

NONBANK CREDIT

CHRISTINA PARAJON SKINNER*

Investment funds increasingly substitute for banks in supplying credit to the economy. Regulators have paid considerable attention to the potential financial stability risks of this migration to nonbank credit. This Article, however, argues that certain private investment funds (and the asset management institutions that house them) can enhance financial stability by promoting economic resilience. Specifically, it argues that certain private funds are incentivized and structured to supply the economy with a countercyclical source of credit—turning on their credit spigots precisely when banks are likely to turn theirs off. In doing so, these private funds have the potential to keep the economy buoyant in periods of economic downturn or distress.

Drawing from that descriptive claim, the Article presents a normative argument that legal and regulatory frameworks should facilitate the flow of capital into the nonbank market for credit, in order to augment the supply of countercyclical credit. In particular, the Article urges some departure from the current securities law framework by suggesting that retail investors—not only sophisticated and accredited investors—should be eligible to invest in private debt funds. It also provides a preliminary blueprint for how relevant law and regulation might be re-designed to safely allow for this new form of retail investing in private funds.

INTRODUCTION	150
I. THE LAW AND MACROECONOMICS OF FINANCIAL CYCLES	156
A. <i>Economic Theory</i>	157
B. <i>Financial Stability Regulation</i>	159
II. THEORY: SUPPLYING COUNTERCYCLICAL CREDIT	160
A. <i>Sources of Nonbank Credit</i>	160
1. A Snapshot of the Industry	161
2. The Private Funds	162
3. The Asset Management Institutions	165
B. <i>Theorizing Countercyclical Capital</i>	166
1. Balance sheet Freedom	168
2. Patient Capital	169
3. Open-ended Business Model	171
III. CASE STUDIES: COUNTERCYCLICAL CAPITAL IN THE ECONOMY	171
A. <i>Gap-Filling for Banks</i>	172
1. Direct Lending	173
2. Business Development Companies	175

* The Wharton School, University of Pennsylvania. Assistant Professor, Legal Studies and Business Ethics. With thanks, this draft benefited from the feedback of Dick Berner, Amil Dasgupta, Howell Jackson, Kate Judge, Henry Monaghan, Jeff Gordon, Andrew Tuch, and participants at the London School of Economics Financial Markets Working Group, the University of Oxford Faculty of Law Business Law Workshop, the Vanderbilt Law School Central Banking Conference, and the Legal Studies Department faculty workshop at the Wharton School.

3. Rescue Lending	175
<i>B. Palliative Effects: Healing Bank Balance Sheets</i>	177
<i>C. Reviving Stagnant Structured Credit Markets</i>	180
<i>D. Keeping Debt Markets Liquid</i>	181
<i>E. Helping Firms Shed Systemic Risk</i>	183
IV. EXPANDING THE BASE OF COUNTERCYCLICAL CAPITAL WITH RETAIL INVESTMENT	185
<i>A. Existing Regulatory Tools</i>	185
<i>B. Vetting Funds for Soundness and Suitability</i>	187
1. Liquidity	187
2. Exuberance	188
3. Education	189
<i>C. Modifying Regulatory Tools</i>	190
1. Accredited Investor Definition	191
2. Regulation D	194
CONCLUSION	195

INTRODUCTION

Today may well be the “golden era” of the asset management industry where financial activity migrates from a banking sector that has been badly battered by the last financial crisis and the heightened regulation that followed.¹ Credit-oriented activity has been a particular area of explosive growth.² Today, many of the largest asset management institutions are home to investment funds that supply credit to the real and financial economies or otherwise invest in credit assets.³ While a wide range of funds and nonbank institutions now engage in credit intermediation,⁴ this Article focuses on a

¹ Emma Dunkley, *Fears Mount Over Asset Managers’ Shadow Banking Operations*, FIN. TIMES (June 23, 2014), <https://www.ft.com/content/913c2794-facd-11e3-8959-00144feab7de>; see also Andrew G. Haldane, Exec. Dir., Fin. Stability, Bank of England, *The Age of Asset Management?* Address at the London Business School (Apr. 4, 2014).

² See, e.g., Madison Marriage, *More Asset Managers Become Shadow Banks*, FIN. TIMES (June 21, 2015), <https://www.ft.com/content/1ba49682-1666-11e5-b07f-00144feabdc0>. (reporting that “[t]he numbers of asset managers lending directly to companies in the US and Europe has more than doubled” between 2013 and 2015; in those years, “the number of direct lending managers increased from 44 to 110 [in the U.S.] . . . [i]n the EU, their numbers increased to 85.”); see also Simon Wu & Alex G. Kfoury, *Understanding “Shadow Banking”: Benefits and Risks of the Asset Management Industry*, 48 SEC. REG. & L. REP. 1, 39 (2016).

³ See Mark Vandeveld, *How the Biggest Private Equity Firms Became the New Banks*, FIN. TIMES (Sept. 19, 2018), <https://www.ft.com/content/ec43db70-ba8e-11e8-94b2-17176fbf93f5>.

⁴ See, e.g., Stanley Fischer, Vice Chairman, Bd. Of Gov. of Fed. Res., Remarks at a conference on Debt and Financial Stability—Regulatory Challenges sponsored by the Bundesbank and the German Ministry of Finance: The Importance of the Nonbank Financial Sector, (Mar. 27, 2015).

relatively recent and scantily studied evolution: the emergence of private credit and private debt funds.⁵

The private credit industry has quadrupled in size in the past ten years and is predicted to hold \$1 trillion of assets under management (AUM) by the year 2020.⁶ The development of a robust market for nonbank credit has some financial stability watchdogs worried.⁷ Those concerns dovetail with longstanding regulatory efforts to identify financial stability risks involved in nonbank credit intermediation and, more broadly, with the so-called shadow banking sector.⁸

⁵ Recently, Professor Andrew Tuch has written on the growth of private equity firms, and the financial stability issues associated with those private funds. See Andrew F. Tuch, *The Remaking of Wall Street*, 7 HARV. BUS. L. REV. 315 (2017). Other legal scholarship has comprehensively treated other components of the investment fund universe. For example, Professor Frank Partnoy has written extensively and foundationally on hedge funds, and hedge fund activism in particular. See, e.g., Frank Partnoy, Alon Brav, Wei Jiang & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 6 J. OF FINANCE 1729 (2008); Frank Partnoy, *U.S. Hedge Fund Activism*, RESEARCH HANDBOOK ON SHAREHOLDER POWER (Jennifer G. Hill & Randall S. Thomas eds. 2015). Professor John Morley has written about public funds, such as mutual funds and, most recently, on the regulatory structure surrounding ETFs. See, e.g., John Morley, *A Regulatory Framework for Exchange-Traded Funds*, 91 S. CAL. L. REV. 839 (2018). Finally, in their comprehensive treatment of current issues in and legal frameworks for financial regulation, Professor John Armour and his co-authors discuss funds, public and private, in JOHN ARMOUR ET AL., PRINCIPLES OF FINANCIAL REGULATION 25–52, 49–1, 445 (2016). This Article, however, focuses specifically on private credit and debt funds.

⁶ DECHERT LLP, FINANCING THE ECONOMY 2017: THE ROLE OF PRIVATE CREDIT MANAGERS SUPPORTING THE ECONOMY FORWARD 4 (2017), <https://www.aima.org/uploads/assets/uploaded/b30be521-1092-479a-8d70f9d2db9d4ee7.pdf>; see also Preqin, Press Release, Private Debt Industry Assets Approach \$600bn (Mar. 15, 2017), <http://docs.preqin.com/press/GPDR-Launch-17.pdf>

⁷ See, e.g., Vandeveld, *supra* note 3; see also OFFICE OF FIN. RES., 2016 FINANCIAL STABILITY REPORT 13 (2016) [hereinafter OFR REPORT] (noting that [t]he term “shadow banking” is “used to describe the extension of credit by nonbank companies, or credit funded by liabilities that are susceptible to runs because they are payable on demand and lack any government backstop.”); see also EUR. CENT. BANK, OCCASIONAL PAPER SERIES: SHADOW BANKING IN THE EURO AREA: RISKS AND VULNERABILITIES IN THE INVESTMENT FUND SECTOR (2016) [hereinafter ECB SHADOW BANKING REPORT]; EUR. SYSTEMIC RISK BD., EU SHADOW BANKING MONITOR 9 (2016) [hereinafter ESRB SHADOW BANKING REPORT]; FIN. STABILITY BD., GLOBAL SHADOW BANKING MONITORING REPORT 2016 (2017) [hereinafter FSB, SHADOW BANKING REPORT].

⁸ A broad view of shadow banking includes many kinds of nonbank credit intermediation. See, e.g., ESRB SHADOW BANKING REPORT, *supra* note 7, at 4 (noting that “[n]on-banks play a role in providing credit either through the direct provision of financing . . . or by supporting the credit intermediation role of banks. . . [b]esides lending, credit intermediation also includes the holding of debt securities.”). Some scholars have advanced a narrower definition, such as that which implicates the same kind of funding and liquidity mismatch inherent in bank-based funding, as in the money markets. See MORGAN RICKS, THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION 4 (2016); see also ARMOUR ET AL., *supra* note 5, at 445, 479 (explaining the divide among policymakers and academics in the appropriate scope of the term shadow banking). This Article adopts the broad definition as most consistent with regulators’ interest in fund-intermediated credit and, as Professor John Armour and his co-authors point out, the better definition for studying time-varying tools, as this Article does. ARMOUR ET AL., *supra* note 5, at 445.

This Article adds nuance to that debate by highlighting an important financial stability benefit of private, nonbank credit. The core claim of the Article is that certain private funds are structured and incentivized to supply the economy with a countercyclical source of credit, turning on their credit spigots precisely when banks pull back from lending.⁹ As such, these private funds can enhance economic resilience by helping to smooth the credit cycle, making downturns in the financial cycle less prolonged and less severe.

It is well-established among financial regulators and economists that readily available credit is key to financial stability.¹⁰ Thus, a stable financial system has capacity to continue supplying credit to the real economy, even when turbulence hits.¹¹ However, the usual source of credit in the economy—banks—lend procyclically.¹² In fact, procyclical lending appears to be an unavoidable consequence of a big bank's balance sheet and its regulatory constraints.¹³ When banks' existing credit assets (such as loans) suffer losses, their balance sheets become impaired and equity must be written down. At such point, further lending becomes difficult given that prudential regulation requires banks to sustain a certain level of equity capital against the sum of their risk-weighted assets.¹⁴ Moreover, a bank's go-to funding source—customer deposits—is also likely to decline during economic downturns as a consequence of depositors' reduced confidence in banks, lower disposable income, or both.

Investment funds, meanwhile, can and do serve as credit substitutes for banks. In contrast to banks, some investment funds—like private credit or debt funds—operate with a different set of strategic priorities and operational constraints. These funds are likely to have an aggressive and some-

⁹ See Marriage, *supra* note 2 (noting “[a]ssets in the industry have more than tripled since 2006”—rising to “\$441 [billion] by the end of [2014].”).

¹⁰ Fischer, *supra* note 4, at 3.

¹¹ See ORG. FOR ECON. COOPERATION & DEV., STRENGTHENING ECONOMIC RESILIENCE: INSIGHTS FROM THE POST-1970 RECORD OF SEVERE RECESSIONS AND FINANCIAL CRISES 5 (2016).

¹² See ARMOUR ET AL., *supra* note 5, at 49 (noting that banks' “core asset class”—loans—“rise[] and fall[] with the economic cycle”).

¹³ See Simon H. Kwan, *Financial Crisis and Bank Lending* 1 (Fed. Reserve Bank of San Francisco, Working Paper Series 2011, 2010); see also Ruth Simon, *Big Banks Cut Back on Loans to Small Business*, WALL ST. J. (Nov. 26, 2015), <https://www.wsj.com/articles/big-banks-cut-back-on-small-business-1448586637>; see generally Rafael Repullo & Javier Suarez, *The Procyclical Effects of Bank Capital Regulation*, 26 REV. OF FIN. STUD. 452, (2013).

¹⁴ See Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,018, 62,030–38 (Oct. 11, 2013) (requiring all banking organizations comply with Basel III's 4.5% capital to risk-weighted assets ratio and Basel III's leverage ratio for advanced approaches banking institutions, maintain a capital conservation buffer of 2.5% of additional common equity Tier 1 capital over regulatory minimums, and adopt a countercyclical conservation buffer of up to 2.5%). The EU has implemented Basel III through the Capital Requirements Directive, see Regulation (EU) 575/2013.

times risk-seeking strategy that is a function of their investor base.¹⁵ More specifically, such funds' investors tend to have a decent appetite for risk but also seek to diversify that risk, usually over a long- (or at least medium-) term horizon.¹⁶ As a result, the private fund's strategy will be opportunistic, meaning that it is contrarian in many cases, buying debt in directions that are opposite the market's momentum—that is, in countercyclical directions. In a similar vein, where the strategy is long-term in nature, the fund will tend to invest in assets that are distressed but quite likely have fundamental value to recover.

Importantly, these private funds' nimble structure enables them to pursue these strategic objectives.¹⁷ For one, because they lack the balance sheet constraints of a bank, private funds can more readily raise and then deploy capital in down times and after economic shocks. Relatedly, unlike a bank, private funds tend to have locked-in capital, which allows them to deploy their capital in periods of downturn without the possibility of flight.¹⁸ Finally, on a corporate level, a substantially large asset management institution will have a flexible business model, giving it the latitude it needs to raise fresh capital for a new fund and in pursuit of any opportunity—regardless how esoteric—that presents.¹⁹

In practice, this general fund makeup and mixture translates to countercyclical credit supply in a variety of ways.²⁰ A private debt fund may, for example, lend to an energy company so that it can build a renewable energy plant after an economic downturn, at a time when fewer banks could. In such scenario, not only does the loan stimulate economic growth but it also enables knock-on economic benefits associated with the creation of innovative and energy-conserving infrastructure in society. In other examples, debt funds might invest in a bank's nonperforming loan portfolio, thereby helping that bank repair its balance sheet so that it can eventually return to full-steam lending. In addition, apart from this role in supplying countercyclical credit and investment, asset managers can provide other credit-related services to financial markets at times when banks cannot. For example, some of these institutions' entries into corporate bond trading helps sustain that market's liquidity.²¹

This in-depth study of the link between private funds and financial stability comes at a timely juncture in the debate surrounding the regulation of the asset management industry and, in particular, nonbank credit intermediation. While the conversation surrounding fund-intermediated credit has, in

¹⁵ See *infra* Part II.B.

¹⁶ *Id.*

¹⁷ See *infra* Part II.B.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ See *infra* Part III (providing a case-study analysis).

