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**ANOTHER VIEWPOINT ON INVESTMENT  
FUNDS AND THEIR OPAQUE GOVERNANCE**

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**ANOTHER VIEWPOINT ON INVESTMENT FUNDS  
AND THEIR OPAQUE GOVERNANCE**

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## ***ABSTRACT***

Firstly, this paper brings forth an encompassing definition of investment funds intended to track down some patterns of deviant governance. Secondly, it will focus on three conspicuous types among those funds: banks, mutual funds, and hedge funds. Such approach seeks to reveal deep similarities among them, albeit they may superficially look dissimilar. Afterwards, hinging upon the notion of opaque governance, we point out that investment funds more often than not misapply special purpose vehicles, in particular the so-called collateralized-debt obligations, just to hide their transactions, debasing their transparency, flouting good practices, even showing contempt of the law. Last of all, it will be put forward a protocol of covenants to be enforced by regulators on behalf of investors, taxpayers and financial markets.

**JEL codes:** F34; G01; G18; G30

**Key words:** investment funds, banks, mutual funds, hedge funds, corporate governance, opaque governance.

### **Institutional disclaimer**

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## INTRODUCTION

Last financial crisis in 2007 raised strong concerns, even outrage, over the fact that governments had to bail out some banks and institutional investors from their own failures and wrongdoings, so as to allegedly avoid or put an end to macroeconomic turmoil. It goes without saying that such connivance with global Ponzi's schemes made governments face an angry backlash from voters and tax payers who blamed investment funds for bringing about such havoc, and claimed that the time was ripe for a comprehensive overhauling of financial markets and their practices<sup>1</sup>.

Be that as it may, and in spite of the faulty record of many investment funds, we cannot help acknowledging that hundreds of them usually abide by the law, delivering to their investors what they promise, and showing good governance practices. Therefore, we pay heed to the bad fellows only, whose misdeeds and opaque governance make a case for more regulation to the whole industry.

This paper sets forth three contributions to the current literature. Firstly, it shapes an embracing definition of investment funds that would be applied to the analysis of three well-known collective investment organizations, namely banks, mutual funds and hedge funds. Secondly, it casts to light how investment funds have purposefully been taking advantage of opaque governance structures through special purpose vehicles (SPVs) and collateralized-debt obligations (CDOs). Last, and in pursuit of improving the governance and performance of investment funds, we will advocate for a composite of covenants to be enforced by regulators on behalf of investors, taxpayers and financial markets.

Our line of argument will require the following stages of development. In section 1, we are going to expand on the semantics of investment funds. Sections 2, 3 and 4 will deal respectively with banks, mutual funds and hedge funds. It is for section 5 to benefit

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<sup>1</sup> There have been several worthy proposals so far, among which we can notice the ones rendered by Bank for International Settlements (2011); Cooper (2008); Minsky (1986); OECD (2008); Vickers (2011)]



ensues if we consistently regard the manager's organization and the portfolio as being functional tiers of a manifold structure we are calling "investment fund".

c) As long as this sort of funds work with the money of their investors, hence they carry out a fiduciary role towards them, which entails that the targeted risk-return profile aimed by the fund's managers ought to stem from their considered judgment over ex-ante commitments and ex-post responsibilities<sup>3</sup>.

A methodological caveat is due here. Although there are many players in the investment fund business, among which we can underline, namely endowments (like foundations and universities), insurance companies, venture capital and private equity organizations, pension funds, fiduciary trusts<sup>4</sup>, this paper only deals with three types of investment funds that can be regarded as paradigms in their class, either for good or evil reasons: banks, mutual funds, and hedge funds.

## **2. BANKS**

Whereas it is not customary to view banks as investment funds, their being so grows straightforward out of Definition 1. To ascertain their nature, it may prove useful to give a look at what amounts to be the stylized balance sheet of any bank (see next table) while keeping in mind the following remarks:

- a) Any kind of non-current deposit, like safe- or term-deposits, might be viewed as standing for par-bonds with only one coupon of interest due at maturity, issued by the bank on behalf of their depositors<sup>5</sup>.

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<sup>3</sup> A further expansion on this topic will be found in section 5. For a thorough development, see Aprea (2012a)

<sup>4</sup> They could be either financial or non-financial. They are widely favored in countries following the Civil Law tradition. For instance, in Spanish speaking countries they are called "Fideicomisos".

<sup>5</sup> When John Smith lends his money, for instance, through a 3-month 1,000 USD term deposit, he will be given back at maturity his 1,000 USD plus the accrued interest on such loan. Therefore, what he really has bought amounts to a bond sold by the bank at par, which includes only one coupon of fixed interest.

- b) To all intents and purposes, the bank's creditors end up purchasing those bonds through private placements.

Cash	Current-Account deposits
Fractioned Reserves	Saving deposits
Bonds and Bills bought as temporary investments	Term deposits
Loans to household units	Bonds and bills issued by the bank
Loans to non-financial companies	Loans from other institutions
Loans to investment funds, mainly of short-term nature, either Repos or CDOs.	Other current or long-term liabilities
Loans to other institutions	Equity
Other current or long-term assets	Regulatory provisions to equity

- c) On the side of the assets, the whole package of loans granted by the bank to household units, companies, or other institutions, may also be regarded as bonds privately placed to the bank by those economic units in need of financial help.
- d) Securitization of assets allows banks to sell chunks of their credit portfolios to other investment funds mainly through the conduit of special purpose vehicles, a process that can be translated as tapping resources to be loaned but outside the pool of regular deposits and hence not constrained to reserve requirements enforced by any Central Bank.
- e) As witnessed by the credit-crunch crisis, there has been a debatable and opportunistic abuse of short-term loans from banks to hedge funds and even mutual funds, through Repos or CDOs mechanisms<sup>6</sup>.

