Financial Institutions* (Chicago and London: University of Chicago Press, 2006) at 235-338; Gary Gorton and Andrew Metrick, 'Regulating the Shadow Banking System' (Fall 2010) *Brookings Papers on Economic Activity* 261.

[3] Steven L. Schwartz, 'Commercial Trusts as Business Organizations: Unraveling the Mystery' (February 2003) 58 *The Business Lawyer* 559.

[4] Steven L. Schwarcz, 'Commercial Trusts as Business Organizations: An Invitation to Comparatists' (2003) 13 *Duke Journal of Comparative & International Law* 321.

(CDS) or governmental guaranties to hedge the default risks.[5]

All the participants in securitization trusts would concern more with the securities or certificates they are holding than the substantial industries they are investing to, like real estate market and the actual solvency of individual credit card debtors[6]. As a consequence, when the debtors fail to repay their loans, all the investors would be impacted seriously, in other words, the systemic crisis will be triggered. Above facts has happened in US since 2007, to a large extent, the organizational structure of securitization may give us some explanations.

Firstly, the 'true sale' rule in trust law removes those bad loans and long-term debt from the balance sheet of commercial banks, which means that the banks can gain cash back with less risk. By contrast, traditional civil trusts are commonly used to be a form of 'gift' for the benefit of a third party, which means that the motivation of the settlers is relatively prudential and more likely to impose strict fiduciary duty on trustees by trust deed.[7] However, in terms of securitization, although originators also hold a portion of trust certificates, nevertheless, the fundamental purpose of it is to strip the loans away from themselves, so the motivation of settlers has been changed from 'preserving the value for third parties' into 'transferring the risks to third parties'. To a large extent, securitization trusts are used to speculate diversify loan risks, by which the banks would not pay more trade cost on bargaining with the trustees when they sell their packed loans to an SPV.

Secondly, the incentive of the 'trustee' in securitization is getting higher management fees. Generally, the amount of fees depends on how much certificates would be sold to investors, therefore, the managers of securitization are prone to have strong motivation to apply a set of structured derivatives with high-rate interest or complicated collaterals which can enhance the credit of the certificates to attract investors. According to the basic principles of trust law, trustees should be responsible for the security of the assets and manage or dispose the trust assets by themselves prudently and carefully.[8] However, the nature of the highly structured financing means that the trustees are removing their fiduciary duty to other financial institutions, such as insurance companies, although SPV still 'owns' the securitized assets. Therefore, if we admit that the organizational structure of securitization is a kind of commercial trust, we should apply the basic principles of trust law, namely the rules of 'prudent investor' and 'fiduciary duty', both of which require and expect trustees to manage, use, and assign the trust assets with adequate duty of care.[9]

Thirdly, if we apply trusts principles to regulate securitization, we should also consider why other types of commercial trusts, such as mutual funds (or unit trusts), have not generated so serious systematic problems. From the perspective of organizational law, the differences between them are:

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[5] See related discussion from Joseph Tanega, 'Credit Crisis Solutions: Risk Symmetric Criteria for the Reconstruction of Socially Fair Asset-backed Securities' In Iain MacNeil and Justin O' Brien (eds.) *The Future of Financial Regulation* (Hart Publishing, 2010) at 227-252.

[6] Atif Mian and Amir Sufi, 'The Consequences of Mortgage Credit Expansion: Evidence from the U.S. Mortgage Default Crisis' (2009) 124 (4) *The Quarterly Journal of Economics* 1449.

[7] Jamie Glister & James Lee, *Modern Equity* (20th edn, Sweet & Maxwell, 2015) at 577-608.

[8] See example of the trustee's duty of care in practice under a context of British law from Iain G. MacNeil, *An Introduction to Financial Investment Law* (2nd edn, Hart Publishing 2012) at 165-183.

[9] *Ibid*.