²¹ See *infra* Part III.D.

some corners, gained more balance,²² prudential regulators in the U.S. and globally have dedicated considerable resources to tracking and mapping shadow banking activities, including and especially among investment funds. In the U.S., the Office of Financial Research (OFR)—the arm of the Treasury Department that is dedicated to market monitoring and researching financial stability risks—has spearheaded the effort to focus on shadow banking activity;²³ this effort has now become “central” to the OFR’s work.²⁴ For a time, the FSOC had considered whether asset managers should be designated as nonbank systemically important financial institutions for a myriad of other related reasons.²⁵

On the international level, the G20’s financial regulation agenda-setting body—the Financial Stability Board (FSB)—has for several years now been monitoring the shadow banking world, in which funds are included as a key part.²⁶ The FSB’s goal is to refine a methodology for dissecting the shadow banking sector, organizing it taxonomically, and distilling its contribution to systemic risk.²⁷ The FSB’s 2018 report confirmed that it continues to monitor structural vulnerabilities in investment funds.²⁸ The European Central Bank²⁹ and European Systemic Risk Board³⁰ are also invested in this same project to detect and monitor any financial stability risks associated with fund-intermediated credit. Collectively, these efforts have led to a mainstream view that

²² See, e.g., Sir Jon Cunliffe, Deputy Gov. for Fin. Stability, Bank of England, Speech given at Asset Management Derivatizes Forum: Market-Based Finance – A Macroprudential View, (Feb. 9, 2017), <https://www.bankofengland.co.uk/-/media/boe/files/speech/2018/market-based-finance-a-macroprudential-view-speech-by-jon-cunliffe.pdf?la=en&hash=90730D80729CD344186E4D3CEAF6078CB396E57D>.

²³ Credit provided by the shadow banking sector has “grown more than \$1.2 trillion since 2011.” OFR REPORT, *supra* note 7, at 15. “This growth has been driven by mutual funds and other asset managers.” *Id.*

²⁴ See *id.* at 13 (explaining that “[u]nderstanding the incentives that drive these [shadow banking] activities and the potential risks and vulnerabilities they may create for financial stability is central to the OFR’s work.”).

²⁵ See FIN. STABILITY OVERSIGHT COUNCIL, UPDATE ON REVIEW OF ASSET MANAGEMENT PRODUCTS AND ACTIVITIES 3, 22 (2016) [hereinafter FSOC, ASSET MANAGEMENT UPDATE]; see also FIN. STABILITY BD., POLICY RECOMMENDATIONS TO ADDRESS STRUCTURAL VULNERABILITIES FROM ASSET MANAGEMENT ACTIVITIES 1 (2017) [hereinafter FSB, ASSET MANAGEMENT REPORT].

²⁶ See FSB, ASSESSMENT OF SHADOW BANKING ACTIVITIES 3-5 (2017); FSB, TRANSFORMING SHADOW BANKING 2 (2017).

²⁷ See FSB SHADOW BANKING REPORT, *supra* note 7; see also ECB SHADOW BANKING REPORT, *supra* note 7, at 2 (stating that “[w]hile investment funds provide important intermediation services to the real sector . . . their rapid expansion may present systemic risks that need to be detected, monitored and managed”); see also *id.* at 5–6 (noting that “investment funds can pose risks to the stability of the wider financial system”).

²⁸ FSB, 5TH ANNUAL REPORT 5–6 (Dec. 2018).

²⁹ See ECB SHADOW BANKING REPORT, *supra* note 7, at 15–29.

³⁰ See ESRB SHADOW BANKING REPORT, *supra* note 7, at 16–17. For reference to other international or foreign regulatory bodies considering these risks, see INT’L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: NAVIGATING MONETARY POLICY CHALLENGES AND MANAGING RISKS 93 (2015), and the FINANCIAL CONDUCT AUTHORITY, ASSET MANAGEMENT MARKET STUDY: FINAL REPORT (2017).

some segments of the shadow banking sector should be more tightly regulated; the only questions are when and how.³¹

As a relatively new form of investment vehicle, the private credit and debt funds that this Article considers have not been sufficiently studied as a distinct form of nonbank financial intermediation.³² The Article thus aims to shed light on the various ways in which certain private funds differ from riskier forms of nonbank credit intermediation and how they can support a stable and resilient financial system.³³ Drawing on that distinction, the Article ultimately suggests that facilitating the flow of investors' capital into those nonbank credit and debt funds which are structured stably might better serve economic resilience than would existing macroprudential tools.

To that end, the Article proceeds in four parts. Part I discusses the law and macroeconomics of the financial cycle. It explains the link between the financial cycle and macro-financial stability regulation and how the latter—referred to as “macroprudential regulation”—has, thus far, attempted to tackle the financial cycle. It explains how macroprudential regulation has been focused on leaning against the upswing of a financial cycle but has not adequately dealt with the financial stability consequences of its eventual downturn. Part I thus animates the balance of the Article, which makes the case that certain private investment funds, if structured correctly, can enhance financial stability.

Part II begins to make that case. It first provides the necessary institutional details for grasping the technical facets of the private credit and debt fund universe, focusing on those fund or fund activities that supply credit or indirectly support credit intermediation. Part II then goes on to discuss why it is, as a matter of law and finance theory, that these private funds are incen-

³¹ See, e.g., RESEARCH HANDBOOK ON SHADOW BANKING: LEGAL AND REGULATORY ASPECTS 7 (Iris H. Chiu & Iain MacNeil eds., 2018); Yesha Yadav, *The Too Big to Fail Shareholders* 2 (Vand. U. L. Sch. Legal Stud. Res. Paper Series, Working Paper No. 17-3, 2018); see also Michael Flaherty & Howard Schneider, *U.S. Regulators Struggle in Effort to Tackle Shadow Banking*, REUTERS (Apr. 1, 2015), <http://www.reuters.com/article/2015/04/01/usa-fed-shadowbanks-idUSL3N0WY4O420150401#UHvyzRgyAYo1RG8c.971>; Ryan Tracy, *SEC Official: 'Not Clear' Bank Regulation Has Made Economy Safer*, WALL ST. J. (Apr. 1, 2015), <http://blogs.wsj.com/moneybeat/2015/04/01/sec-official-not-clear-bank-regulation-has-made-economy-safer> (reporting that Fed Vice Chairman Stanley Fischer “floated several ideas for regulating shadow banks, some of which might take SEC action to implement”). But see U.S. TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITY: ASSET MANAGEMENT AND INSURANCE (Oct. 2017).

³² Regulatory data on private funds is sparse and, indeed, even basic disaggregation of these funds is in some places lacking. On the international level in particular, the FSB has taken strides toward narrowing and separating the shadow banking sector into five economic “functions,” each of which could pose stability risks. See FSB, SHADOW BANKING REPORT, *supra* note 7, at 42–43. Private credit and debt funds presumably fall within the sub-category “other funds” within the broader category “other investment funds” in this taxonomy. See *id.* at 19–24.

³³ In 2015, for example, the European Central Bank included a broad range of investment funds as shadow banks, where they provide credit but are not regulated like banks. See EUR. CENT. BANK, REPORT ON FINANCIAL STRUCTURES 48–55 (Oct. 2015).

tivized and well-structured to play this countercyclical credit-intermediation role.

Part III engages a case-study methodology and largely descriptive analysis. It covers five cases, each of which demonstrates a distinct way in which private credit or debt funds have supplied or supported the credit cycle in recent, post-crisis years. In analyzing these cases, Part III's overall aim is to demonstrate a link between these funds' countercyclical credit activities and economic resilience: It does this by illustrating how such activity translates in financial-stability-enhancing ways.

Part IV draws out the key legal and policy implication of Parts II and III—namely, that certain forms of nonbank credit can be beneficial to economic resilience and, thus, to financial stability. Part IV suggests that countercyclical credit is a social and economic good and that securities regulation should therefore be designed to facilitate the flow of capital into this market for private, nonbank credit. In particular, it urges that certain private fund investments should be made accessible to retail investors, thereby increasing the base of countercyclical capital available for these funds to deploy during economic downturns. It also points out that affording the retail investor access to private fund investments would also serve the socially desirable goal of greater financial inclusion.

I. THE LAW AND MACROECONOMICS OF FINANCIAL CYCLES

Macroprudential regulation is principally concerned with systemic risk.³⁴ It thus aims to prevent negative spillovers from the financial system to the real economy. Indeed, a disruption in the flow of credit—from banks to businesses and households—during the last financial crisis resulted in severely adverse macro-economic effects. Consequently, the question of whether the financial system has capacity steadily to supply the real economy with credit—as manifest in a smooth financial cycle—is a key concern for macro-financial stability regulation.

This Part first fleshes out the connection between the financial cycle and financial stability regulation. Part I then explains how macroprudential regulation has so far attempted to address the financial cycle—by seeking to lean against the build-up of the cycle. Taken together, Part I makes the case that macroprudential regulation is under-resourced with tools for dealing with the downturn of the financial cycle. In Parts II and III, the Article presents theoretical and descriptive arguments that private investment funds, by supplying credit during economic downturns, can fill that gap in regulatory tools.

³⁴ For a comprehensive treatment of systemic risk and countervailing macroprudential policies, see generally XAVIER FREIXAS, LUC LAEVEN & JOSÉ-LUIS PEYDRÓ, *SYSTEMIC RISK, CRISES, AND MACROPRUDENTIAL REGULATION* (2015).

A. *Economic Theory*

It is now undisputed that financial cycles have upturns, peaks, downturns, and troughs. In decades past, however, the prominent view among macro-economists and financial regulators was that the capital markets are efficient. The efficient capital market hypothesis (ECMH), which developed in the 1960s, holds that financial markets are informationally efficient—that markets rapidly incorporate all publicly available information, producing prices that reflect the true value of the underlying asset.³⁵ But given its basic premise, ECMH has great difficulty explaining or accounting for financial bubbles which fuel the upswing (and then bust) of a financial cycle.

Not surprisingly, the financial crisis—which was set off by a paradigmatic debt bubble—cast doubt over ECMH at least where the financial cycle is concerned. In its place, the long-held views of economist Hyman Minsky came into the mainstream of economic and regulatory thought. Decades prior to the crisis, Minsky had attacked ECMH's core tenets by theorizing that there are “deep-seated forces in financial systems [that] propel them towards trouble” and, he thus proposed, financial stability is only ever “a fleeting illusion.”³⁶

Minsky's theory, known as the “financial instability hypothesis,” essentially holds that periods of prosperity inevitably give way to periods of financial instability.³⁷ More specifically, he posited that exuberance and risk-taking, prevalent during good economic times, sow the seeds for a financial downturn when the bubble bursts. Contemporary scholars of financial regulation and financial history have lent support to Minsky's theory by documenting financial cycles—driven by debt-related booms and busts—that have repeated throughout time and geography.³⁸ Today, it is relatively uncontested that financial cycles are endemic to capitalist economies.

We also now know that financial cycles, and their downturns in particular, wreak havoc in the real economy. Again, credit is the culprit. Typically, during the downturn of a financial cycle, banks pull back from lending—they “deleverage”—which disrupts the flow of credit to the real economy. Consider the last financial crisis as a prime example. When global banks' credit assets—in the form of mortgage-related products—suffered losses, those banks that were affected had to write-down nearly \$1.3 trillion in as-

³⁵ See JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, *SECURITIES REGULATION: CASES AND MATERIALS* 91-101 (7th ed. 2013).

³⁶ *Minsky's Moment*, *ECONOMIST* (July 30, 2016), <https://www.economist.com/news/economics-brief/21702740-second-article-our-series-seminal-economic-ideas-looks-hyman-minskys>.

³⁷ See Hyman P. Minsky, *The Financial Instability Hypothesis* 1, 8 (Jerome Levy Econ. Inst. of Bard C., Working Paper No. 74 1992).

³⁸ See, e.g., ERIK GERDING, *LAW, BUBBLES, AND FINANCIAL REGULATION* (2013); CARMEN REINHART & KENNETH ROGOFF, *THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY* (2009).

sets.³⁹ As a result of their damaged balance sheets, banks then had to write-down their equity to absorb those losses. With less equity, banks' capacity to make new loans—that is, buy more credit assets—was sharply curtailed.⁴⁰

When credit allocation is disrupted in this way, the real economy suffers in very concrete ways.⁴¹ In his book, *The Money Problem*, Professor Morgan Ricks discusses at length what he refers to as the “financing crunch” of 2008 and 2009. He presents compelling evidence of a contraction in the amount of debt financing available to consumers and businesses during that period, which, he shows, led to a “macroeconomic disaster” in the form of high unemployment and low output.⁴² In a similar vein, Ben Bernanke's “financial accelerator” model provides a theory as to why an economic shock can have outsized impact: When a shock reduces the creditworthiness of borrowers (e.g., the value of their collateral and cash flows decline), their “external financing premium” (i.e. their cost of borrowing) increases, thereby limiting their ability to access more debt.⁴³ This cycle is a feedback loop with consequences that mirror Ricks' description: a reduction in real economic activity in the form of spending, investment, and output.⁴⁴

These theories of financial economics thus suggest that the downturn—not just the upswing—of a financial cycle presents systemic risk.⁴⁵ Accordingly, not only are financial cycles inevitable and recurring, but the financial cycle should also be regarded as a distinct form of market failure that requires government (that is, regulatory) intervention.⁴⁶ And indeed, that is

³⁹ MATHIAS DREHMAN, CLAUDIO BORIO & KOSTAS TSATSARONIS, BANK FOR INT'L SETTLEMENTS, ANCHORING COUNTERCYCLICAL CAPITAL BUFFERS: THE ROLE OF CREDIT AGGREGATES 1 (2011).

⁴⁰ See John Heltman, *Is Regulation Really Keeping Banks from Lending?* AM. BANKER (Aug. 9, 2017), <https://www.americanbanker.com/news/is-regulation-really-keeping-banks-from-lending> (noting that some regulators and market analysts debate that capital requirements have impeded bank' lending).

⁴¹ See José-Luis Peydró, CREDIT CYCLES AND SYSTEMIC RISK, CENTRE DE RECERCA EN ECONOMIA INTERNACIONAL 1 (Antonio Ciccone, et al. eds., No. 35 2013) (noting that “[t]he main channel by which banks' balance sheet weaknesses affect the real economy is via a reduction of the supply of credit, a credit crunch . . .”).

⁴² RICKS, *supra* note 8, at 113; see also DREHMAN ET AL., *supra* note 39, at 1 (noting that in the most directly affected economies, nearly 10% of GDP was impacted, and average unemployment rose from around 5% to 9%).

⁴³ Ben Bernanke, Mark Gertler & Simon Gilchrist, *The Financial Accelerator and the Flight to Quality*, 78 REV. OF ECON. & STAT. 1, 2 (1996); Ben Bernanke, (former) Chairman, Fed. Reserve, Speech Given at the Credit Channel of Monetary Policy in the Twenty-first Century Conference, Federal Reserve Bank of Atlanta, Atlanta, Georgia: The Financial Accelerator and the Credit Channel (June 15, 2017), <https://www.federalreserve.gov/newsevents/speech/bernanke20070615a.htm>.