Taking advantage of the qualifications deployed above, we are able now to narrow down the scope of the balance sheet into a format which highlights creditors and equity

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<sup>6</sup> We are going to expand further on this critical issue in sections 5.1 and 5.2.

holders on the one side, as well as the financial assets bought by the bank with the resources provided by their investors, on the other side.

Cash	Deposits from customers, companies and other institutions
Bonds and Bills bought as temporary investments	Bonds and Bills issued by the Bank
Loans to household units and non-financial companies	Equity
Loans to investment funds, mainly of short-term nature, either Repos or CDOs.	Other current or long-term liabilities, and equity provisions
Loans to other institutions	
Other current or long-term assets	

At the end of the day, hence, any bank carries out its job as an investment fund in the sense of Definition 1.

### 3. MUTUAL FUNDS

Mutual funds stand as a sect of themselves. The table on next page depicts their stylized balance sheet<sup>7</sup>. If we tried to assess the composition of any mutual fund's assets, we would find out three striking differences with bank assets:

- a) Although banks directly finance companies or governments by means of privately placed bonds, hence becoming first lenders, mutual funds are not necessarily involved in being first lenders to those companies whose stock or bonds they might purchase; in point of fact, such is not their customary line of business. They become buyers in the secondary market of available financial assets either through stock-exchanges or over-the-counter markets.

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<sup>7</sup> The argument is referring either to open-ended or closed-ended mutual funds, although the former are by far the most common.

b) The gains for investors in mutual shares mainly accrue out of the valuation of the underlying portfolio following a marking-to-market process at the end of each trading day, what translates into a sort of residual cash flows eventually. In contrast, bank creditors (depositors or bondholders) can only reap contractually fixed cash flows.

<p>Cash</p> <p>Bonds and Bills issued by companies or governments</p> <p>Stocks issued by companies</p> <p>Shares or ownership certificates issued by other investment funds, like hedge funds, other mutual funds, venture capital and private equity funds, endowments, and insurance companies</p> <p>Collateralized debt obligations issued by hedge funds, special purpose vehicles, insurance companies, banks</p> <p>Other financial assets</p> <p>Other current or long-term assets</p>	<p>Equity (mutual shares) issued by the mutual fund on behalf of investors, as proportional certificates of ownership over the assets of the funds</p> <p>Equity eventually issued by the mutual fund on behalf of the manager company.</p> <p>Other short- or long-term liabilities, and equity provisions</p>
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c) Last of all, banks are regulated by the Central Bank whereas mutual funds in most cases by the Stock Exchange Commission<sup>8</sup>.

By the same token, and shifting the analysis to the other side of the balance sheet, there are two noticeable features:

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<sup>8</sup> In some countries, mutual funds are regulated by a specific Act. Whenever any bank manages mutual funds of their own, they become overlooked by two gatekeepers, the Central Bank and the Stock Exchange Commission, at least in their home country.

- i) Although they have usually stayed away from issuing debt certificates or bonds, last financial crisis has shown that many mutual funds engaged themselves with collateralized-debt obligations, and short-term notes to finance their long and short positions.
- ii) Nevertheless, the bulk of traditional mutual funds may ultimately be regarded mainly as a composite of equity holders that invest their money and receive mutual shares.

The ongoing conflict between mutual and hedge funds hinges upon what the former regard as unfair dealing on the side of the latter, because mutual funds are heavily regulated while hedge funds are not. In point of fact, mutual funds are told by the regulator how they should invest, what their managers are to be paid, what fees they must charge to their customers, and how their organizations have to be governed [a detailed analysis of this topic can be followed in Stulz (2007)]. But it should not be neglected the fact that there are thousands of mutual funds working offshore, Luxembourg being a leading case for instance.

#### **4. HEDGE FUNDS**

Last but not least, we arrive at one of the most elusive investment organizations in the financial markets, not only because they thrive on either missing or lenient regulations (a fact that has entailed, in several cases, regrettable leeway and shameless wheeling-dealing), but also of entrenched habits of secrecy involved in their transactions whereby regulators, investors, and the public mind have no means to know whether they are or not collective investment schemes for handling dirty money, coming from drug dealing, terrorism, tax evasion, political corruption or the smuggling of critical commodities.

Hedge funds predicate their competitive advantages upon two characteristics: a self-assertive claim on their unusual skills in portfolio management, and their commitment to an unyielding confidentiality. This could be praised as a marketing device,

but it also conveys a double-edged issue, as The Economist put it in its Special Report on Offshore Finance (February 2013):

Individuals have a right to financial confidentiality but only as long as they set about their business lawfully. When it comes to tax crimes, money-laundering and the like, such confidentiality needs to be set aside. [ ... ] A recent example is the alleged use of Cayman (Islands) companies as conduits for bribes to Saudis by a subsidiary of EADS, a European aerospace and defence company. (page 4)

Hedging risks is of the essence for these funds or, at least, that is what they ultimately promise to their investors. To meet such commitment their portfolio strategy consists in the relentlessly buying and shorting of financial assets. They buy to take advantage of upward trends in prices, and they short (particularly by short-selling) to profit from downward swings in prices. To gain a deeper insight over these vehicles, let us take a closer look at their stylized balance sheets, as displayed below on next page.

Hedge funds share some key attributes when pursuing their professional tasks:

- a) They widely appeal to wealthy individual investors and big players in the market, by betting on high-return but low-risk profiles through long-term contracts granting limited liability to investors, who become hence limited partners.
- b) Investors in hedge funds are promised to reap great returns on the grounds of a two-fold commitment: firstly, that long- and short-positions are balanced so as to hedge the risks and hence to constrain volatility up to a very mild range of variance; and secondly, a farfetched warrant of lasting and outstanding skills of their managers, seemingly the most talented in town<sup>9</sup>.
- c) Not surprisingly, they are powerful players in the derivative markets, so as to hedge their long and short positions either. In general, hedge funds do not trade on floor-exchanges but over-the-counter markets

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<sup>9</sup> This naïve pretense has been denied in practice after the scandalous and shameless behavior of some conspicuous hedge-funds like the ill-fated Long Term Capital Fund. On the failure of Hedge Funds over the last decade, see The Economist (2013, 2012).