1) the beneficiary of mutual fund is sole, therefore, fund managers should invest prudently only on behalf of unitholders, whereas the manager of residential mortgage backed securities (RMBS) assumes the fiduciary duties for two different parties. Precisely speaking, the 'trustee' is expected to utilize financial derivatives to sell out more securitization certificates for commercial banks, meanwhile, as the trustee of public investors, the manager should also be responsible for due diligent investigation of the underlying loans and be sure that the quality of underlying assets is safe and acceptable for investors 2) mutual fund managers must subscribe a portion of units of the fund they are managing, which better avoids the moral hazard of fund management than securitization.[10]

As a result, securitization only use the trust model to diversify risks, but the trustees or managers do not create the value of underlying assets, neither for banks nor institutional investors. In addition, the incentive system for trustees only focuses on the management or underwriting fees from investors, which is hardly to motivate trustees to pay attention to the substantial quality of the financial assets. Finally, the lack of fiduciary duty triggers the systemic financial disaster in US.

2. Hedge Funds: a passive limited partnership model

Since the crisis took place, hedge funds have been talked frequently together with private equity funds and securitization.[11] As a type of alternative investment vehicles, hedge fund is well-known for the use of complicated derivatives and hedging strategies, like short/long position. However, until now it is not easy to find out an accurate legal definition of hedge fund.[12] According to a series of existing literatures, hedge fund may be characterized by following features: 1) its legal nature is a type of pooled assets which can be invested to various securities, derivatives and even commodities and currencies; 2) the offers can only be privately issued to qualified institutional or individual investors; 3) the investors are entitled to redeem their investment periodically, the practice of which is commonly restricted by the certain contractual provisions; 4) the profit of fund managers is mainly based on the performance of the fund, namely the carried interest and finally 5) hedge funds are mostly formed as limited partnership or offshore LLC for purpose of tax avoidance.[13]

In terms of systemic risks, hedge funds are considered as an serious threat to the stability of financial market.[14] Compared with mutual funds in US, hedge funds can be regarded as a kind of 'private securities investment fund' that makes profit by using complicated mathematic models to predict the losses or profit of a set of certain securities and make mass financial speculation on the basis of their predictions. However, until now there has been no completely reliable and accurate mathematic model can predict all the risk in the market, the inherent risk and vulnerability of

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[10] See more detailed analysis in this issue from Robert H. Sitkoff, 'Trust as 'Uncorporation': A Research Agenda' (2005) *University of Illinois Law Review* 31.

[11] Houman B. Shadab, 'The Challenge of Hedge Fund Regulation' (2007) 30 (1) *Regulation* 36.

[12] See Phoebus Athanassiou (eds.) *Research Handbook on Hedge Funds, Private Equity and Alternative Investments* (Edward Elgar 2012) at 1-12.

[13] Ludwig Chincarini, 'Hedge Fund-an introduction' In Phoebus Athanassiou (eds.) *Research Handbook on Hedge Funds, Private Equity and Alternative Investments* (Edward Elgar 2012) at 13-62; Joseph A. McCahery, Erik P.M. Vermeulen, 'Private Equity and Hedge Fund Activism: Explaining the Differences in Regulatory Responses' (2008) 9 (4) *European Business Organization Law Review* 535.

[14] *Ibid., supra note* 11.

hedge fund is still existing. Moreover, the extensive use of short/long transactions in a short period of time will influence the market prices considerably, thus, the unregulated hedge funds can impose serious threat to the whole market.[15]

From a legal perspective, although the organizational structure of hedge funds is almost the same as private equity (PE) funds, however, the two significant distinctions make hedge fund much riskier: the one is that since hedge fund is open-ended, the redemption pressure will be existing through all the process of fund management.[16] Once any unpredicted event happens, such as the crash of housing market since 2006 in the US, investors will redeem their cash from the fund simultaneously. In this scenario, fund managers may sell out or even undersell securities in bulk to get adequate cash to refund to investors, which may exacerbate the price volatility in public market and mislead public investors. The other factor making hedge funds much riskier is the excessive use of leverage. In order to maximize the profit, fund managers are likely to borrow great deal of cash from banks which is secured by the total value of the investor's capital in the fund.[17] In this case, if the prediction of the market trends is turn out to be false, the losses would be magnified by the leverage remarkably, and even all the investment would be used to repay the debt.[18]

According to above analysis, if we define the 'actual control, management or reduction of risk' is a kind of 'positive' strategy, hedge fund is likely to be categorized as a type of 'passive' business organization, because its speculative investment is mainly based on a series of calculative judgement or macro-economic statistics, instead of the substantial participation in any value-increasing activities. Although the limited partnership structure is expected to impose more strict liability upon general partners (GPs) of the limited partnership enterprise to make the investment prudent, however, as most managers can easily be protected under limited liability by forming an investment entity, the legal nature and original function of GP, to a large extent, have been diminished by risky financial speculation.