⁴⁴ See *id.*; see also Panayiotis P. Athanasoglou, *Procyclicality in the Banking Industry 1* (Bank of Greece, Working Paper No. 139, 2011).

⁴⁵ See John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 797 (2011); Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 207 (2008).

⁴⁶ See generally ANTHONY I. OGUS, REGULATION: LEGAL FORM AND ECONOMIC THEORY (2004).

precisely where the so-called “time-varying component” of the macroprudential agenda takes aim: It seeks to address the financial stability risks posed by the financial cycle.⁴⁷ However, as the next Part will show, these time-varying policies are largely targeted at the upswing of the cycle, neglecting, in comparison, the downturns.

B. Financial Stability Regulation

In the case of the financial—that is, credit—cycle, macroprudential regulation aims to “lean against the winds.”⁴⁸ The gist of this regulation involves bank capital requirements, which incentivize (if not force) banks to build up capital and liquidity during strong economic times so that these institutions have sufficient cushions during down economic times.⁴⁹

There are several tools that have been fit for such purpose—they are said to be “time-varying” tools because they can be leveled-up or leveled-down. Macroprudential authorities like the Federal Reserve in the U.S.,⁵⁰ the Financial Policy Committee (FPC) in the U.K., or the European Systemic Risk Board in the EU, will decide whether, when, and by how much these buffers should rise or fall based on their assessment of economic and market conditions.

The chief of these tools is the countercyclical capital buffer (CCyB).⁵¹ It requires banks to build up additional tier 1 equity capital during flush economic times, which can then be used to absorb losses during down times and, in theory, reduce the risk that banks will curtail their lending in order to maintain their ordinary regulatory capital requirements.⁵² In addition to the CCyB, regulator limits on loan-to-value or debt-to-EBITDA ratios are two other related tools that can be used to dampen frothiness in debt (credit) markets.⁵³ In effect, by imposing restrictions on the amount and degree of marginal lending that banks can do, macroprudential authorities put some

⁴⁷ See ARMOUR ET AL., *supra* note 5, at 413 (noting that “financial cycles of credit and leverage are perhaps no less important to economic well-being than the business cycle”).

⁴⁸ Sir Jon Cunliffe, Member, Bank of Eng., Fin. Pol’y Comm., Speech at The Graduate Institute, Geneva: The Outlook for Countercyclical Macroprudential Policy (Nov. 10, 2015).

⁴⁹ See DREHMAN ET AL., *supra* note 39, at 2.

⁵⁰ See Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Board Approves Final Policy Statement Detailing Framework for Countercyclical Capital Buffer (Sept. 8, 2016), <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160908b.htm>; see also *Applicable CCyB Rates*, EUR. SYSTEMIC RISK Bd., https://www.esrb.europa.eu/national_policy/ccb/applicable/html/index.en.html (last visited Aug. 10, 2017).

⁵¹ See BASEL COMM. ON BANKING SUPERVISION, FREQUENTLY ASKED QUESTIONS ON THE BASEL III COUNTERCYCLICAL CAPITAL BUFFER 1 (Oct. 2015).

⁵² *Countercyclical Capital Buffer (CCyB)*, BANK FOR INT’L SETTLEMENTS, <https://www.bis.org/bcb/ccyb/> (last visited Aug. 10, 2017).

⁵³ See, e.g., Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17,766 (March 22, 2013); see also BANK OF ENGLAND, THE FINANCIAL POLICY COMMITTEE’S POWER OVER HOUSING POLICY INSTRUMENTS 7, 11 (Nov. 2016); EUR. CENTRAL BANK, GUIDANCE ON LEVERAGED TRANSACTIONS 4, 7, 11 (May 2017).

brakes on the credit cycle by reducing mortgage debt or the leverage undertaken by banks and other corporations.⁵⁴

However, despite its advantages and potential, it remains that this body of prophylactic regulation gives short shrift to the inevitability—borne out by economic theory and financial history—that financial regulation cannot build the perfect levee. And the question of what tools exist for buoying the financial cycle during downturns remains an understudied topic on the macroprudential agenda.⁵⁵ As a result, when the next financial downturn arrives,⁵⁶ regulators are likely to be under-resourced with tools for aiding the economy to *recover*. The next part takes up that cause directly with a theoretical analysis of private investment funds' role in supplying countercyclical credit and credit-investments.

II. THEORY: SUPPLYING COUNTERCYCLICAL CREDIT

With this theoretical and regulatory background in hand, the Article now begins to build its core claim—that certain private investment funds serve economic resilience by supplying (and supporting) credit in countercyclical ways, thereby acting to smooth out the credit cycle. To that end, Part II first provides some institutional details about the various funds and asset management institutions that provide debt to businesses in the real economy. These funds thus function as alternatives to banks or the capital markets. Part II then offers a theory of why these alternative investment funds are naturally—that is, per market forces—incited to supply credit in countercyclical ways.

A. Sources of Nonbank Credit

As the then-CEO of the U.K.'s Prudential Regulatory Authority explained, “a stable financial system, which is resilient in providing the critical financial services the economy needs, is a necessary condition for a healthy and successful economy.”⁵⁷ Again, providing credit is one such economi-

⁵⁴ See *Record of the Financial Policy Committee Meeting on 21 June 2017*, BANK OF ENG., <https://www.bankofengland.co.uk/-/media/boe/files/record/2017/financial-policy-committee-meeting-june-2017.pdf?la=en&hash=F3702890C3F76408B42937A616CF96A5967A4AC5> (July 4, 2017).

⁵⁵ See generally FREIXAS ET AL. *supra* note 34 (explaining why it is that the metes and bounds of macroprudential financial regulation are still being set).

⁵⁶ Financial analysis has already begun to predict the triggers of the next downturn or crisis. See, e.g., Adam Samson, *JP Morgan: Central Bank Normalisation May Spark Next Financial Crisis*, FIN. TIMES (Oct. 4, 2017), <https://www.ft.com/content/61b4312a-19b5-3f35-9a93-e28873a6a86a>.

⁵⁷ Andrew Bailey, (former) Deputy Gov. of Prudential Regulation and CEO of the PRA, *Speech at the Bank of England: The New Approach to Financial Regulation* (May 1, 2013), <https://www.bis.org/review/r130502a.pdf>.

cally essential service.⁵⁸ Historically, banks, acting as financial intermediaries, occupied the main economic role as credit providers.⁵⁹ And in that capacity, banks were long-thought to enjoy a unique place in the financial system. The rise of the modern asset management firm, however, has in many ways disrupted that bank-centric balance of financial (credit) power.⁶⁰

This Part constructs a framework for understanding this disruptive interplay. More specifically, it sets out the various ways in which investment funds buoy credit markets through their various activities. The framework is intended to support the Article's following theoretical, descriptive, and normative analysis by laying some technical groundwork.

1. A Snapshot of the Industry

Many investment funds, like mutual funds or ETFs, are offered to the general investing public and typically invest in the public capital markets, usually in debt or equity securities.⁶¹ They are regulated by the SEC under the Investment Companies Act of 1940.⁶² But those are not the subject of this study.

This Article examines a type of "alternative" investment fund—private funds that invest in debt or credit. These private funds are excluded from the definition of investment company under the 1940 Act, but many private fund advisers register with the SEC on Form ADV and provide information about the funds that they manage via Form PF.⁶³ As will be described in greater detail, these private funds principally invest in credit assets by making loans, buying loans, or buying corporate bonds.

Investor appetite for investing in funds has generally skyrocketed in post-crisis years,⁶⁴ with analysts predicting assets under management (AUM)

⁵⁸ See, e.g., BANK OF ENGLAND, THE BANK OF ENGLAND'S APPROACH TO RESOLUTION (Oct. 2017), available at <https://www.bankofengland.co.uk/-/media/boe/files/news/2017/october/the-bank-of-england-approach-to-resolution.pdf?la=en&hash=FC806900972DDE7246AD8CD1DF8B8C324BE7652F>.

⁵⁹ See ARMOUR ET AL., *supra* note 5, at 278, 288.

⁶⁰ See FSB, SHADOW BANKING REPORT, *supra* note 7, at 1 (noting that through 2015, shadow banking institutions continued to grow in twenty-one jurisdictions studied, while banks' share of financial activity declined for a fourth consecutive year).

⁶¹ A mutual fund is an investment company registered with the SEC that pools its investors' money and invests in publicly traded securities—commonly stocks or bonds. See SEC, MUTUAL FUNDS AND ETFs: A GUIDE FOR INVESTORS 4–6 (2016). In return for their investment, investors receive shares in the fund which they can redeem, typically on relatively short notice. *Id.* Money market mutual funds (MMFs) have the same legal form as a mutual fund but function like a bank account. ARMOUR ET AL., *supra* note 5, at 481. ETFs are similar to mutual funds insofar as they pool investor cash into a fund and then invest that cash in a collection of stocks, bonds, other assets, or some combination thereof. See SEC, MUTUAL FUNDS AND ETFs: A GUIDE FOR INVESTORS, *supra*, at 6–8.

⁶² See generally Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-80a-64 (2010).

⁶³ See *Private Fund Adviser Overview*, U.S. SEC. EXCH. COMM'N. <https://www.sec.gov/divisions/investment/guidance/private-fund-adviser-resources.htm> (last visited Dec. 23, 2018).

⁶⁴ See, e.g., David Oakley, *Global Fund Industry Manages Record \$74tn*, FIN. TIMES (July 7, 2015), <https://www.ft.com/content/5a395bb4-24a6-11e5-9c4e-a775d2b173ca>.

in the asset management industry to reach nearly \$102 trillion by 2020.⁶⁵ Much of this growth is in alternatives.⁶⁶ Alternative fund investors tend to be institutions such as pension funds, insurance companies, nonprofits, endowments, or sovereign wealth funds.⁶⁷ For most of the private funds discussed here, investment is usually limited to “accredited” or “sophisticated” investors, which are investors that meet certain income or educational thresholds, respectively.⁶⁸

The recent growth of alternative funds can be explained by events from the crisis and the migration of financial activity from banks to asset managers specifically.⁶⁹ In broad overview, the losses suffered on banks’ balance sheets, combined with heightened regulatory requirements, generally prompted banks to deleverage and/or retreat from certain capital markets activities.⁷⁰ Asset managers seized credit-investment opportunities where banks were forced to pull back.⁷¹

A quick note on parlance: While not all alternative investment funds are private funds, all private funds are generally referred to as part of the universe of alternative investment funds. The asset management institutions that house private funds are generally referred to as “alternative asset managers.” Going forward, references to “alternative funds” are only to the private funds that are the focus of this Article.

2. *The Private Funds*

Large alternative asset management firms typically offer investors a variety of funds to choose from, each comprised of a mix of assets and strate-

⁶⁵ PwC, ASSET MANAGEMENT 2020: A BRAVE NEW WORLD 7 (2014), www.pwc.com/gx/en/asset-management/publications/pdfs/pwc-asset-management-2020-a-brave-new-world-final.pdf.

⁶⁶ See, e.g., Ponneh Baghai, Onur Erzan & Ju-Hon Kwek, *The \$64 Trillion Question: Convergence in Asset Management*, MCKINSEY & CO., (Feb. 2016), <http://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/the-64-trillion-question>.

⁶⁷ EUR. FUND AND ASSET MGMT. ASSOC., ASSET MANAGEMENT IN EUROPE (9th ed.)29, 34 (2017), <https://www.efama.org/Publications/Statistics/Asset%20Management%20Report/Asset%20Management%20Report%202017.pdf>.

⁶⁸ See 17 C.F.R. §§ 230.501(a), 506(b)(2)(ii) (these are provisions of “Regulation D” of the Securities Act of 1933).

⁶⁹ See Dunkley, *supra* note 1.

⁷⁰ See, e.g., BASEL COMM. ON BANKING SUPERVISION, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS 54–57 (2011) [hereinafter BASEL III]; 12 U.S.C.A §1851(b)(2)(B) (Volcker Rule); see generally ASSOC’N FOR FINANCIAL MARKETS IN EUR., IMPACT OF REGULATION ON BANK’S CAPITAL MARKETS ACTIVITIES (Apr. 2018), <https://www.afme.eu/globalassets/downloads/publications/impact-of-regulation-on-banks-capital-markets-activities.pdf>.

⁷¹ See *Private Debt: A Case Study in Today’s New Market Dynamics*, BNY MELLON, <https://www.bnymellon.com/us/en/what-we-do/articles/private-debt-a-case-study-in-todays-new-market-dynamics.jsp> (last visited Jan. 6, 2019); see also Michael Grill, Daria Kalyaeva & Claudia Lambert, *How Competition and Regulation Drive Bank and Investment Fund Risk Profiles and Their Market Shares*, ECB, MACROPRUDENTIAL BULLETIN (Apr. 30, 2018), https://www.ecb.europa.eu/pub/macprudential-bulletin/html/ecb.mpbu201804_02.en.html#toc1.

gies.⁷² A more fulsome analysis of many of these activities is explored below in Part III. For now, what follows is a highly generalized overview of the private funds engaged in credit intermediation.

Private Credit or Debt Funds. Private credit or debt funds can supply or support credit in three main ways: through direct lending; through mezzanine funds in which a fund makes private loans that are subordinate to a senior secured loan but senior to equity; and through distressed debt funds, which buy the debt of companies with imminent covenant defaults.⁷³

The private debt business is booming.⁷⁴ Market intelligence reveals that this asset class has grown consecutively since 2006,⁷⁵ and there was no contraction in this sector during the 2008-2009 period in contrast to many other asset classes.⁷⁶ In a 2014 survey of 240 institutional investors, two-thirds of participants reported that they were active in the market or considering investing.⁷⁷ In 2016, 6% of investors surveyed planned to increase their allocation to private debt over the longer term.⁷⁸ In 2017, 42% surveyed planned to commit more capital to private debt funds in 2018.⁷⁹

That interest appears to have materialized. According to a 2016 Preqin study of twenty-six private debt funds, those funds raised \$15.7 billion in capital commitments in the second quarter of 2016—\$8.1 billion more than the previous quarter.⁸⁰ A year later, Preqin's study of 136 private debt funds showed \$107 billion raised by funds closed in 2017.⁸¹ In total, private debt assets under management were \$638 billion AUM as of June 2017.⁸²

Generally speaking, the private debt market views the crisis as a “watershed” moment for its business.⁸³ Following the crisis, many banks had decreased capacity to lend due to impaired balance sheets and heightened regulatory capital requirements.⁸⁴ Meanwhile, other forms of structural regulation like the Volcker Rule had some unintended consequences that made private debt comparatively more attractive than other forms of credit.⁸⁵ Both empirical and anecdotal evidence suggest that the Volcker rule's restriction on pro-

⁷² It bears noting that some traditional mutual funds, like bond funds, also intermediate credit. But because they do not ordinarily do so in a meaningfully countercyclical way, those mutual funds are not studied here.