- d) Hedge funds' managers usually pull their strings behind a thick veil of secrecy, arguing that competitive advantages arising out of their superior skills could be jeopardized if letting competitors know about how they ultimately invest the money.

<p>Cash</p> <p>Provisions and collaterals for marginal account transactions pertaining to short-selling positions</p> <p>Long positions in Bonds and Bills issued by companies or governments</p> <p>Long positions in Stock issued by companies</p> <p>Long positions in shares or ownership certificates issues by other investment funds like mutual and hedge funds</p> <p>Collateralized-debt obligations issued by other investment funds, mainly hedge funds, insurance companies, banks, foundations and universities endowments, venture capital and private equity funds.</p> <p>Other current or long-term assets</p>	<p>Equity issued by the hedge fund on behalf of investors, as proportional certificates of ownership over the assets of the funds</p> <p>Equity eventually issued by the hedge fund on behalf of the manager company.</p> <p>Liabilities arising from financing the purchasing of long positions and marginal short selling positions, (for instance, by Repos or collateralized-debt obligations) to other investment funds, banks, insurance companies, and mutual funds.</p> <p>Other current or long-term liabilities, and equity provisions</p>
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- e) More often than not, to cope with the uncertainties of markets they leverage their long and short positions borrowing from banks with collateralized debt obligations (CDOs) and repurchase agreements (Repos)<sup>10</sup>. As the last credit-crunch crisis has brought to light, this usually triggers off a widespread domino-effect that heavily damages the hedge funds balances<sup>11</sup> to the extent that, and not

<sup>10</sup> Repos will be briefly described in section 5.2, at point e).

<sup>11</sup> For a further analysis of the crisis, and the ensuing governance risks, see Aprea (2012a, 2012b).

surprisingly, some scholars have regarded the last crisis as a full-fledged run on Repos. For instance, Gorton (2011a) argued that

The current financial crisis is a system-wide bank run. What makes this bank run special is that it did not occur in the traditional-banking system, but instead took place in the “securitized-banking” system. A traditional-banking run is driven by the withdrawal of deposits, while a securitized-banking run is driven by the withdrawal of repurchase (“repo”) agreements. Hence, we describe the crisis as a “run on repo”. [...] We argue that the current crisis is similar in that contagion led to “withdrawals” in the form of unprecedented high repo haircuts and even the cessation of repo lending on many forms of collateral. Evidence of insolvency in 2008 is the bankruptcy or forced rescue of several large firms, with other (even larger) firms requiring government support to stay in business.(pp. 1-2)

For the last decades there has been not only an increasing concern about the role of hedge funds, but also a mounting pressure to enact a comprehensive regulation in order to constrain their outrageous leeway and lack of transparency. On this point, Stulz (2007) has cautiously highlighted a likely convergence of hedge funds to mutual funds that would be grounded on two developments:

i) The more regulated hedge funds grow eventually, the more similar to mutual funds they would become, mainly through regulations by the Securities Exchange Commission. But this convergence will take away the traditional appeal of hedge funds, because their returns would decline and meet those offered by mutual funds.

ii) As long as hedge funds buy greater participations in the ownership of big companies, they become involved with their sustainability and even get access to their Boards. The unavoidable outcome of this process is what has been called the activism of hedge funds, which sooner or later backfires on their aggressive pursuit of higher returns and secrecy.

## 4.1 The downside of hedge funds

For the sake of illustration, we are going to highlight four negative features that seem to prevail in hedge-funds' performance.

### *The fallacy of superior returns (1)*

As The Economist (2012a) asserted

A simple-minded investment portfolio (60% of it in shares (SP500) and the rest in government bonds) had delivered returns of over 90% over the past decade, compared with a meager 17% after fees for the hedge-fund global index HFFX. (page 15)

### *The fallacy of superior returns (2)*

Conventional wisdom and vested interests have been holding that the competitive advantage of hedge funds lies in their performance at delivering higher returns than any other. On this point, increasing empirical evidence denies this assumption. For instance, Amin and Harry (2003) point out that traditional research is misleading whenever it is not wrong:

In general, the conclusion for this type of research is that hedge funds indeed generate superior results. There is a problem however. All these methods assume hedge funds returns to be normally distributed and to be linearly related to other asset classes. Recent research, however, has shown that neither of these assumptions is correct. (page 252)

### *Failure in valuation issues*

Among the many technical and ethical problems that surround the business of hedge funds, there is one that makes a difference with mutual hedges: we are speaking, of course, about the valuation issue. Whereas mutual funds value their portfolios on a daily basis, and by the worldly convention of bookkeeping closing prices as valuation benchmarks, none of this applies for hedge funds, which proceed to design their portfolios values by means of secret procedures and theoretical models (Stulz, 2007). Not surprisingly, evidence seems overwhelming about how institutional investors have been changing their strategies and shopping around for the best deals with index trackers and

Exchange Trade Funds (ETFs), hence attaining lower fees and better returns than with hedge funds.