3. Private Equity: a positive limited partnership model

As above discussed, individuals' high leveraged consumption and the lack of responsibility of the material quality of the loans by financial institutions were the root causes of the credit crisis, which could be obviously seen through the legal structure of securitization and the operational strategies of hedge funds. Accordingly, due to the high-level debt financing, leveraged buyouts (LBOs) and PE has been swept into regulators' view. However, to what extent PE industry will give rise to systemic crisis is still a question need to be examined.[19]

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15 Veronika Krepely Pool, 'Hedge funds and the detection of managerial fraud' In Phoebus Athanassiou (eds.) *Research Handbook on Hedge Funds, Private Equity and Alternative Investments* (Edward Elgar 2012) at 218-243.

16 Douglas J. Cumming and Na Dai, 'A Law and Finance Analysis of Hedge Funds' (Autumn 2010) *Financial Management* 997.

17 Report of the Investors' Committee to the President's Working Group on Financial Markets: Principles and Best Practices for Hedge Fund Investors (2008) Available at: http://www.amaicmte.org/Public/Investors_Committee_Report.pdf.

18 See the regulatory response to the related risk in hedge fund industry from Eilís Ferran, 'After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU' (2011) 12 (3) *European Business Organization Law Review* 379.

19 See the debate from Steen Thomsen, 'Should Private Equity Be Regulated?' (2009) 10 (1) *European Business Organization Law Review* 97; Jennifer Payne, 'Private Equity and Its Regulation in Europe' (2011) 12 (4)

First of all, private equity industry is usually formed as limited partnership, the PE firm partners must also hold shares of portfolio companies, which means that the manager of PE firm will have strong motivation to concern the quality of the enterprise and participate in management to increase the equity value. Compared with securitization, the fundamental interests of PE manager[20] is 'carried interest', not only the management fees, therefore, PE manager would closely and diligently monitor the conduct of the boards and help the board increase the value of share.[21] This can explain why securitization is more prone to spread the risks: the managers of SPV can only use additional guaranty to enhance the 'credit', instead of increasing the value of the investee assets; in other words, no matter how complex the derivatives would be, once the default of underlying debts take place, securitization can do nothing but transfer the losses to CDS providers, for instance, and insurance companies or other financial derivative holders.[22] In this regard, PE funds can be deemed as an 'positive' alternative investment tools, whose investment strategies aims at materially increasing enterprises' value.

Secondly, in quite a large number of LBOs, the director(s) are likely to be the controlling shareholders in portfolio firms. Although we admit the phenomenon that the managers would divest inefficient assets to repay the leverage, which is likely to damage the long-term development of target companies, however, for the considerations of the sales are mostly adequate to cover the debt and interest, the chain of default risk would be cut off by divestitures. In this context, the systemic risk may not be as serious as securitization.

Thirdly, compared with hedge funds, PE fund is also considered as much safer. The most striking problem to be widely condemned is the excessive leverage ratio of the investee company, which can lead the investee company into serious financial distress. However, we should know that the 'leverage' in hedge fund and PE fund is different, for the former, the leverage is used by the whole fund, which means that all investors' capital all mortgaged to gain great deal of loans for the purpose of magnifying the profit. By contrast, the term 'leveraged buyout' is referred to the following capital structure, the acquiring firm (GPs) uses a small amount of cash combined with a large deal of capital from limited partners (LPs) to buyout a company, but the buyout fund itself is not likely to use leverage.[23] As a result, even though the restructuring of the target company fails, the losses are not as serious as hedge funds, at least the LPs' cash will not be used to repay the additional leverage.