⁷³ DECHERT LLP, *supra* note 6, at 11, 24; *see also* CAMBRIDGE ASSOCIATES, PRIVATE CREDIT STRATEGIES: AN INTRODUCTION 3-5 (2017).

⁷⁴ *See generally* Preqin, Quarterly Update: Private Debt Q1 2017 (2017)

⁷⁵ PREQIN, 2017 PREQIN GLOBAL PRIVATE DEBT REPORT 24 (2017).

⁷⁶ *Id.*

⁷⁷ PREQIN, SPECIAL REPORT: PRIVATE DEBT: THE NEW ALTERNATIVE? 3 (2014).

⁷⁸ PREQIN, *supra* note 75, at 14.

⁷⁹ PREQIN, 2018 GLOBAL PRIVATE DEBT REPORT 14 (2018).

⁸⁰ PREQIN, THE Q2 2016 PREQIN QUARTERLY UPDATE: PRIVATE DEBT 4 (2016).

⁸¹ PREQIN, *supra* note 79, at 14.

⁸² *Id.*

⁸³ AMIN RAJAN, THE RISE OF PRIVATE DEBT AS AN INSTITUTIONAL ASSET CLASS 3 (2015).

⁸⁴ *See infra* Part III (discussing this phenomenon).

⁸⁵ RAJAN, *supra* note 83, at 6; *see generally* NEUBERGER BERMAN, COMBINING PUBLIC AND PRIVATE DEBT: CONSIDERATIONS FOR INVESTORS (2018), <https://www.nb.com/pages/public/global/insights/combining-public-and-private-debt-considerations-for-investors.aspx>.

prietary trading decreased banks' willingness to trade in the corporate bond markets which, in turn, crimped liquidity in those markets.⁸⁶ As result, high-yield bonds have become nearly as illiquid as private debt investments. But because private debt earns a premium over high-yield debt owing to its illiquidity, investors have preferred it.⁸⁷

Credit Hedge Funds. Generally speaking, hedge funds *qua* fund (not institution) are a form of actively managed fund that tends to be characterized by its strategy—speculative trading and, in some cases, highly leveraged bets. While hedge funds invest in public markets, they tend to take on much more risk than a traditional mutual fund.⁸⁸

Long-short strategies are a common hedge fund strategy. To illustrate, consider a hypothetical example:

Sony is about to release a new gaming station that is expected to be a hit. The hedge fund's analysis suggests that the market is not pricing in the upside value of this new product rollout. A straightforward investor would articulate such thesis by buying the stock, or in other words, taking a long-position. But a hedge fund is aware that, in taking a long position, it will be exposed to currency risk (with the stock denominated in Yen) as well as economic risk (with exposure to the Japanese economy). So, the hedge fund will buy the Sony stock and also short the Japanese stock market, such that if the Japanese economy goes south, the Sony investment is 'protected.' In this way, the hedge fund has isolated its investment thesis regarding Sony.

This hedge fund might be seen to have been engaged in credit-intermediation if, in a slight variation on this example, it took a position in Sony *bonds*.⁸⁹

Finally, while they are not private funds, it does bear mention that there now also exist some alternative mutual funds that are commonly referred to as "hedge funds for the masses" because they provide hedge fund-like exposures through a registered and thus more tightly regulated fund.⁹⁰ These

⁸⁶ See *infra* Part III.D.

⁸⁷ RAJAN, *supra* note 83, at 6.

⁸⁸ *Hedge Funds*, U.S. SEC. EXCH. COMM'N, <https://www.sec.gov/fast-answers/answers/hedgehtm.html> (last visited Aug. 10, 2017).

⁸⁹ Hedge funds also enter into derivatives contracts in a non-directional way. As one example, a fund might pursue a put opportunity, on a belief the price of an asset will move against current market momentum. The owner of a put has the option to sell a security (or another asset) at a later date, at some pre-agreed price. The investment thesis behind a put option is that the asset in question will be worth less than the exercise price at some point after the holder can exercise the option to sell—this is the "strike" price. If this happens, the put is said to be "in the money."

⁹⁰ See *Mutual Funds and Exchange-Traded Funds (ETFs)—A Guide for Investors*, U.S. SEC. EXCH. COMM'N, <https://www.sec.gov/reportspubs/investor-publications/investorpubsinwsmfhtm.html> (last visited Aug. 10, 2017).

funds invest in some illiquid assets (e.g., real estate or private debt.).⁹¹ On some scores, then, these funds might supply or support credit by, for instance, investing in niche bond funds or in funds-of-funds that themselves more directly provide credit.

3. *The Asset Management Institutions*

To conclude this framework, this Part will provide a glossy overview of the firm structures of some of the largest asset managers that engage in these alternatives: BlackRock, Blackstone, Bridgewater, and the Man Group.

BlackRock, while known mainly as a traditional asset manager, also offers alternatives,⁹² which provide “lower correlation to public markets.”⁹³ BlackRock offers two main categories of alternatives: “core” alternatives, and “currency and commodities.” Together, these funds have over \$116 billion AUM.⁹⁴ Notably, the core category also offers exposure to private debt.⁹⁵ BlackRock also began raising capital for a new private credit fund in the spring of 2018, which will lend directly to businesses or invest in the credit of distressed businesses. BlackRock also raised capital for a European debt fund in 2018.⁹⁶

BlackRock has suggested that it might, going forward, pivot even further toward alternatives. As it stated in its 2016 annual 10-K report, the firm “believe[s] that as alternatives become more conventional and investors adapt their asset allocation strategies, investors will further increase their use of alternative investments to complement core holdings.”⁹⁷ Furthermore, “[a]s a top ten alternative provider,” BlackRock expects that its “highly diversified \$116.9 billion alternatives franchise is well positioned to meet growing demand from both institutional and retail investors.”⁹⁸

⁹¹ *See id.*

⁹² At the end of 2016, BlackRock had over \$5 trillion AUM. BlackRock, Inc., Annual Report 1 (Form 10-K) (Feb. 28, 2017) [hereinafter BlackRock 10-K]. Passive equity funds comprise the lion’s share of its business, with \$2.38 trillion AUM. *Id.* at 6. This consists of equity *iShares* and non-ETF index equity. *Id.* BlackRock’s active equity mutual funds have \$275 billion AUM and its active fixed income \$750 billion AUM. *Id.* BlackRock’s passive fixed-income funds are a smaller piece of its business with \$520 billion AUM. *Id.* Its multi-asset funds, which can include global equities, bonds, currencies, and commodities, have \$395 billion AUM. *Id.* at 6–9. BlackRock also manages the world’s leading ETF, *iShares*, which had \$1.3 trillion AUM at the end of 2016. *Id.* at 3. It also runs a cash management business with MMFs, and a securities lending program. *Id.* at 9–10.

⁹³ *Id.* at 7.

⁹⁴ *Id.* at 6–7.

⁹⁵ *Id.* at 7.

⁹⁶ *See* Sabrina Willmer, *BlackRock Seeks \$2.5 Billion for Private Credit Fund*, BLOOMBERG (Apr. 4, 2018), <https://www.bloomberg.com/news/articles/2018-04-04/blackrock-is-said-to-seek-2-5-billion-for-private-credit-fund>; *Blackrock Completes Final Close of First European Middle Market Private Debt Fund*, PRIVATE EQUITY WIRE <https://www.privateequitywire.co.uk/2018/07/17/266457/blackrock-completes-final-close-first-european-middle-market-private-debt-fund> (lasted visited Jan. 6, 2019).

⁹⁷ BlackRock 10-K, *supra* note 92, at 7.

⁹⁸ *Id.*

Other premier alternative funds tend to break down along PE-oriented or hedge-focused lines. Examples of firms with a PE-bent include Blackstone, KKR, and Carlyle. Blackstone has over \$366 billion AUM as of December 2016.⁹⁹ It has four main business lines: private equity, real estate, hedge fund solutions, and credit.¹⁰⁰ Blackstone has a direct credit fund that invests in loans (and portfolios of loans) as well as in the securities of noninvestment grade companies. That fund invests in three kinds of credit: performing, distressed, and long-only.¹⁰¹

Hedge funds *qua* institution—like Bridgewater or the Man Group—in fact employ a wide range of activities and strategies (other than pure hedging), rendering their name a bit of a misnomer.¹⁰² As mentioned, in the credit space, these firms' strategies can involve the kinds of long-short strategies illustrated in the Sony hypothetical.¹⁰³ Hedge fund institutions also supply credit via the public markets by investing in high-yield (also known as “junk”) bonds (these can sometimes be the bonds of distressed companies).¹⁰⁴

Having set out a broad macro overview of asset managers, and granular details on alternative funds and their institutional superstructure, this technical framework is now complete. On a conceptual level, it has previewed the increasing amount of space, even within the alternative fund universe, that is dedicated to credit and credit investments. The framework grounds the discussion to follow of how, in supplying this credit and investment in countercyclical ways, private funds can play a role in bolstering economic resilience.

B. Theorizing Countercyclical Capital

Unlike banks, which face incentives to lend procyclically, asset managers are incentivized in the opposite direction—to supply credit during downturns or in distressed situations and assets. That is, the funds discussed here have a strategic orientation and business structure that motivates them to invest in the credit market during its down phases.

To see why, first consider the preferences and appetites of a private fund investor. These investors, in all likelihood, are driven by a few strategic

⁹⁹ The Blackstone Group L.P., Annual Report (Form 10-K) 5 (Feb. 24, 2017) [hereinafter Blackstone 10-K].

¹⁰⁰ *Id.* at 5.

¹⁰¹ *Id.* at 8.

¹⁰² See, e.g., MAN GROUP PLC, ANNUAL REPORT FOR THE YEAR ENDED 31 DECEMBER 2016.

¹⁰³ See *infra* Part III.A; see generally PREQIN, GLOBAL HEDGE FUND REPORT (2017), <https://www.preqin.com/docs/reports/2017-Preqin-Global-Hedge-Fund-Report-Top-Performing-Funds-February-2017.pdf>; PREQIN, CREDIT HEDGE FUNDS (June 2013), https://www.preqin.com/docs/newsletters/hf/Preqin_HFSL_Jun_2013_Credit_Funds.pdf;

¹⁰⁴ See, e.g., Mary Childs and Robin Wigglesworth, *Distressed Debt Hedge Funds Miss Out on Bound Rebound*, FIN. TIMES (Aug. 15, 2016), <https://www.ft.com/content/823a0de2-60d3-11e6-ae3f-77baadeb1c93>.

priorities. One such priority is diversification, that is, to pair what may be other more conservative holdings (like shares in an equity mutual fund) with something more daring yet higher-yielding like a private credit fund. For the same reason, these alternative fund investors who are seeking to diversify will be comfortable with an illiquid investment in return for the premia that compensate for the illiquidity (and, sometimes, the accompanying complexity).¹⁰⁵

Indeed, interviews with a range of fund managers confirm that diversification lies at the heart of investors' appetite for alternative funds. As the surveying organization, the McKinsey consulting firm, reports:

Many investors seek to complement the low-cost beta achieved through index strategies with the "diversified alpha" and "exotic beta" of alternatives. Further, some of the most sophisticated institutions are beginning to abandon traditional asset-class definitions and embrace risk factor-based methodologies, a trend that repositions alternatives from a niche allocation to a central part of the portfolio.¹⁰⁶

Notably, these kinds of priorities among the alternative investor group are likely to differ significantly from those of the typical bank depositor who will almost by definition be investing in a bank's demand deposits as a purely safe asset.

The push for diversification and appetite for risk and illiquidity arguably translate into a few characteristics of a private fund's strategy. For one, the alternative strategies of the private funds are, for the most part, opportunistic. This is to say that these funds perform well for their investors by recognizing underappreciated, and quite likely depressed, value in an asset (or security). As will be seen, such opportunistic investing often cuts in countercyclical ways by lending to firms that are in distress and in need of "rescue," investing directly in existing distressed loans or buying portfolios of nonperforming loans.¹⁰⁷ One might say, then, that these private funds' strategies implicate, to varying degrees, some amount of economic contrarian positioning.

Additionally, and related, many private funds of the variety studied here take a long-term view. Pursuant to such strategy, they seek to invest in companies or real assets with an ultimate aim of increasing their value.¹⁰⁸ To that end, the fund will bring to bear the collective expertise of the asset management professionals at the firm—with expertise in management, capi-

¹⁰⁵ See EUR. FUND & ASSET MANAGEMENT ASSOC., *ASSET MANAGEMENT IN EUROPE 7* (May 2017); see also Joshua Anderson & Tom Collier, *Earning an Illiquidity Premium in Private Credit*, PIMCO (July 2015), <https://www.pimco.com/en-us/insights/investment-strategies/featured-solutions/earning-an-illiquidity-premium-in-private-credit/>.

¹⁰⁶ Baghai et al., *supra* note 66.

¹⁰⁷ See *infra* Part III.A.

¹⁰⁸ See, e.g., Blackstone 10-K, *supra* note 99, at 5.

tal structuring, and operations. In turn, this longer-term horizon facilitates an opportunistic strategy because it means that these funds have the luxury of dabbling in down times. They can acquire or invest in underperforming assets or securities and wait-out a thesis that is only likely to materialize over several years.

Not only are these funds incentivized to pursue countercyclical credit strategies, but they are also structured to do so. By design, these funds are nimble enough to engage in countercyclical credit and credit investing.

1. Balance sheet Freedom

Private funds are nimbler than banks because they lack the type of balance sheet constraints that limit banks' investment choices. This relative freedom makes a private fund more agile in raising, and then deploying, its equity (investors' capital) during a downturn.

Let us consider in closer detail these balance sheet constraints. A bank balance sheet has broad economic exposure. On the asset side, a big bank makes loans to a range of different households (in many geographic areas), and to an equally wide range of business sectors. On the liabilities side—from where it draws its funding—a bank's exposure is equally broad. Again, the socioeconomic and geographic makeup of depositors (one source of funding) are bound to vary greatly, as are a bank's equity investors (another funding source), who could range from individual, retail investors to large institutions.

The exposed nature of the retail bank's balance sheet hinders it from raising funding during a downturn. A hypothetical can help illustrate this proposition.

Suppose there were a financial crisis in 2050 in which 30% of the real economy were in distress—and, let us assume, 20% of that population both had mortgages with and were depositors at Bank B. In such circumstance, Bank B would likely have trouble obtaining funding from either deposits or equity raises. As for raising equity, Bank B's share price would be likely to plummet, making it more difficult and expensive to raise fresh capital in the public markets. In addition, the bank's depositor pool (a second possible funding source) would dwindle as cash-strapped households would probably redeem their demandable deposits for hard cash.