### *Offshore locations and hedge funds*

Most scholars and gatekeepers name offshore locations as the actual busters for investment funds deceiving. For instance, Cayman Islands (population 57,000) is the world's leading hedge-fund hub and spoke, whereas Bermuda (population 65,000) is number one in the reinsurance offshore business. But we have to keep in mind that a group of islands with legislative powers are not the only culprits in the field of offshore activities, as it has been remarked in a leader note by The Economist (2013):

If you define a tax haven as a place that tries to attract non-resident funds by offering light regulation, low (or zero) taxation and secrecy, then the world has 50-60 such havens. These serve as domiciles for more than 2m companies and thousands of banks, funds and insurers. Nobody really knows how much money is stashed away: estimates vary from way below to way above \$20 trillion. [...] Mr Obama likes to cite Uglund House, a building in the Cayman Islands that is officially home to 18,000 companies, as the epitome of a rigged system. But Uglund House is not a patch on Delaware, which is home to 945,000 companies, many of which are dodgy shells. Miami<sup>12</sup> is a massive offshore banking centre, offering depositors from emerging markets the sort of protection from prying eyes that their home countries cannot get away with. [...] London is no better than Cayman Islands when it comes to controls against money laundering. (page 5)

## **5. THE OPAQUE GOVERNANCE OF INVESTMENT FUNDS**

Let us assume that we are concerned, at certain date, with companies or investment funds belonging to a well known sample space:

$$C = \{ (c_1, g_1) ; (c_2, g_2) ; (c_3, g_3) ; \dots ; (c_M, g_M) \}$$

or, equivalently,

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<sup>12</sup> We can read in the same Report: "A congressional investigator, asked where America keeps its dirtiest money, answers without hesitation: "Brickell" (Miami's financial district)". (page 8)

$$C = \{ (c_k, g_k) : k = 1, 2, 3, \dots, M \}$$

where  $g_k$  stands for the underlying corporate governance of company  $c_k$ , whose main structural details are available, either through the current Companies Law in their host country, or each company's founding charter and by-laws<sup>13</sup>.

After these preliminaries, we move onto the key concept of this section<sup>14</sup>.

*Definition 2*

*Opaque Governance*

By **Opaque Governance**, pertaining a certain company, we mean a substitution process whose main features and outcomes are the following:

- a) there is a persistent and purposive design of misconstruing the original governance of the company;
- b) such process hinges upon three sustainable procedures:
  - the accountability structure is shadowed,
  - transparency morphs into mere window-dressing,
  - there is a systematic flouting of the fiduciary duties of good-faith, diligence, and trust;
- c) the original governance of the company is taken over by a new governance shaped to meet the former procedures;
- d) the company counterclaims that no change has actually taken place in the old governance.

Let us bring this definition down to the realm of investment funds<sup>15</sup>. For the sake of example, nothing better than the collateralized-debt obligations (CDOs) scheme,

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<sup>13</sup> Some companies around the world have started to issue a Statute of Governance. On this subject, see Apreda (2011a, 2011b).

<sup>14</sup> Up to our knowledge, this was the first operational definition of the expression “opaque governance” in the current literature (Apreda 2012a, 2012b).

because the three main types of investment funds we are dealing with in this paper have been strongly related so far to this structured finance vehicle. Firstly, and for the sake of foundations, we expand on the opaque governance of special purpose vehicles (SPVs) since CDOs happen to be a particular class of such vehicles<sup>16</sup>.

## 5.1 SPECIAL PURPOSE VEHICLES

These organizational forms are legal entities that require a sponsoring entity. Among the sponsors (or sellers), we find commercial banks, finance companies, investment banks, mutual funds, hedge funds, endowments, insurance companies, non-financial corporations, or charitable foundations<sup>17</sup>, whereas on the side of SPVs, there will be limited liability companies, partnerships, endowments, corporations, and trusts (therefore, banks, mutual funds or hedge funds are able to carry out this role, directly or vicariously through partners). One distinguishing feature of these organizations consists in their being isolated from any financial distress of the sponsors; on this ground, it said that they grant “bankruptcy remoteness” to investors.

The plain vanilla mechanism by which SPVs become operative entails four characteristics (see Figure 1):

- a) The sponsor sells assets to the SPV, receiving money for them.
- b) The SPV sells securities to investors and shifts the money to the sponsor.
- c) The sponsor contracts out a servicing provider to manage the SPV’s administrative functions, even recruiting staff and directors.

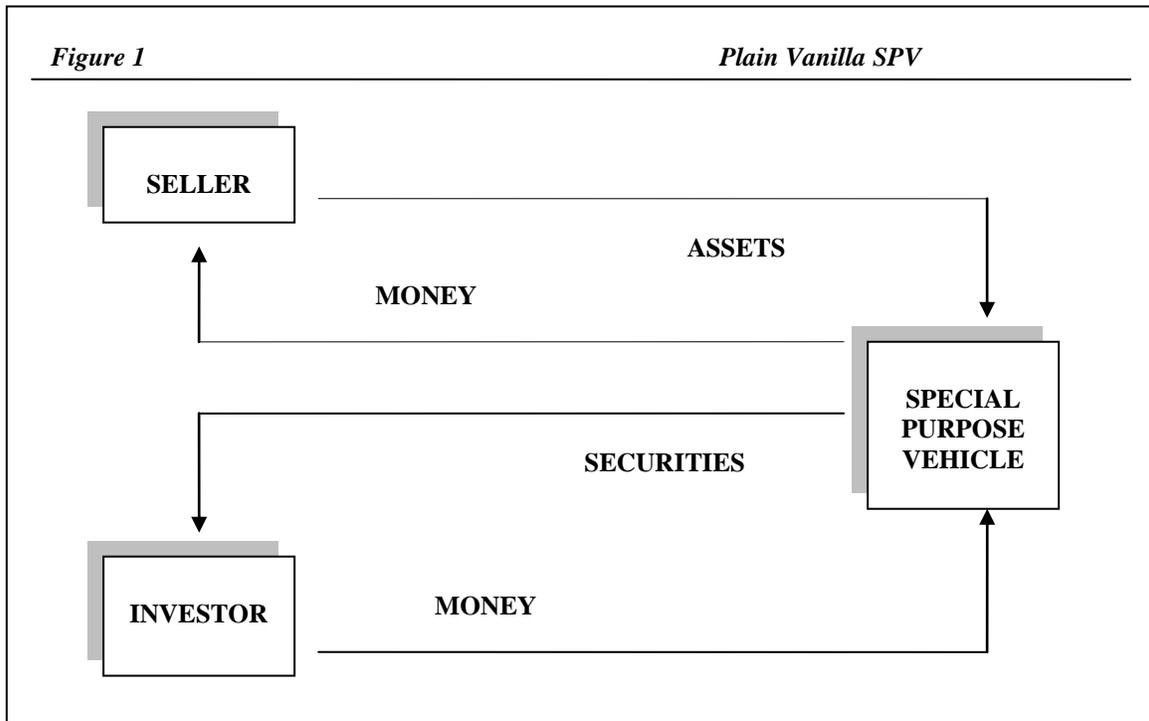
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<sup>15</sup> Although offshore centers are main contributors of opaque governance around the world, the subject is beyond the scope of this paper, but the reader is referred to our paper on special purpose vehicles (Aprada, 2012b) for a considered appraisal of this issue within a corporate governance context. Professor Palan has written two authoritative books on offshore locations and tax heavens (Palan, 2003, 2010). A well-thought piece of investigative journalism has been supplied by Shaxson (2011).