Moreover, LPs' capital will be locked in the fund for a longer period of time, differing from the open-ended funds like hedge funds. Because of the investors in close-ended fund have less freedom to adjust their investment, LPs will have strong motivation to carry out due diligence investigation prior to investing. This internal motivation will reduce the potential risk at the

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[20] In terms of organizational governance, we may deem GPs also as a kind of 'trustee', even though the actual legal natures of the two organizations are quite different. If we regard GPs as a kind of business trustee, that means that regulators can apply the principle of 'fiduciary duty' to the PE managers more practically which can impose more restrictions on the speculative activities.

[21] Jennifer Payne, 'Private Equity and Its Regulation in Europe' (2011) 12 (4) *European Business Organization Law Review* 559.

[22] *Ibid., supra note* 6.

[23] *Ibid., supra note* 19.

inception of a certain PE project. Furthermore, close-ended fund is less impacted by sudden events like Madoff scandal, which means that the managers do not have to undersell the securities emergently to meet investors' redemption demands. In respect of financial stability, because PE funds invest only to those securities that do not dealt in public market and the total amount of fund capital is relatively much more stable, the possibility of triggering price volatility is not serious in PE industry.

However, the most possibility of systemic risk in PE industry is that if commercial banks are playing the role as LPs in PE, the lenders will have strong desire to use credit derivatives to transfer their risks in PE fund to public market for the purpose of getting their capital return and meet the compulsory capital adequacy ratio (CAR) in banking laws and the Basel Accords, which may spread credit risks from private into public again[24]. Even so, it can be seen that systemic risk in relation to PE transaction is not caused the organization itself, but the relationship between PE firms and lenders.[25]

Concluding Remarks

The financial recession that we have been going through was triggered by excessive debt consumption in the US society and the lack of responsibilities for the underlying debts in financial market. The Parliament's over-lax monetary policy overly stimulated the mortgage loan market, which drove the commercial banks to find a way to diversify the serious risks. From the view of finance, the root cause of credit crisis is the over liquidity between financial institutions, which eventually stimulated the use of alternative investment tools including securitization, hedge funds and private equity. However, the regulatory responses to the three business organizations should be distinctive.

In respect of organizational analysis, the nature of securitization is a kind of financial trust, whose functions are transferring the debt to institutional trustees and getting consideration by selling the beneficiary certificates to public investors. The reason why investment bankers used so many kinds of financial derivatives in securitization is that the inherent conflicts of interest between public investors and originators can only be covered up or mitigated by using complicated guaranty agreements or other legal techniques. Finally, to some extent, the 'independent assets' and 'true sale' principles of trust law not only exacerbated the lack of responsibility of underlying debts but also distorted the credit system.

Hedge funds' risk exposure is largely based on its speculative strategies in financial market, in other words, the profitability of hedge funds relies on the statistical analysis or macro prediction of certain securities or economy, however, any measurement of statistics cannot guarantee the absolute accuracy for investment practices, the high risk feature makes hedge fund managers have to provide more liquidity to investors, as a result, redemption right and over-speculative participation in securities markets involves hedge funds into the plight of systemic risk.

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[24] Financial Service Authority (FSA), *Private Equity: a discussion of risk and regulatory engagement* (2006) (DP06/6).

[25] Viral V. Acharya, Julian Franks, and Henri Servaes, 'Private Equity: boom or bust?' (2007) 19 (4) *Journal of Applied Corporate Finance* 44.

By contrast, the legal structure and incentive system of private equity funds would keep the ownership of portfolio company still in the hands of actual managers, which means that the risks and profitability of PE can be controlled and finally, exit strategies by PE investors usually are able to cut off the chain of bankruptcy risks. Eventually, to analyze the causes of systemic risks in financial market should be associated with each organizational business respectively, for example, even though leverage is ‘harmful’, however, the performance of it varies from different business organizations. Whether an investment vehicle will give rise to systemic risk is mostly determined by its internal investment style and which market it would invest in, both of which finally determined the specific legal mechanisms within each of them.