In the face of funding trouble, Bank B would likely slow or halt its lending and possibly deleverage. Suppose again, Bank B were capitalized with \$100 equity and \$1,000 debt. After the bank's mortgage loan portfolio lost value, Bank B would have to then write down a corresponding amount of its equity to rebalance its balance sheet. Now, Bank B would have only \$50 in capital and the same amount of debt. Its capital position would thus have gone from

10% to 5%. Because Bank B's regulators—the central bank of A—would require it to maintain 8% equity capital, the bank would then be operating below its regulatory thresholds. As a result, Bank B could not make new loans—that is, invest in new credit assets—unless and until it raised new capital, which, again, would probably be too expensive during an economic downturn. Bank B, in short, could not perform its critical economic function of supplying the economy with new credit.

But if one considers a private fund instead of a bank in this hypothetical, the outcome is much different. In the first instance, a fund has a more targeted and sturdy funding base that is not broadly exposed to economic events. In other words, even in a downturn, an alternative fund can raise fresh capital by targeting a specific and niche investment pool—say, for example, 40% of the 70% of investors that were unaffected by the crisis. Also, an investment fund will have no regulatory capital constraints and can thus deploy any capital it raises toward new investments (including loans) as it pleases—wherever the opportunity presents itself. And because the fund has a long-term investment horizon, it can wait until the value of those assets recovers. Thus, these funds are structurally and systematically poised to step-in and fill credit gaps that are left in banks' post-crisis or post-economic-shock wake.

2. Patient Capital

Another structural feature that keeps funds nimble is the patience of their capital. Investors are patient because they have no choice: to invest, one must agree to be “locked-in.” Indeed, locking in capital is a common strategy for private debt and credit funds. Consider the lock-in strategy of a typical PE fund: The initial period during which new capital is raised is normally around one year; once raised, the fund has around five years to invest and then another period of several years to harvest those investments.¹⁰⁹

Compounding this patience-forcing effect, the premier alternative funds are increasingly using structures to secure capital for even longer periods of time or to ensure fresh inflows of capital without the possibility of outflows. Typically, these additional provisos to the LPs' investments are referred to as “evergreen” fund structures.¹¹⁰ In such funds, returns are “recycled back” into the fund rather than distributed to the investors.¹¹¹ Evergreen funds can be especially accretive to countercyclical lending and credit investment.

¹⁰⁹ See ARMOUR ET AL., *supra* note 5, at 490, 492.

¹¹⁰ See Nick Benson, *Interested in Evergreen Funds? Consider This*, LATHAM & WATKINS (July 23, 2015), <https://www.lw.com/mediaCoverage/evergreen-funds>; see also *Evergreen Fund Definition*, LONDON SOUTH EAST, http://www.lse.co.uk/financeglossary.asp?searchTerm=&iArticleID=1979&definition=evergreen_fund (last visited Aug. 10, 2017).

¹¹¹ See *id.*

Such provisions have allowed some funds, for example, to avoid harvesting investments that were made in the early 2000s. Without the evergreen structure, those funds would therefore have been forced to exit at an economically inauspicious time—during or shortly after the crisis when asset values were artificially low.¹¹²

Ultimately, having patient capital means that investors cannot withdraw their funds when economic turbulence hits. Thus there is little “run-risk” posed to the fund managers’ ability to effectuate their long-term and opportunistic strategy. By extension, lock-ins also mean that funds are guaranteed to have ample “dry power”—capital ready to be invested—when a downturn comes, because, again, even if investors are spooked, they are unable to run.

To illustrate this point about the benefits of patient capital, consider another hypothetical: a fund with a very “good vintage.”

At T_0 , a private debt fund, Fund F, is raised, in what are very strong economic times.

At T_1 , a credit crisis hits. Because Fund F raised its capital prior to the economic downturn but is predominantly investing immediately post-crisis, the fund is said to be of an excellent vintage. This means that Fund F will have an investing heyday at the height of the market panic: At that point, credit assets are temporarily depressed and banks have created opportunities for lending by drastically pulling back.

This hypothetical has borne out repeatedly in recent years. Data show that across a range of debt funds, those funds with vintages from years 2008 to 2010 had average returns ranging from 10% to 15%, representing a significant outperformance relative to funds invested between 2004 and 2007 (whose returns ranged from 5% to 10%).¹¹³ Other estimates suggest that, in 2017, 61% of unrealized value in debt funds is held in funds with vintage 2006-2012.¹¹⁴ This implies that the funds that invested during the crisis, or shortly thereafter, are still waiting patiently to harvest their positions when value returns.

Overall, the key point for resilience is that many of these funds have patient capital that stands *ready*—and *hungry*—to seize opportunities during moments of downturn. To be sure, this is profit-maximizing behavior on the

¹¹² See *id.*

¹¹³ See Tom Moskal, *Breaking Down a Decade’s Worth of PE and VC Fund Performance*, PITCHBOOK (Sept. 9, 2015), <http://pitchbook.com/news/articles/video-draft-3q-2015-pe-vc-benchmarking-report>; see also PREQIN, QUARTERLY UPDATE: REAL ESTATE, Q3 2013, at 7 (Oct. 2013). It is worth highlighting that the 5% to 10% returns, while lower than those with the ‘best vintage,’ are still attractive returns. This suggests that even these funds were invested in a prudent manner and not contributors to euphoria and the type of bubble-building activity that resulted in significant losses.

¹¹⁴ PREQIN, *supra* note 75, at 24.

fund's part, to serve it and its investors' financial interests. But at the same time, this behavior provides a social good to the extent it helps restore health to financial markets.

3. *Open-ended Business Model*

An open-ended business model is a third structural feature that keeps funds nimble enough to lend and invest in downturns. This characteristic speaks at the corporate rather than fund level. In essence, large alternative asset management institutions have a highly varied business model. These firms operate a range of distinct funds that can support credit markets during downtimes and in a range of different ways.

Consider a typical hedge fund. As noted, while hedge funds are commonly known for their ignominious "hedging" strategies—and often in the equities space—they are also, increasingly, venturing into the credit and debt space. Many hedge funds operate credit funds, investing in fixed-income securities. Sometimes these funds invest in high-yield corporate "junk" bonds, which in turn serve as the primary supply of credit for companies that are struggling.¹¹⁵

Now consider the similar evolutionary trajectory of the PE firm—from core private equity strategies to a range of new debt businesses. KKR, for example, is a canonical private equity shop. Launched in the 1970s, KKR was once (in)famous for the leveraged buy-out. Decades later, in 2004, it pivoted in a completely new direction, opening its first credit platform.¹¹⁶ Ten years later, KKR expanded its credit business into Europe.¹¹⁷

Indeed, this tilt toward credit and debt funds is perhaps the best illustration of the nimbleness of the alternative asset manager, featuring a supple business model that enables it to re-direct toward new business lines whenever the opportunity arises.

III. CASE STUDIES: COUNTERCYCLICAL CAPITAL IN THE ECONOMY

Turning from theory to practice, this Part provides a case-study analysis of funds that have, in post-crisis years, supplied or supported credit in countercyclical ways. Through this in-depth analysis, the Article will now make more concrete the theory set out above regarding how and why these private funds are incentivized, and well equipped, to pursue countercyclical credit opportunities.

¹¹⁵ See Robin Wigglesworth, *Retail Funds Flock to High Yield Bonds*, FIN. TIMES (May 21, 2015), <https://www.ft.com/content/08f635c0-ea99-11e4-96ec-00144feab7de>.

¹¹⁶ See KKR, *Our Firm History*, <http://www.kkr.com/our-firm/firm-history/2010-present> (last visited Aug. 10, 2017).

¹¹⁷ *Id.*

A. *Gap-Filling for Banks*

“For private debt, the 2008 credit crisis was a game changer,” writes Amin Rajan, a researcher at Preqin, a data and intelligence research group that covers alternative asset managers.¹¹⁸ As has already been discussed, due to the extent of banks’ losses on mortgage-related credit assets during and after the crisis, bank balance sheets became severely impaired—“ravig[ed],” in Rajan’s words.¹¹⁹ And, as noted, this suffering, combined with heightened regulatory capital requirements, curtailed banks’ ability to lend.¹²⁰ Investment funds stepped in to fill the gap between the available bank supply and corporate demand for credit.¹²¹

Indeed, soon after the crisis, unmet demand for credit appeared high. Notwithstanding what had happened in mortgage markets, companies still needed fresh capital to refinance, fund new projects, or both. Funding gaps persisted years after the crisis. Recent data and market analysis suggest that the mortgage markets lacked sufficient credit well after the crisis. As one asset management firm wrote in 2015, commercial and residential real estate loans presented “compelling” opportunities at that time.¹²² On the residential side, the “origination of U.S. residential mortgage loans that [did] *not* qualify for government agency guarantees ha[d] been barely perceptible.”¹²³ As a result, there were still “opportunities to originate such loans at historically high yields” or “to acquire legacy residential mortgage exposure in a form that others find problematic”—an activity that will be considered shortly.¹²⁴

Similarly, in commercial real estate, funding gaps resulted from the fact that “traditional lenders ha[d] reduced CRE lending volumes, restricted maximum loan-to-value ratios, and generally tightened underwriting standards” while other “regulatory restrictions on commercial banks ha[d] made CRE lending less profitable.”¹²⁵ All of these factors limiting banks from lending “create[d] a better entry point for lending capital with the potential to earn above-average returns with reduced downside risk.”¹²⁶

Gaps also existed in global shipping and energy sectors. For some years after the crisis, global energy suffered from a capital imbalance where “demand for financing far outpace[d] funding available from the traditional banking system.”¹²⁷ Again, capacity for growth and innovation surpassed

¹¹⁸ RAJAN, *supra* note 83, at 4.

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ ECB SHADOW BANKING REPORT, *supra* note 7, at 13–14 (noting that “[c]redit provision by investment funds to the non-financial private and public sector through loans and debt securities holdings has increased by nearly 50% since the beginning of 2010.”).

¹²² Anderson & Collier, *supra* note 105, at 3.

¹²³ *Id.* (emphasis added).

¹²⁴ *Id.*

¹²⁵ BLACKROCK, WHAT IS PRIVATE MARKET DEBT 3 (undated).

¹²⁶ *Id.*

¹²⁷ *Id.*

banks' ability to finance such socially beneficial projects. Shipping, meanwhile, was distressed by "decreasing fleet and shipyard utilization rates [and] low day rates," as the sector had also seen its traditional sources of financing "disappear."¹²⁸ The sector thus presented "opportunities for less traditional providers to step in at attractive pricing."¹²⁹

Alternative asset managers, chasing opportunities created from banks' retrenchment, stepped in to fill those funding gaps. Alternative asset management institutions like BlackRock, Blackstone, Cerberus, Oaktree Capital, and PIMCO, among several others, all raised new funds to supply credit to corporate borrowers who were unable to obtain debt from banks (or, in some cases, the capital markets). Thus, alternative funds such as these are perhaps the most straightforward and powerful case-study of alternative asset managers supplying countercyclical credit through various of their private funds.

Over the past four or five years, these institutions have created three (related) permutations on the debt/credit fund: the 'plain-vanilla' direct lending fund, the rescue lending fund, and the Business Development Corporation.

1. Direct Lending

Direct lending is the asset management frontier.¹³⁰ As a partner at Deloitte's debt advisory practice told the *Financial Times* in 2015, "[t]he development of direct lending as an alternative asset class is ultimately where we think the market will develop over the next 12 to 18 months."¹³¹ That prediction has proven more or less accurate, as direct lending funds have continued to expand in size and profitability.¹³² In 2016, the approximate market size of direct lending was \$350-500 billion in the U.S. and about \$90-120 billion in Europe.¹³³

Several of the premier alternative asset management institutions currently manage or have recently managed direct lending funds. Examples include the business finance affiliate of the private equity fund Cerberus

¹²⁸ *Id.*

¹²⁹ *Id.* For examples of other private debt deals, see DECHERT LLP, *supra* note 6, at appx. 1.

¹³⁰ See FSB, SHADOW BANKING REPORT, *supra* note 7, at 2 (noting that lending by investment funds—and other similar nonbank institutions—has grown in fourteen of the twenty-eight jurisdictions studied and the Euro area since 2011).

¹³¹ Attracta Mooney, *Asset Managers Pour Billions into Direct Lending*, FIN. TIMES (Dec. 13, 2015), <https://www.ft.com/content/23bc5496-a026-11e5-beba-5e33e2b79e46>.

¹³² See generally *supra* notes 74–82; Rob Mannix, *Private Credit's Growing Angst*, RISK.NET, (July 20, 2017), <https://www.risk.net/asset-management/5306486/private-credits-growing-angst>.

¹³³ BFINANCE, DIRECT LENDING: WHAT'S DIFFERENT NOW? 4 (Mar. 2017), <https://www.bfinance.com/insights/direct-lending-what-s-different-now/>.

Capital Management,¹³⁴ the hedge fund Highbridge,¹³⁵ and the also PE-oriented KKR.¹³⁶

These funds structure lending in a variety of ways. In some deals, a loan is provided as traditional senior or subordinated debt (either alone or alongside another financial institution in what is known as a “club deal”).¹³⁷ In other cases, the fund lender may structure the deal in a unitranche model.¹³⁸ A unitranche structure is attractive to a borrower largely for its simplicity. With it, a loan comes from just one lender and in the form of an instrument that has combined senior and subordinated debt. Further, unitranche loans can offer speed, flexibility in covenants and structures, lower debt service, and, again, the relative simplicity of managing only one lender relationship.¹³⁹ As for the lender, a major benefit of using unitranche terms is the greater likelihood of recovering in the event of a default, as there are no other creditors with whom the fund must negotiate.¹⁴⁰

A brief look at some recent transactional anecdotes and fundraising data gives a fuller picture of the direct lending scene. In terms of where (and to whom) these loans are made, a few recent KKR deals add some color: In 2016, KKR’s direct lending platform in Europe closed two direct lending transactions, one for Roompot, a company that operates Holiday Parks, and another for Exterior Media, an outdoor advertising company in Europe.¹⁴¹ In terms of the heat of current activity in this area, some quick statistics on Cerberus’ business finance arm provides a helpful snapshot: In March 2017, it finished raising capital for the third of its “Levered Loan Opportunities” funds (a little over \$2 billion).¹⁴² For lending funds more generally, Cerberus Business Finance has raised over \$6.2 billion since January 2016, and man-

¹³⁴ Press Release, Cerberus, Cerberus Business Finance Raises \$2.05 Billion for Cerberus Levered Loan Opportunities Fund III (Mar. 2, 2017), <https://www.prnewswire.com/news-releases/cerberus-business-finance-raises-205-billion-for-cerberus-levered-loan-opportunities-fund-iii-300416533.html>.

¹³⁵ Michael Stothard, *Highbridge Raises \$3bn for Direct Lending Fund*, FIN. TIMES (July 19, 2013), <https://www.ft.com/content/f870ae0c-d8ec-11e2-84fa-00144feab7de>.

¹³⁶ See *Credit*, KKR, <http://www.kkr.com/businesses/credit> (last visited Jan. 7 2019).