<sup>16</sup> Both sub-sections 5.1 and 5.2 draw out of two former contributions of mine (Aprada, 2012a and 2012b).

<sup>17</sup> The last type of organization has become customary in the United Kingdom.

d) Sometimes, a Trustee may also be appointed to care for the creditors' property rights.



Source: *Aprada (2012a)*

Among the most conspicuous examples of SPVs<sup>18</sup>, we can list the following:

- residential and commercial mortgage-backed securities;
- collateralized debt obligations;
- asset-backed commercial paper programs;
- credit-card receivables and automobile loans and leases;
- structured investment vehicles.

Among the staple variety of innovative products offered by SPVs, the so-called structured finance secures a place for itself. The consequences in the last crisis of getting used to structured finance without transparency and diligence were pungently noticed by Coval, Jurek and Stafford (2009):

<sup>18</sup> Further details can be found in the Report on Special Purpose Entities (BIS, the Basel Bank, 2009).

The essence of structured finance activities is the pooling of economic assets like loans, bonds, and mortgages, and the subsequent issuance of a prioritized capital structure of claims, known as tranches, against these collateral pools. [...] This ability of structured finance to repackage risks and to create “safe” assets from otherwise risky collateral led to a dramatic expansion in the issuance of structured securities, most of which were viewed by investors to be virtually risk-free and certified as such by the rating agencies. At the core of the recent financial market crisis has been the discovery that these securities are actually far riskier than originally advertised. (page 3)

There has been a mounting wave of criticism around the persistent scheming of SPVs throughout the last global financial crisis. For instance, the Basel Bank in its “Report on Special Purposes Entities”<sup>19</sup>, published in September 2009, pointed out the following:

It must be emphasized that the usage of SPE structures is not inherently problematic in and on itself. [...] The current market crisis that began in mid-2007, however, essentially “stress tested” these vehicles. As a result, serious deficiencies in the understanding and risk management of these SPEs were identified. (page 1)

It’s worth underlying the SPV’s structure of governance because it allows them to misconstrue their original governance in favor of another one that grows opportunistic and stealthy, through utter opaqueness.

### ***Ownership structure***

Certain features about the ownership structure depend on the country where the vehicle is created. In the UK, a widely favored organization type is the limited purpose corporation, either domestic or offshore, which favors the use of a charitable trust as owner of the entity. In the USA, predominant ownership structures are the limited-liability corporations following Delaware regulations; alternatively, trust entities can be chosen instead. Most of the time as the SPV is located in an offshore center, such shadowy designs merely stand for bogus ownership.

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<sup>19</sup> “Special purpose entity” is the customary expression used by the Basel Bank when referring to SPVs.

### ***Purposes of the SPV***

In either case, when organizations are incorporated or legally enacted, their purposes are bound to the ownership structure and attested so in their founding charters. On this account, SPVs are single purpose entities. Basically, they hold assets, upon which they issue securities, as it was highlighted in Figure 1.

### ***Control***

The ownership structure and control rights depend on the legal jurisdiction chosen to incorporate the SPV. In the UK, for example, it is frequently favored the enactment of the so-called “orphan vehicles”, whose capital is nominal and held on behalf a charitable trust [Northern Bank is a case in point and has thoroughly been reviewed by Shin (2009)]. The advantage is that the originator does neither own nor control the SPV. Things are different for SPVs in the USA, because the sponsor owns the vehicle when it is a limited liability company, but the latter is legally different from the parental company. When the SPV performs like a securitized entity, its assets are often pledged to a trust.

### ***Management***

As for management and staff, SPVs have no employees, and the sponsors subcontract all ancillary activities to corporate-service providers, who deal with the logistics, management, and even board building with independent directors, pertaining to the SPV’s needs. As Gorton and Metrick (2010a) sardonically put it, “*SPVs are like robots*”. It is not surprising that SPVs utterly fail as far as accountability is concerned.

### ***Assets sales***

How do owners and the board of the SPV deal with control rights? The sponsor sells assets, usually writing them off from its balance sheet. With the money on tap from investors, the SPV brings the purchasing of assets into completion, which gives the SPV a comprehensive control right, keeping investors away from sensitive information.

### ***Bankruptcy remoteness***

This feature is naturally embedded in the incorporation statute or by-laws. The assets are isolated from the sponsor's creditors reach, an alluring fact that gives them leeway for good or evil.

### ***Accountability and transparency***

SPVs have become the darlings of the shadow banking system<sup>20</sup> just because they foster lack of diligence processes and transparency practices, showing an utter disregard for any sort of accountability design eventually. When the dusk settles down, embarrassing doubts and questions come out because of in-depth inquiries by journalists, academics, lawmakers, and the public mind, focusing on the role of law- and audit-firms in the shaping of these dealing and wheeling.