¹³⁷ See BFINANCE, *supra* note 133, at 4.

¹³⁸ *Id.* at 3; see also Claire Ruckin & Hannah Brenton, *European Direct Lenders Give Banks a Run for Their Money*, REUTERS, (Dec. 6, 2016), <http://uk.reuters.com/article/us-eur-ope-leveraged-loans-idUKKBN13Y1XC>.

¹³⁹ See *Unitranche Financing—An Overview*, KWM, <https://www.kwm.com/en/uk/knowledge/insights/unitranche-financing-an-overview-20160318> (last visited Mar. 18, 2016); see Annette Kuridan & Sam Lukaitis, *Unitranche Loans: How Are They Evolving?* LIN-KLATERS, (Feb. 25, 2015), <https://docplayer.net/21423890-Unitranche-loans-how-are-they-evolving.html>.

¹⁴⁰ See KWM, *supra* note 139.

¹⁴¹ KKR, *KKR Credit Continues to Extend Sponsor-Led Financing and Direct Lending Activity to Companies*, http://media.kkr.com/media/media_releasedetail.cfm?releaseid=1001037 (last visited Nov. 28, 2016) (noting that between 2014 and 2016, this KKR platform loaned over \$1 billion to industrials, consumer, retail, and care services companies across Europe.).

¹⁴² Press Release, Cerberus Capital Management, Cerberus Business Finance Raises \$2.05 Billion for Cerberus Levered Loan Opportunities Fund III (Mar. 2, 2017), <http://www.prnewswire.com/news-releases/cerberus-business-finance-raises-205-billion-for-cerberus-levered-loan-opportunities-fund-iii-300416533.html>.

aged twenty-two different funds—with another \$13 billion currently deployed toward direct lending to middle-market lending.¹⁴³ And in 2016, Cerberus funds participated in over seventy loan transactions, mostly as the leading lender.¹⁴⁴

2. Business Development Companies

Debt funds can also be structured to lend directly to (often middle-market) companies through a business development company, or “BDC.”¹⁴⁵ BDC funds are similar to private equity or venture capital insofar as they often make opportunistic investments in—by loaning money to—troubled or fledgling companies. In terms of legal structure, a BDC is a closed-end, publicly traded investment fund that is registered as an investment company under the 1940 Act.¹⁴⁶

In one 2014 example, PIMCO, together in a joint venture with Solar Capital, launched a publicly traded BDC. Its strategic focus was to originate mostly unitranche loans to companies “across sectors with a steady track record of generating annual EBITDA of \$20-50 million.”¹⁴⁷ In another 2014 example, Oaktree Capital launched its first two BDCs. One of those BDCs was positioned to invest in the debt of small and middle market companies.¹⁴⁸ The other BDC, meanwhile, focused on the debt of “stressed” companies—in what is known as the provision of “strategic credit.”¹⁴⁹

3. Rescue Lending

Other direct lending funds invest specifically in stressed companies and are referred to as “rescue lending” funds. Blackstone’s GSO business¹⁵⁰ is an example of this kind of fund. According to GSO co-founder, Bennett Goodman, the fund aims to “[p]rovid[e] credit to companies that might not otherwise have access to capital,” and “helps stabilize viable businesses and

¹⁴³ Benjamin Horney, *Cerberus Capital Biz Clinches \$2.05B Direct Lending Fund*, LAW360 (Mar. 3, 2017), <https://www.law360.com/articles/897919/cerberus-capital-biz-clinches-2-05b-direct-lending-fund>.

¹⁴⁴ *Id.*

¹⁴⁵ As of June 2016, there were sixty-six operating business development companies with more than \$70 billion in outstanding loans. OFR REPORT, *supra* note 7, at 15.

¹⁴⁶ See Kevin Mahn, *The ABCs of Business Development Companies*, FORBES (Dec. 1, 2014), <https://www.forbes.com/sites/advisor/2014/12/01/the-abcs-of-business-development-companies/#1f14e47a69db>.

¹⁴⁷ Abby Latour, *Solar Capital BDC—PIMCO Joint Venture to Focus on Unitranche Middle-Market Loans*, LEVERAGEDLOAN.COM (Sept. 15, 2014), <http://www.leveragedloan.com/solar-capital-bdc-pimco-joint-venture-to-focus-on-unitranche-middle-market-loans/>.

¹⁴⁸ Greg Roumeliotis, *Exclusive: Oaktree Prepares to Launch its First BDC—Sources*, REUTERS (Jan. 16, 2014), <http://uk.reuters.com/article/us-oaktree-bdcs-idUKBREA0F0IJ20140116>.

¹⁴⁹ *Id.*

¹⁵⁰ Blackstone, *Credit (GSO)*, <https://www.blackstone.com/the-firm/asset-management/credit-gso> (last visited Sep. 30, 2017).

enables businesses to grow.”¹⁵¹ As its name suggests, the objective of a rescue-lending fund, like those run by GSO, is to provide a source of credit for companies in distress. In January 2015, for example, a GSO rescue-lending fund (along with other related vehicles) committed up to \$500 million for five years to fund a U.S. oil and natural gas company’s drilling program.¹⁵² In the spring of 2017, GSO announced plans to raise funds for its third rescue lending fund, which again will plan to provide loans to distressed companies facing a range of liquidity problems such as trouble with debt maturities or covenants or even the prospect of bankruptcy.¹⁵³

KKR also has rescue-lending funds with similar aim. And it, too, was active in rescue deals in the post-crisis years.¹⁵⁴ In 2014, for example, KKR provided \$680 million in rescue financing to the near-bankrupt Preferred Sands, which makes sand used in hydraulic fracturing.¹⁵⁵ That company had also fallen on hard times when natural gas prices fell in 2012-13.¹⁵⁶ When its earnings fell, the company breached certain covenants with its previous lenders. Unable to negotiate new terms, the company would have filed for bankruptcy but for the KKR rescue loan.¹⁵⁷

* * *

Overall, it seems likely that this trend in investment fund direct lending, in its various forms, is likely to continue. And these cases suggest that this form of fund-intermediated credit can enhance economic resilience by filling in for bank lending.¹⁵⁸

¹⁵¹ *Id.*

¹⁵² See M. Roohan, *Blackstone’s New Credit Fund To Seek Undervalued Energy Assets*, INT’L BUS. TIMES (Jan. 27, 2015), <http://www.ibtimes.co.uk/blackstones-new-credit-fund-seek-undervalued-energy-assets-1485376>.

¹⁵³ See James Harvey, *GSO Targets \$6.5bn for Rescue Lending Fund*, ALT CREDIT INTELLIGENCE (July 5, 2017); see also *Blackstone Seeks \$6.5 Billion To Toss Lifelines to Distressed Companies*, WALL ST. J. (Mar. 23, 2017), <https://www.wsj.com/articles/blackstone-seeks-6-5-billion-to-toss-lifelines-to-distressed-companies-1490268605>.

¹⁵⁴ See, e.g., Anne-Sylvaine Chassany, *KKR Agrees Eur200m ‘Rescue Lending’ for Swiss Group Selecta*, FIN. TIMES (June 12, 2014), <https://www.ft.com/content/15747248-f252-11e3-9e59-00144feabdc0>.

¹⁵⁵ See William Alden, *In Rescue Deal, K.K.R. Provides Financing to Troubled Sand Maker*, N.Y. TIMES DEALBOOK (July 25, 2014), <https://dealbook.nytimes.com/2014/07/25/in-rescue-deal-k-k-r-provides-financing-to-troubled-sand-maker>.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ See Alex Brazier, Exec. Dir. for Fin. Stability, Bank of England, Speech to the Financial Policy Committee of Bank of England: Nurturing Resilience to the Financial Cycle (Oct. 19, 2015) (noting that “[t]he first step to nurturing a resilient environment is to reduce the prospect of a sudden crunching of credit supply from an injured banking system.”).

B. *Palliative Effects: Healing Bank Balance Sheets*

In August 2007, there was a bank run in the U.K. for the first time in 140 years.¹⁵⁹ The site of the run, Northern Rock, had been a major player in the mortgage-backed securities scene.¹⁶⁰ In summer 2007, when demand for residential mortgage-backed securities sharply declined, “The Rock” was no longer able to rollover its debt in the short-term funding markets. It was forced to approach the central bank—the Bank of England—for a liquidity facility, which in turn sparked the depositor panic-and-run.¹⁶¹

The bank was nationalized for a time and then, in 2009, restructured in two parts so that it could be partially re-sold to private hands.¹⁶² Northern Rock Plc, sold to Virgin Money, would retain the balance of the bank’s retail deposit business, branches, and highly-rated mortgages while an asset management vehicle—or “bad bank,” as they are known in European regulatory parlance—retained most of the bank’s low-performing mortgage book.¹⁶³ The asset management vehicle inherited, to put it mildly, a seriously impaired set of assets. As one U.K. news outlet described the bank:

No other lender ha[d] been more aggressive in growing its share of the ever-more inflated UK housing market. No other bank ha[d] gorged itself on cheap debt to the same extent in order to maintain its relentless growth profile. No other bank ha[d] been so dependent on short-term cash from the money markets to keep funding its business model.¹⁶⁴

Northern Rock’s balance sheet was not unique. The plague of nonperforming loans on banks’ balance sheets has been a particular problem in Europe, where “[t]he legacy of pre-crisis debt continues to haunt the continent.”¹⁶⁵

¹⁵⁹ THE FAILURE OF NORTHERN ROCK: A MULTI-DIMENSIONAL CASE STUDY 7 (Franco Bruni & David T. Llewellyn eds., 2009)

¹⁶⁰ *Id.* at 14.

¹⁶¹ See *id.* at 75–76. For a history of the Northern Rock collapse, see generally FINANCIAL SERVICES AUTH. (U.K.), THE SUPERVISION OF NORTHERN ROCK: A LESSONS LEARNED REVIEW (Mar. 2008); *Lessons of the Fall*, ECONOMIST (Oct. 18, 2007), <https://www.economist.com/briefing/2007/10/18/lessons-of-the-fall>.

¹⁶² See Holly Williams, *Nationalised Northern Rock Split Into Two*, INDEPENDENT (Jan. 4, 2010), <https://www.independent.co.uk/news/business/news/nationalised-northern-rock-split-into-two-1857451.html>; see also THE FAILURE OF NORTHERN ROCK, *supra* note 159, at 7.

¹⁶³ See Philip Inman, *Brussels Approves Plans to Split Northern Rock*, THE GUARDIAN (Oct. 28, 2009), <https://www.theguardian.com/business/2009/oct/28/northern-rock-good-bank-bad-bank>; see also Press Release, Gov. UK, Chancellor Announces Sale of Northern Rock PLC (Nov. 17, 2011), <https://www.gov.uk/government/news/chancellor-announces-sale-of-northern-rock-plc>.

¹⁶⁴ *Why Northern Rock Was Doomed to Fail*, THE TELEGRAPH (Sept. 16, 2007), <http://www.telegraph.co.uk/finance/markets/2815859/Why-Northern-Rock-was-doomed-to-fail.html>.

¹⁶⁵ Thomas Hale, *European Loan Sales Passed €100bn in 2015*, FIN. TIMES (Feb. 16, 2016), <https://www.ft.com/content/ee5be258-d4a0-11e5-8887-98e7feb46f27>; see also Giovanni Legorano & Nektari Stamouli, *Tools for Cleaning Up Europe’s Bad Debt: 18-Wheeler and a ‘Strong Stomach,’* WALL ST. J. (Aug. 8, 2017), <https://www.wsj.com/articles/tools-for-cleaning-up-europes-bad-debt-18-wheeler-and-a-strong-stomach-1502184606> (noting that

In recent years, however, alternative investment funds have begun to “chip away” at this legacy debt by investing in banks’ nonperforming loans.¹⁶⁶ In the case of Northern Rock, private equity firm Cerberus was one of the largest investors in its nonperforming loan (NPL) book. In 2015, it bought £13bn of Northern Rock loans from the U.K. government.¹⁶⁷ Kensington Mortgages, a private equity-owned lender, has also been active in purchasing Northern Rock NPLs.¹⁶⁸ And in 2011, Lone Star Funds—an American PE firm—invested in a \$4.5 billion NPL portfolio of Anglo-Irish Bank, which wound down in 2011.¹⁶⁹

Importantly, not all NPL investments are in defunct or “bad” banks. In January 2017, for example, Oaktree announced that it would be acquiring €250 million of overdue Spanish real estate debt (with face value of €950 million).¹⁷⁰ The industry expects that investment funds are likely to continue acquiring NPLs. Major funds like Cerberus and Oaktree are still eager to invest, and new stores of NPLs are expected to come online from banks in China,¹⁷¹ Ireland,¹⁷² and India.¹⁷³

From this vantage point, funds’ investments in NPLs can be seen as another force for smoothing the credit cycle.¹⁷⁴ Not only can these investments help clean up weak banks, but they can also provide a salve for healing the weakened aspects of otherwise functional banks. In divesting banks of legacy losses, these fund investments enable those banks to repair their balance sheets and, in turn, resume lending again. As such, a steady stream

nonperforming loans in Europe “will continue to eat up capital and depress lending . . . possibly stifling the long-awaited recovery now under way in Europe”).

¹⁶⁶ Hale, *supra* note 165.

¹⁶⁷ Emma Dunkley, *UK Treasury Sells £13bn of Northern Rock Mortgages to Cerberus*, FIN. TIMES (Nov. 13, 2015), <https://www.ft.com/content/d6566948-89dd-11e5-9f8c-a8d619fa707c>.

¹⁶⁸ Thomas Hale, *Private Equity Muscles into UK Home Loans*, FIN. TIMES (Feb. 3, 2016), <https://www.ft.com/content/de8fc8f2-ca5b-11e5-a8ef-ea66e967dd44>.

¹⁶⁹ *NPL Portfolio Sales—Key Issues for Sellers and Buyers*, ALLEN & OVERY (Mar. 6, 2012), <https://www.aohub.com/aohub/viewContent.action?key=Ec8teaJ9VapaKY0bt4XReV7eOOGbnAEFKCLORG72fHz0%2BNbpi2jDfaB8lgiEyY1JAvAvaah9lF3dzoxprWhl6w%3D%3D&nav=FRbANEucS95NMLRN47z%2BeeOgEFCt8EGQBTTrTXtG0BY%3D&popup=HxapDW/MKd4%3D>.

¹⁷⁰ Susana Correia, *Oaktree Buys NPL Portfolio Worth €950 Million from Sabadell*, IBERIAN PROPERTY (Jan. 11, 2017), <https://iberian.property/news/oaktree-buys-npl-portfolio-worth-950-million-from/>.

¹⁷¹ See *China Banks Bad Loans Surge Most on Record Amid Deleveraging*, BLOOMBERG, <https://www.bloomberg.com/news/articles/2018-08-13/china-banks-bad-loans-surge-most-on-record-amid-deleveraging> (last visited Jan 7, 2019).

¹⁷² *Irish NPL Wave Expected*, STRUCTURED CREDITOR INVESTOR, May 26, 2017, at 11–12 (industry newsletter for AFME & IMN 2017 Global ABS Conference) (on file with author).

¹⁷³ Simon Mundy, *Bank Results Spotlight Stubborn India Bad-Loans Problem*, FIN. TIMES (Feb. 15, 2017), <https://www.ft.com/content/ada8f680-f32e-11e6-8758-6876151821a6>; Anirban Nag, *RBI’s Warning as Indian Bank Loans Hit 14-Year High*, BLOOMBERG MARKETS (Dec. 29, 2016), <https://www.bloomberg.com/news/articles/2016-12-29/india-s-dominant-state-banks-face-significant-stress-rbi-says>.

¹⁷⁴ For a discussion of the financial stability impact of NPLs, see Arthur Beesley, *Ireland’s Banking Sector Steps Up Drive To Sell Soured Loans*, FIN. TIMES (Aug. 21, 2018), <https://www.ft.com/content/1899a8f4-a512-11e8-8ecf-a7ae1beff35b>.

of asset manager NPL investment should in theory make the down phase of a credit cycle—the point during which bank lending is impaired—much shorter and much shallower than it otherwise would be.

Aside from smoothing credit cycles, NPL investing promotes economic resilience in several other important ways. For one, it might reduce the number of foreclosures in the real economy. Investment funds are likely to have greater incentives and capacity than banks to work out the NPLs. Typically, the fund will purchase the NPL portfolio at a discount of somewhere between 25% and 50% of the loans' face value.¹⁷⁵ This means that, unlike a bank, the fund has the capacity and flexibility to cut deals with the original borrower on adjustments to rate or principal terms. The fund will also be motivated to do this, having acquired the portfolio on an investment thesis that the fund could deploy its capital-markets-structuring expertise to work out a more profitable arrangement (which is also likely to be more borrower-friendly). In contrast, a bank lacks such flexibility or incentive—for the bank, foreclosing (or collecting interest on a loan sitting in default) is the easier choice to make.

Consider, for example, the Banco Sabadell case and Oaktree's so-called "Project Normandy," which involved working out that portfolio of nonperforming loans.¹⁷⁶ The portfolio at issue consisted of around 500 loans to property developers. Oaktree's plan in Project Normandy was not simply to foreclose on these developers—who had fallen on tough times after the crisis—and collect what it could. Rather, Project Normandy strategized to either restructure the loans or to acquire the assets collateralizing the loans and then team up with the local property developers to finish out their projects.¹⁷⁷ In that case, the knock-on economic benefits of the fund's involvement is manifest in the continued operation of the (borrower) development companies themselves, the eventual completion of their projects, and the future employment and revenue that those projects would eventually generate.

Moreover, investing in NPLs serves resilience by helping banks meet regulatory expectations and objectives. In Europe especially, the reduction of NPLs was, as late as 2017-18, a particular goal of central banks and other macroprudential authorities in light of the still high NPL ratios at many banks. As a prime example, the Governor of the Central Bank of Ireland announced in May 2016 that the Bank would be pushing for a faster pace of NPL reductions and—importantly—also pushing banks to find "new strategies" to "combat the still elevated volume of bad loans."¹⁷⁸ With similar aim, the European Central Bank has targeted a 5% reduction in NPLs by

¹⁷⁵ See *Irish NPL Wave Expected*, *supra* note 172; see also Correia, *supra* note 170.

¹⁷⁶ Correia, *supra* note 170.

¹⁷⁷ *Id.*

¹⁷⁸ *Irish Central Bank Steps Up NPL Pressure*, STRUCTURED CREDITOR INVESTOR (May 26, 2017), at 3. (industry newsletter for AFME & IMN 2017 Global ABS Conference) (on file with author).

2019-21.¹⁷⁹ For countries like Ireland, with still high NPL ratios, loan sales to investment funds are essential in satisfying these prudential objectives.¹⁸⁰ What is more, as fund investment in NPLs becomes more of a regular and historic market practice, banks can come to incorporate this anticipated source of demand for NPLs in crafting their resolution plans.¹⁸¹

C. Reviving Stagnant Structured Credit Markets

Investment funds have also, quite recently, played some part in stimulating previously dormant markets in structured credit products like mortgaged-backed securities. In spurring activity in this market, investment funds can be seen playing an indirect role in smoothing the credit cycle by paving avenues for banks to lend again (by propping up funding from securitization markets).

Like bank balance sheets, the crisis devastated the market for structured credit products like mortgaged-backed securities. Data surrounding commercial mortgaged-backed securities (CMBS) well illustrates the depth and sharpness of that market's drop: The issuance of CMBS fell from \$229 billion in 2007 to \$12 billion in 2008, and to then just \$3 billion in 2009.¹⁸² As one scholar noted, the CMBS market "had ceased to function."¹⁸³ Largely, the market pullback from CMBS and their residential cousins, RMBS, was a function of their stigma. RMBS and their related synthetic and derivative products had, after all, been at the center of the crisis. Regulators, too, contributed to that sentiment by grouping and critiquing securitization as a source of funding under the "shadow banking" heading.¹⁸⁴

The bottoming out of the securitization market may have made the credit cycle bumpier by crimping credit liquidity. Banks use securitization to free up their balance sheets. By pooling loans together and then issuing bonds that are collateralized by those fixed-income assets, banks can effectively transfer their role as lender to the new bond buyers. Securitization is thus another way to transform liquidity as a process of converting illiquid mortgage loans into liquid and tradeable bonds.¹⁸⁵ As another related benefit,

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ Cf. Jeannette Neumann, *Blackstone Buys Billions in Spanish Real-Estate Assets*, WALL ST. J. (Aug. 8, 2017), <https://www.wsj.com/articles/blackstone-to-take-majority-stake-in-spanish-lenders-real-estate-portfolio-1502214267> (reporting on Blackstone's agreement to acquire a majority of the Banco Popular—a recently rescued bank—real estate portfolio).

¹⁸² Sam Chandan, *The Past, Present, and Future of CMBS*, WHARTON REAL ESTATE REVIEW, Spring 2012, at 1.

¹⁸³ *Id.*

¹⁸⁴ See, e.g., ZOLTAN POZSAR ET AL., SHADOW BANKING 13 (Fed. Reserve Bank of N.Y., Staff Report No. 458, 2010) (2012).

¹⁸⁵ BASEL COMM. ON BANKING SUPERVISION, REPORT ON ASSET SECURITISATION INCENTIVES 1 (2011) (noting that "[s]ecuritisation increases the availability of credit by converting non-tradable financial assets into securities that can be issued to investors and traded on capital markets").

securitization enables an investor to diversify the risk associated with owning mortgage assets, because holding a bond that is collateralized by a pool of mortgages spread across geographic regions is inherently less risky than concentrated exposure to a single housing market.¹⁸⁶ But, again, when banks are not lending, they are neither benefiting fully from securitization nor supplying securitized products to investors who would buy them. Notably, in Europe, where securitization has languished even longer than in the U.S., EU legislators and financial regulators have embarked on a specific project to try and restore confidence in that market.¹⁸⁷

In some ways, investment funds have helped to stimulate this market and fill unmet demand. More specifically, in a recent trend, investment funds have been turning to securitization to fund their NPL and other mortgage investments. Funds at Blackstone, Cerberus, Lone Star, and TwentyFour have all financed credit investments through securitization.¹⁸⁸ Kensington Mortgages, for example, was one of the biggest mortgage securitizers in 2015, securitizing the loans it had acquired from Northern Rock.¹⁸⁹ Cerberus also issued a £6.2 billion securitization—the largest since the crisis, in fact—with some of the Northern Rock NPLs it had acquired in 2015.¹⁹⁰ Another alternative asset manager, TwentyFour, has very recently stated that it plans to become a “routine issuer” of mortgage bonds.¹⁹¹

To be sure, financing credit investments through securitization is an efficient choice for asset managers. But, as with direct lending activity, it also is a social good to the extent it serves a credit-cycle-smoothing role by supporting funds’ NPL acquisitions. Relatedly, to the extent funds’ activity in the securitization markets is helping to revive that market, it also, in turn, can support banks’ ability to return to normal lending. From that perspective, investment funds’ participation in the securitization markets is not necessarily—or solely—a concern for financial stability but also a boon to it.

D. Keeping Debt Markets Liquid

In parallel to pullbacks in lending, banks also retreated from trading debt securities, especially corporate bonds. Though regulators continue to

¹⁸⁶ See Andra Ghent, *Comparing Securitized and Balance Sheet Commercial Mortgages*, WISCONSIN SCH. OF BUS. (Nov. 19, 2015), <https://bus.wisc.edu/mba/current-students/mba-specializations/real-estate/blog/2015/11/19/comparing-securitized-and-balance-sheet-commercial-mortgages>.

¹⁸⁷ See Communication from the Commission to the European Parliament, European Council, the European Economic and Social Committee and the Committee of the Regions. Action Plan on Building a Capital Markets Union, COM (2015) 468 (September 30, 2015).

¹⁸⁸ *Loan Buyers Drive Europe MBS*, ASSET-BACKED ALERT (June 2, 2017), at 6 (weekly industry update on worldwide securitization) (on file with author).

¹⁸⁹ Hale, *supra* note 165.

¹⁹⁰ *Id.*; Lizzie Meager, *Europe’s £6.2Billion RMBS Signals Changing Tide*, INT’L FIN. L. REV. (May 5, 2016), <http://www.iflr.com/Article/3551623/Europes-62-billion-RMBS-signals-changing-tide.html>.

¹⁹¹ *Loan Buyers Drive Europe MBS*, *supra* note 188.

debate it,¹⁹² industry participants have confirmed that liquidity from banks has been crunched. According to market research, investors report it takes *seven times* longer to liquidate their bond portfolios as it did in 2008.¹⁹³ And as one portfolio manager at a relatively small fund (\$1.5 billion AUM) described it, before the crisis he would “call a few banks to sell a bond and it would be snatched up within hours.”¹⁹⁴ Now, however, “it takes at least a couple of days” and the banks take a bigger cut.¹⁹⁵

Most blame post-crisis regulation and the Volcker Rule specifically. That rule prohibits banks from engaging in proprietary trading, which means they cannot take risk for profit on their own accounts. The rule tries to distinguish between proprietary trading and the bank’s market-making function—that is, connecting would-be buyers and sellers of corporate debt securities. But in practice that line has proved difficult to draw. A bank, acting as intermediary, always makes some profit for market-making activities given the risk involved.¹⁹⁶ Moreover, in order to consummate orders quickly, a bank must keep an inventory on hand. Problematically, however, both of these normal features of market-making—keeping stocks of bonds and making profits—can look dangerously close to proprietary trading. In light of the uncertainty, most banks have simply cut back on market-making. The result is an illiquid or “choppy”¹⁹⁷ corporate bond market, which ultimately can make it costlier and more time-consuming for corporations to raise debt in primary markets.

But here, too, asset managers have filled the credit void by acting more like traders. By holding large portfolios of bonds, mega asset management

¹⁹² See William C. Dudley, Pres. of Fed. Reserve Bank of N.Y. & CEO, Remarks at the SIFMA Liquidity Forum, New York City: Regulation and Liquidity Provision (Sept. 30, 2015); but see Jack Bao, Maureen O’Hara & Alex Zhou, *The Volcker Rule and Market-Making in Times of Stress* (FRB Staff, Working Paper 2016-102, 2016) (noting that “[the FRB’s] main finding is that the Volcker rule has a deleterious effect on corporate bond liquidity and dealers subject to the rule become less willing to provide liquidity during stress times. While dealers not affected by the Volcker rule have stepped in to provide liquidity, [the FRB] found that the net effect is a less liquid corporate bond market.”); see also OFFICE OF FIN. RESEARCH, 2014 ANNUAL REPORT 31–32 (2015), <https://www.financialresearch.gov/annual-reports/files/office-of-financial-research-annual-report-2014.pdf> (citing, among various reasons for declining liquidity, that “[r]egulations requiring banks to hold more capital and more restrictive constraints on leverage have increased the cost of securities financing activities and reduced incentives to maintain them”).

¹⁹³ RAJAN, *supra* note 83, at 6.

¹⁹⁴ Jon Sindrew, *In the New Bond Market, Bigger is Better*, WALL ST. J. (June 21, 2017), <https://www.wsj.com/articles/in-the-new-bond-market-bigger-is-better-1498046401>.

¹⁹⁵ *Id.*

¹⁹⁶ See ANNETTE THAU, THE BOND BOOK 8–9 (3d ed. 2011) (explaining that “[t]he spread is a markup: it is the difference between what a dealer pays to buy a bond, and the price at which he wants to sell it. . . .the bid is what you sell for; the ask, the price at which you buy”). The standard exception is for “reasonably expected near-term demand of customers.” See PwC, VOLCKER RULE: ARE YOU REALLY MARKET-MAKING? 1 (2015) <http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/volcker-rule-rentd.pdf>.

¹⁹⁷ Christopher Whittall & Juliet Samuel, *Investors Raise Alarm Over Liquidity Shortage*, WALL ST. J. (Mar. 18, 2015), <https://www.wsj.com/articles/investors-raise-alarm-over-liquidity-shortage-1426701094>.

institutions like BlackRock and PIMCO have found ways to bypass banks' trading desks and buy directly from fixed-income funds.¹⁹⁸ One can reasonably assume that, with masses of bond-holdings, these asset managers have the market power to set their own purchase prices rather than having to ask banks to do so for them.¹⁹⁹ In essence, then, the size of their fixed-income holdings can enable some asset managers to replicate the market-making that banks used to do, thereby sustaining liquidity in those debt markets. Keeping corporate debt markets liquid during times when banks are stressed is thus arguably another important way in which asset managers can help flatten the credit-cycle curve.

E. Helping Firms Shed Systemic Risk

In July 2013, the FSOC designated General Electric Capital Corp., Inc. (GECC)—a subsidiary of GE Company—as a “systemically important” nonbank financial institution.²⁰⁰ The designation was based on, among other reasons, the fact that GECC was highly active in wholesale short-term funding markets and therefore counterparty to other institutions that purchased its commercial paper.²⁰¹ The FSOC was also concerned that GECC was providing credit directly to middle-market companies.²⁰²

Relatively quickly after its designation, GE set out to shed its SIFI label to avoid the heightened capital and supervisory requirements that would follow.²⁰³ It thus embarked on what the company called “Project Hubble” to divest its financial arm, GECC. Project Hubble required GE to offload around \$180 billion of assets from GE capital.²⁰⁴ Clearly, finding able and willing buyers for these assets was critical to GE’s divestment plan, and, as per one of management’s top priorities, to find such buyers and then execute the sales *quickly*.²⁰⁵

¹⁹⁸ In 2015, the ten largest asset management firms active in fixed-income had \$1.98 trillion in bond holdings, as compared to \$921 billion in 2008. David Oakley & Barney Jopson, *Asset Managers Push into Bonds Prompts Regulatory Scrutiny*, FIN. TIMES (June 2, 2015), <https://www.ft.com/content/2d22b9a2-092d-11e5-881f-00144feabdc0>.