## **5.2 COLLATERALIZED-DEBT OBLIGATIONS**

Collateralized-debt obligations, CDOs, carried out an important role in last crisis. The simple vanilla SPV depicted on Figure 1 can be regarded as a stylized and particular environment for CDOs. The asset-side of any CDO consists of a variegated portfolio of different financial assets: residential and commercial mortgage-backed securities; investment grade corporate bonds; securitized bank loans; emerging markets bonds; trust preferred securities (trups); commercial paper and other CDOs.

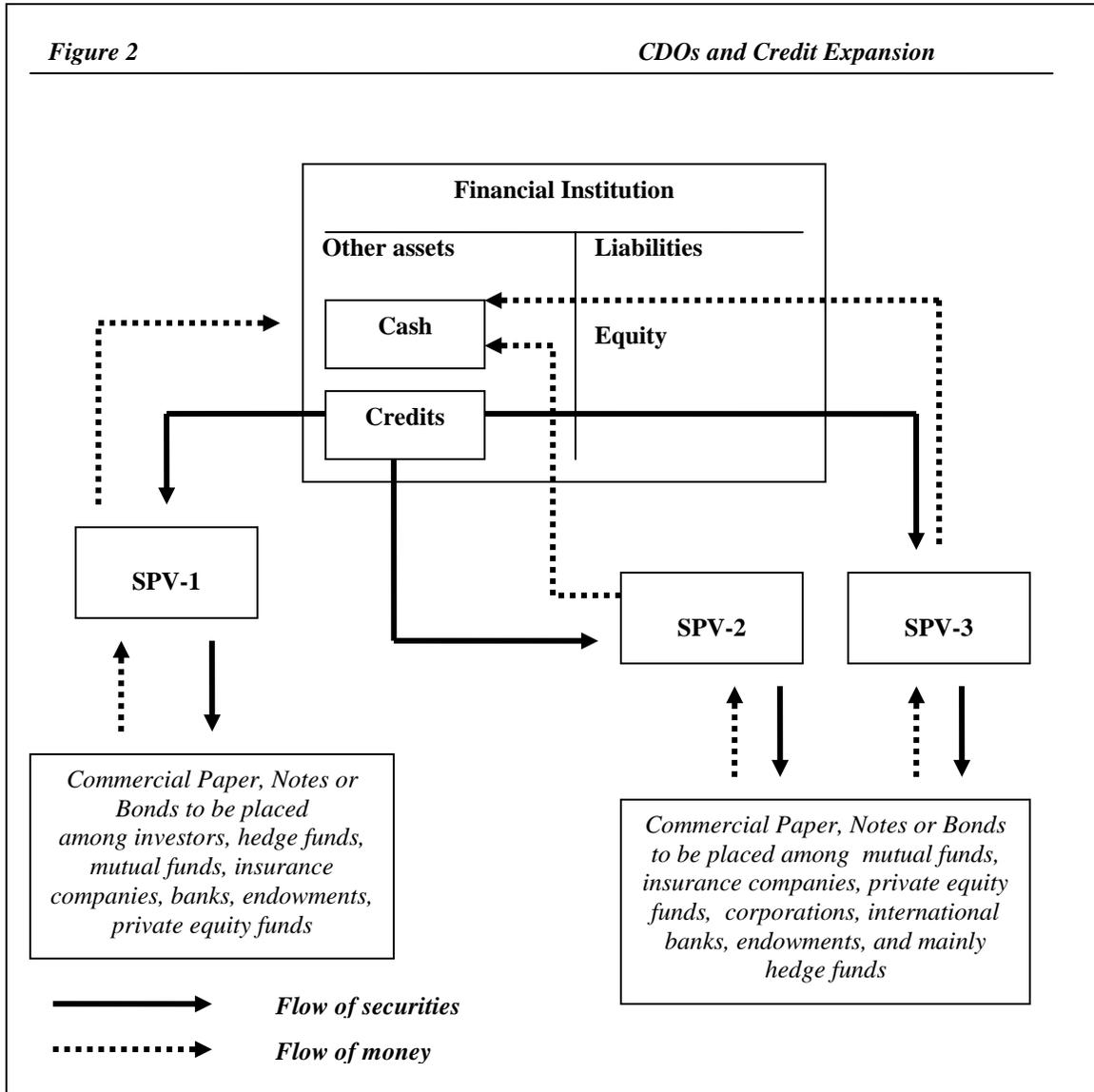
Therefore, a CDO stems from the design of a portfolio manager, a trust fund that issues their own securities backed by the financial assets that belong to the underlying portfolio. In spite of some advantages, these vehicles are two-edged constructs, whose bad edge follows from the fact that they contribute to credit expansion beyond any prudential measure and control of regulators. Let us examine on Figure 2.

For the sake of illustration, let us consider a financial institution that sponsors three SPVs designed after the CDO's structure. The bank, taking advantage of a portfolio

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<sup>20</sup> The paper by Gorton and Metrick (2010b) seems a good starting point to do research on this topic.

based on credits (mortgage-backed or secured otherwise) sells it to his SPV-1, which issues CDOs backed by the securitized portfolio<sup>21</sup>. In point of fact, the money that SPV-1 gets from the CDOs sale is used to repay the bank for the securitized portfolio. After the transaction is brought into completion, the bank will substitute new money for old credits.



Source: Apreda (2012a) modified.

At this juncture, the bank has two basic options: either it lends money to companies and households, under the guise of plain-vanilla loans; or it buys mortgages,

<sup>21</sup> Mostly notes and bonds.

credit cards receivables, cars and trucks loans or leases, and the sort, which are easily securitized. In other words, the bank funds its credit lines without taking deposits, what amounts to credit expansion outside the central bank mechanism of fractional reserves.

Next step replicates the pattern of the first stage, whereby SPV-2 buys a portfolio of credits in the bank's books, and issues CDOs, but with an innovation that allow mutual funds and hedge funds move to center stage: SPV-2 can buy not only the bank securitized portfolio, but other financial assets, among which CDOs from other SPVs (even from the SPV-1 itself). After the full round-robin transaction is concluded, the bank will be able to set into motion SPV-3. As we guess, this is a process that can go on through several replications.

When looking for the consequences of this kind of financial engineering, five features stand out, namely:

- a) It goes without saying that as long as SPVs are nurtured by increasing values in mortgage or securitized assets, many investors will buy more securities issued by the vehicles, even resorting to new borrowing from banks.
- b) On their own side, banks are responsive to the increasing demand of CDOs and set up new SPVs, so that when investors borrow more money for purchasing SPVs notes and bonds, banks are ready to cater for their demand. At this stage, mutual funds and hedge funds follow suit availing themselves of structured-finance vehicles.
- c) Many SPVs that issue short-term commercial paper or notes to pay off standing CDOs take advantage of the increasing demand from their securities and, it goes without saying, go on issuing more CDOs and rolling them over at maturity dates.

- d) But if the upside trend that stands to back the financial engineering happens to revert to a downward path, then the chain of SPVs is doomed to fail and, worst of all, it sets into motion the well-known<sup>22</sup> and time-dishonored Ponzi's Scheme.
  
- e) At this point, and to fuel the Ponzi's Scheme, Repurchase Agreements (Repo) enter stage. This device allows borrowing by selling spot financial assets, to repurchase them forward, and is a healthy procedure as long as the assets pledged to secure the loan do not worsen their value in the market beyond prudential thresholds. If this took place, SPVs would be unable to pay their securities since loan rates by Repos would wildly run upwards, whereas the value of collaterals go bust. The latest crisis, for some authors like Gorton and Metrick (2010a) for instance, was a "run on Repo"<sup>23</sup>.

A final comment is in order to bring home what I regard as the gist of the matter: the less enforceable the law becomes and the more lenient regulators or governments turn out to be, then the more opaque the governance of organizations will grow eventually.

## **6. A NEW PROTOCOL OF COVENANTS FOR INVESTMENT FUNDS**

There is widespread evidence that in most countries some governance variables<sup>24</sup> end up regulated one way or another, as can be checked out in the available literature [see, for instance, Lopez Iturriaga (2009); also Kostyuk, Braendle, and Apreda (2007)].

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<sup>22</sup> A Ponzi's scheme is a procedure by which companies, investment funds, banks, and governments, engage themselves whenever they resort to new financing not only because they run short of cash to pay interest on their older borrowings, but mainly because they need to pay principals at maturity and do not have the money, borrowing again and again at increasing pace. For a non-standard approach to financial conduits that foster the seeds of financial instability, Minsky's contribution (1986) is a major achievement that has deservedly been reappraised by *The Economist* (2010, 2011). A recent and shameless Ponzi's scheme was devised by Bernard Madoff who stole 65 billion dollars from investors (Arvedlun, 2009).

<sup>23</sup> Further on this in section 4, point e).

<sup>24</sup> The meaning of the expression corporate governance assumed in this paper is based on Apreda (2005, 2012b):

Among the variety of governance variables we can list, for instance, the nature of ownership structure, the fiduciary role of Boards of Directors toward Shareholders, the variegated relationships with creditors, the fiduciary role of Managers toward the Board of Directors and Shareholders, the compliance risk managerial function as well as conflicts of interest among the main stakeholders (in our line of argument the latter are equity holders, creditors, regulators, managers and directors). To put it in another way, governance strongly matters for regulators everywhere<sup>25</sup>.

But governance issues do not remain enclosed within the regulator's realm only, since there is latitude for fostering good governance from within each company through discretionary decision-making. What the past decades have shown, after the spate of corporate scandals epitomized by Enron and World Com, is that the betterment of corporate governance pays off, adding value and reputation to them by and large<sup>26</sup> which is a commendable and healthy outcome by all means. However, such attempts have often been drained away, in most cases by opportunistic window-dressing and deliberate opaque governance<sup>27</sup> concoctions.

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*Corporate Governance within corporations and nearly alike organizations (including state-owned firms) is a field of learning and practice that brings to focus the following issues:*

- *Ownership structure choice and owners rights.*
- *Company's founding Charter and by-laws; organization purposes.*
- *Board of Directors and Trustees; their fiduciary duties and the allocation of control rights.*
- *Managers' fiduciary duties and their decision rights; managerial performance and incentives.*
- *Accountability and transparency.*
- *Investors' property rights and protective covenants.*
- *Conflicts of interest between owners, directors, managers, creditors, and other stakeholders.*
- *Rent-seeking, soft-budget constraints, tunneling.*
- *Institutional constraints, the role of regulators and gatekeepers, compliance risks.*

<sup>25</sup> This regulatory zeal often brings about either excesses on the one hand, or complacent window-dressing of companies' governance practices, mainly in the so-called Crony, Captured, or Rogue States [Aprea (2007a); Gambetta (1996); Varese (2001); Tilly (2005); MacIntyre (2003)] where disregard of the Constitution and contempt of Law are nurtured by populist or authoritarian governments within which mafia groups thrive to the extent of capturing institutions and politicians eventually.

<sup>26</sup> On this topic, Gomperz et al (2001) can be useful.

<sup>27</sup> More background on this concern can be found in Aprea (2012a).

Although the disgraceful failure of gatekeepers and sometimes their apparent connivance at corporate regrettable practices has been widely reported, we can't help thinking about the sensible issue of the sheer lack of incentives offered to officers working for regulators, which brings about a perverse mechanism forcefully described by Thomas Sowell (1996):

Much criticism of “incompetent bureaucrats” implicitly assumes that those in the bureaucracy are pursuing the assigned goal but failing to achieve it due to lack of ability. In fact, they may be responding very rationally and ably to the set of incentives facing them. For example, government regulatory agencies are often very ineffective in controlling the industry or sector which they have a legal mandate to regulate. But it is a common pattern in such agencies for those in decision-making positions to (1) earn far less money than comparable individuals earn in the regulated sector, and (2) after a few years' experience to move in to jobs in the regulated sector. In short, they are regulating their future employers. Under such a set of incentives, it is hardly surprising that decision makers in regulatory agencies approach those whom they are assigned to regulate with an attitude that is sympathetic, cooperative, and even protective. (p. 15)

If we now return to the line of argument running through sections 2, 3 and 4, some well-grounded remarks ensue:

- a) By far, banks are the most regulated among investment funds, followed by mutual funds albeit this does not apply, unfortunately, to their involvement with offshore funds and transactions.
- b) In contrast, hedge funds are the less regulated among investments funds.
- c) Not surprisingly, banks have been keen on showing to the market participants their commitment with a stronger sort of discretionary governance, a likely outcome after the Basel Bank suggestions on compliance risk<sup>28</sup>. Unfortunately, most of such efforts have been jeopardized by the banks themselves wherever they involve themselves in offshore transactions.

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<sup>28</sup> Bank for International Settlements (2005).

It is my contention that a sensible approach to fix unhealthy and misconceived practices pervading the global financial system should comprise a group of precepts, under the guise of a protocol of covenants that investment funds ought to comply on behalf of investors and taxpayers. It goes without saying that they are to be enforced by regulators worldwide, and over country-by-country agreements. The protocol brought forward here is well-meaning, tentative, and open to debate. It must be regarded as a humble contribution to make the best out of investment funds and for the sake of global financial markets.

*P1 With regard to your governance statute and code of good practices, you must follow the principle of “comply or explain”.*

The widespread usage of voluntary codes of good practices does not go hand in hand with the design of a Governance Statute, although a promising case has been put forward by the Sydney Stock Exchange. Nowadays, the “complain or explain rule” is compulsory for listed companies only, whereby non-listed companies do not follow suit, which is regrettable. Further details on the governance statute can be found in Apreda (2011a, 2011b).

*P2 Can you show your Governance-Risks Protocol and your Compliance Risk managerial function? If not, you must explain why.*

The protocol for governance risks was firstly introduced by Apreda (2012a). The precedent for a compliance risk managerial function has been the Basle Bank proposal (2005). An expansion of this managerial function to non-financial companies was provided by Apreda (2007b).

*P3 If you want to invest offshore, tell regulators why and show your files.*

Staunch supporters of offshore centers surprisingly neglect the fact that they are contributing to put offshore locations beyond and above the tax-law claims of other countries and, still worse, setting up ideal haunts for criminals linked to drug-dealers, terrorists, tax evaders, corrupt politicians from all over the world

stashing away their plundering, and corporations that eagerly plunge into transfer-pricing contrivances.

*P4 For any standing or oncoming financial device you offer to investors, you must provide a certified report, updated on a yearly basis, of expected downward and upward risks.*

Just as companies often undergo credit-risk ratings, there must be regulated agencies that issue such certifications, to make financial innovations not only less risky, but more accountable to regulators, portfolio managers and investors.

*P5 How are you ring-fencing your own business from others you cannot carry out?*

After the credit-crunch crisis in 2007, the Vickers proposal (2011) comprised a comprehensive treatment about the ring-fencing of commercial banks from investment banks transactions. This standpoint suggests a natural expansion just to ring-fence banks and mutual funds from being involved with hedge funds whose structured-finance engineering could jeopardize the compliance of their fiduciary duties towards counterparties.

*P6 What sort of certified capital requirements and collaterals are you ready to display on behalf of investors?*

For capital requirements, the precedent can be tracked down to the so-called Basle Bank Pillars<sup>29</sup>. There is no technical reason to prevent these regulations from being enacted to investment funds and a lot to be gained in terms of governance quality. As regards collaterals, they should be tangible. This seems a core feature to provide with a safety network on behalf of investors.

*P7 If you are an investment fund, you have to change your external Accounting and Law firms every three years.*

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<sup>29</sup> Basel Committee on Banking Supervision (downloadable from [www.bis.org](http://www.bis.org) )

This practice has been enforced on a few markets, at least for listed companies, like the Milano Stock Exchange did after the Parmalat's scandal<sup>30</sup>.

*P8 All offshore locations must enter an international agreement for disclosing and auditing of their transactions in case judges or regulators of any country make their claims upon considered and compelling reasons for enacting such requests.*

Otherwise, the global judiciary arrangements would be granting impunity to offshore centers that mock up the law and connive at criminal activities. There is an interesting attempt that would become fully enforced in 2014. We mean the FACTA (Foreign Account Tax Compliance Act) whereby the United States will require foreign financial firms to identify account-holders and investors who might be American. In turn, USA will reciprocate signing bilateral agreements (more than 50 countries so far), offering information about their citizens holdings in the USA.

## CONCLUSIONS

By and large, investment funds are decisive players in any global financial architecture whereby banks, mutual and hedge funds become conspicuous carriers that cater for the widest range of investors. At the same time, they shape avenues through which companies, households, dealers, institutional investors and governments work out their financial problems and shortages.

Be that as it may, however, some patterns of behavior in the investment fund industry have been triggering off waves of criticism that hinge upon the outrageous leeway and secrecy that pervades their decision-making and their financial innovation. What is even worse, their failures bring about social and economic havoc among countries, investors, households and taxpayers.

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<sup>30</sup> Apreda (2012b) addresses the thorny issue of how little we know about the corporate governance of audit and law firms that, apparently, take advantage of the "preacher's waiver".

After defining investment funds on a wider basis than it is usually done, this paper brought to light key features of those funds that play a consequential role in the global financial system and showed how they shift to the building up of their own opaque governance with guile. Finally, this paper contributes with a protocol of covenants that investment funds ought to follow on behalf of investors and tax payers all around the world.

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