¹⁹⁹ See *id.*

²⁰⁰ See FIN. STABILITY OVERSIGHT COUNCIL, BASIS OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL’S FINAL DETERMINATION REGARDING GENERAL ELECTRIC CAPITAL CORPORATION, INC. 2 (2013), <https://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20General%20Electric%20Capital%20Corporation,%20Inc.pdf>.

²⁰¹ *Id.*

²⁰² *Id.* at 2–3.

²⁰³ See Press Release, GE, *GE to Create Simpler, More Valuable Industrial Company by Selling Most GE Capital Assets* (Apr. 10, 2015), <https://www.genewsroom.com/press-releases/ge-create-simpler-more-valuable-industrial-company-selling-most-ge-capital-assets>.

²⁰⁴ Ben McLannahan, *General Electric Makes Divestiture of Financial Unit Add Up*, FIN. TIMES (July 24, 2016), <https://www.ft.com/content/a6b02fae-5051-11e6-8172-e39ecd3b86fc>.

²⁰⁵ See *id.*

The problem that GE faced, however, was precisely that—a shortage of buyers willing to pay acceptable prices for its balance sheet.²⁰⁶ In the end, alternative asset managers stepped in again, playing a large role in acquiring GECC's credit assets.²⁰⁷ Many of these fund purchasers were interested and able to do those deals by tapping into securitization markets.²⁰⁸ In turn, GE succeeded in persuading the FSOC to de-designate GECC in 2016.²⁰⁹ To be fair, without the funds' involvement GECC would probably have secured traditional bank buyers eventually. But, as one of GE's executive explained, the company would have lost substantial value waiting.²¹⁰ Moreover, while waiting for bank buyers, GE would have continued operating with an overly large systemic footprint.

Again, this case study speaks to investment funds' ability or incentive to smooth the credit cycle through countercyclical credit or credit investing. It also features the use of another form of nonbank credit intermediation (securitization) to do so. And, this case points to an ancillary benefit of private fund intermediated credit. Here, the investment funds involved were able to assist another nonbank financial institution to restructure its business in stability-enhancing ways.

* * *

Together, these case studies have illustrated the myriad ways in which private, nonbank credit helped smooth the credit cycle after the 2008 financial crisis: through countercyclical lending and credit-investment in the first instance and by otherwise supporting credit-market liquidity during economic down times. Ultimately, then, these cases provide evidence in support of this Article's core claim: that certain private investment funds *promote* financial stability by helping to smooth the credit cycle.

²⁰⁶ Panelist Remarks, Global ABS Conference: The Emerging Role of Private Equity in the Securitisation Market [Hereinafter: Global ABS Conference], (June 8, 2017) (on file with author).

²⁰⁷ See, e.g., Press Release, Blackstone, Blackstone and Wells Fargo to Buy GE Capital's Real Estate Assets (Apr. 10, 2015), <https://www.blackstone.com/media/press-releases/blackstone-and-wells-fargo-to-buy-ge-capital-s-real-estate-assets>.

²⁰⁸ Global ABS Conference, *supra* note 206; see also Swati Pandey & Sharon Klyne, *KKR, Varde, Deutsche Seek to Securitise A\$7 Bln of GE Capital Debt-Sources*, REUTERS (Mar. 16, 2015), <http://www.reuters.com/article/kkr-ma-general-electric-idUSL4N0UZ1MO20150316> (discussing the securitization of debt acquired from GE, a slightly different use of securitization markets).

²⁰⁹ Press Release, U.S. Treasury Dep't Office of Pub. Affairs, Financial Stability Oversight Council Announces Rescission of Nonbank Financial Company Designation (June 29, 2016), <https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Announces%20Rescission%20of%20Nonbank%20Financial%20Company%20Designation.pdf>.

²¹⁰ See Global ABS Conference, *supra* note 206.

IV. EXPANDING THE BASE OF COUNTERCYCLICAL CAPITAL WITH RETAIL INVESTMENT

By this point, the Article has offered a theoretical explanation of why certain private investment funds are incentivized and well-positioned within the financial system to support the credit markets in a countercyclical way. It has also provided evidence to support that theory through a detailed case study analysis of how, in recent years, these investment funds have played such a role in the credit markets. Overall, that analysis has suggested that funds providing nonbank credit can promote economic resilience by helping to smooth the credit cycle—that is, by making economic downturns (and their accompanying credit slumps) less severe and less prolonged.

This claim has poignant implications for the optimal balance and flow of capital between banks and asset management institutions. Specifically, it suggests that increasing the amount of this kind of patient capital in the financial system—relative to that in banks (as deposits) or in open-ended funds (as redeemable shares)—would improve the resilience of the economy and, as such, promote financial stability. But, as will be discussed next, macroprudential regulators have not yet developed new (or deployed existing) tools to redirect the flow of capital in the financial system to serve the goal of economic resilience.

A. Existing Regulatory Tools

Before suggesting new regulatory tools for accomplishing a smoother financial cycle, it is helpful to consider again which macroprudential tools already exist and why they fall short.

As earlier discussed, the chief macroprudential tool for addressing the financial cycle does not deal with capital allocation at all—it is addressed to banks' lending activity. That tool, the CCyB, is designed to lean against the upswing of the credit cycle by incentivizing banks to dampen their lending. But alone, the CCyB may not be sufficient to aid economic recovery when the downturns come.²¹¹

For one, countercyclical capital buffers require regulators to stimulate the credit supply by reducing capital requirements during a down phase. But the efficacy of such corrective action depends on human judgment and bureaucratic decision-making. Regulators must be relied upon to gauge when the economy is heading downward and when credit is likely to become scarce. But can such decisions be made accurately and free from political interference? And, above all, can they be made quickly? Empirical research

²¹¹ Cunliff, *supra* note 48, at 10 (noting that “[t]he literature and theory of macroprudential policy is yet relatively under-developed and concentrates on prudential regulation of banks and their role in the credit cycle. But . . . the time-varying risks we need to address go wider than the banking system”).

from the Bank of International Settlements confirms that banks would need a “prompt and sizeable release” of the countercyclical capital buffer to effectively mute periods of stress.²¹²

Moreover and related, adjustments to capital buffers are invariably hard to calibrate correctly.²¹³ As Professor John Armour and his co-authors point out, so as not to over- or under- adjust, macroprudential authorities must be able to distinguish between overheating asset booms (dangerous) and secular growth in demand (healthy).²¹⁴ Given that we can expect regulators to be risk-averse and therefore wary of dropping capital requirements *too* low, there is a strong likelihood that any reductions in a capital buffer would be too little or too late. Again, such delay in or incomplete action would render the tool lackluster.

As such, targeting the *allocation* of capital across the financial system—with the aim of increasing the amount of countercyclical capital at work during downturns—may be an effective and efficient time-varying approach to complement the CCyB. As this Article has argued, as opportunistic investors standing with fresh capital at the ready, these private investment funds will be eager to bring their additional credit supply to bear on the economy relatively quickly after the economy drops.²¹⁵ These funds will use their supply of patient capital to provide credit countercyclically—importantly, their business model incentivizes them to do so without the need for regulatory intervention that requires it.²¹⁶

Thus, the CCyB and capital allocation efforts may be seen as complements: While the CCyB may be deployed to make the upturn to the cycle less steep, opening investment channels for capital to flow into private credit can serve future downturns. Again, as will be explained, because these private funds are naturally incentivized to wait for truly countercyclical moments, regulators would not face the task of opening and closing this channel alongside predictions about the financial cycle; instead, permanently making the channel wider would serve all future cycles.

However, macroprudential authorities do not themselves have the tools to facilitate the flow of capital into the private fund sector. Rather, such regulatory intervention would involve some modification to the existing securities law framework that governs private fund investing. Specifically, the proposal here is that retail investors gain access to certain of these private credit and debt fund investments.

²¹² DREHMAN ET AL., *supra* note 39, at 2.

²¹³ See Daniel K. Tarullo, (former) Gov., Bd. of Governors of the Fed. Reserve Sys., Speech at the Yale Law School Conference on Challenges in Global Financial Services, New Haven, Connecticut: Macroprudential Regulation (Sept. 20, 2013).

²¹⁴ ARMOUR ET AL., *supra* note 5, at 424.

²¹⁵ See *supra* Part II.B; see also Part III.

²¹⁶ See *supra* Part II.B.

B. Vetting Funds for Soundness and Suitability

Investor protection measures would be critical to any initiative to allow retail investors to participate in private funds. In particular, it would be important for the SEC to have the ability to siphon the flow of retail investment into only those private credit and debt funds which were structured suitably and appropriately—that is, in ways that serve both the interests of financial stability and those of the individual retail investor.

The following discussion highlights three structural features that would be key in this suitability assessment: they regard liquidity, incentives, and investor education.

1. Liquidity

The stability benefits of an illiquid, closed-end fund bear revisiting and repeating as they distinguish certain private funds from other forms of riskier investment funds.²¹⁷ As for runs, as earlier discussed, with locked-in capital, private investment funds are not funded at shorter maturities and therefore not vulnerable to runs.²¹⁸

Locked-in capital also mitigates the stability risks associated with leverage, which has been another prominent regulatory concern.²¹⁹ As regulators have correctly pointed out, financial stability risks can materialize from investor withdrawals that require funds to draw down on lines of credit, or use techniques like securities lending, to satisfy redemptions. The problem arises when and if funds are forced to sell some of their assets at fire sale prices with resulting price dislocations.²²⁰ While some of these funds do use leverage, the bona fide stability risk hinges, again, on investors' ability to withdraw their equity. So long as investors hold steady—as they must when their capital is locked-in—such equity flight is unlikely, if not impossible. It is true that leverage may be risky for another reason: for the interconnections it

²¹⁷ See FSO, ASSET MANAGEMENT UPDATE, *supra* note 25, at 4–6; FSB, SHADOW BANKING REPORT, *supra* note 7, at 1–24. The basic fear associated with nonbanks that engage in liquidity transformation is a run-like scenario during which a fund faces an influx of redemption requests from investors (likely triggered by some market or credit event to “spook” the investor into withdrawing) paired with a fund’s inability to meet those redemption requests thanks to its investment in illiquid or long-term assets (such as one might see in a bespoke bond fund). Rules finalized at the end of 2016 now require many of these open-ended funds to maintain liquidity management programs and give these open-ended funds the authority to install redemption gates or the functional equivalent of subscription fees. See SEC, Investment Company Liquidity Risk Management Programs, 81 Fed. Reg. 82,142 (Nov. 18, 2016); SEC, Investment Company Swing Pricing, 81 Fed. Reg. 82,084 (Nov. 18, 2016).

²¹⁸ See Tuch, *supra* note 5, at 317–18 (making a similar observation regarding private equity funds).

²¹⁹ See ECB, SHADOW BANKING REPORT, *supra* note 7, at 26–27; OFFICE OF FIN. RESEARCH, ASSET MANAGEMENT AND FINANCIAL STABILITY 7 (2013); FSO, ASSET MANAGEMENT UPDATE, *supra* note 25, at 14–15; FSB, ASSET MANAGEMENT REPORT, *supra* note 25, at 14–21.

²²⁰ See ECB, SHADOW BANKING REPORT, *supra* note 7, at 26–27.

creates with banks who supply the debt to funds. Yet the risk that a fund will default on its debt obligations arguably can be managed through supervisory schemes. The OFR, for example, has proposed stress testing funds exposed to nonfinancial corporate debt to gauge the impact on the fund, its investors, and associated markets.²²¹

While illiquidity is therefore helpful to the fund's stability, it can be in tension with the interests of retail investors. The average retail investor may not be able (or should not attempt) to withstand a roughly ten-year lock on his or her investment. Innovative funds, however, could likely find some way to structure around this challenge. For example, some structure might develop that would permit existing retail investors to trade their interests in the fund with those investors wishing to enter the fund but who missed the original window for investing. To maintain stability, however, the fund would have to ensure that any trading-out of share positions is always matched with buying in, precisely to avoid any possibility of a sudden decrease in capital (similar to a run).

For these reasons, when vetting funds' suitability for retail investment, regulators would need to scrutinize closely the fund's liquidity structure. In particular, credit hedge funds may not be a suitable kind of investment vehicle for the retail investor because many of these vehicles have open-ended structures. As such, the SEC may want to preclude these funds from accessing retail capital, unless the fund were to adopt a closed-end structure or some other form of redemption gate. (Part III.C suggests how.)

2. Exuberance

It is well known in the finance and economics literature that irrational exuberance is an enduring, human aspect of the financial markets—and that it can lead to systemically dangerous bubbles.²²² This literature points out that managers of some open-ended funds are incentivized to contribute to the build-up of bubbles—that is, to bubble-ride. This can occur where performance is measured on a quarterly basis. The publicity of the fund's performance can create incentives for managers to follow the market's momentum to avoid any reputational risk of underperforming their peers.²²³ With such incentives in place, managers may not act as a rational arbitrageur would; instead they may choose to chase a short-term illusion of profit.²²⁴ Not only does this serve investors poorly during the downturn that follows the inevita-

²²¹ OFR REPORT, *supra* note 7, at 30, 35.

²²² See, e.g., Ryan Bubb & Prasad Krishnamurthy, *Regulating Against Bubbles: How Mortgage Regulation Can Keep Main Street and Wall Street Safe—From Themselves*, 163 UNIV. PENN. L. REV. 1539 (2015).

²²³ See generally Stephen L. Cheung & Andrew Coleman, *Relative Performance Incentives and Price Bubbles in Experimental Asset Markets*, 81 S. ECON. J. 345 (2014); Amil Dasgupta, Andrea Prat & Michela Verardo, *The Price Impact of Institutional Herding*, 24 REV. OF FIN. STUDS. 892 (2011).

²²⁴ See, e.g., *id.*

ble bubble burst, but it is also bad for the real economy writ large. So it is reasonable for policymakers and academics to advocate for regulatory checks on managerial exuberance or, stated differently, sufficient “skin in the game.”

Yet these kinds of incentives should not exist in an appropriately structured private credit or debt fund. These funds are mandated, incentivized, and structured to make only truly countercyclical investments, not to bubble-ride. For one, the fund’s investors can be expected to hold their fund managers accountable for returning very high returns (again, commanding an illiquidity premium). For that reason, managers of these funds are usually required to clear a hurdle of profit and performance before receiving incentive fees. Neither can happen if credit markets saturate because credit yields decline along with the profitability of the funds’ investments. The prospect of such a scenario should force managers to take the long-term view, dampening if not precluding any impulse to lend in frothy credit markets.

These same kinds of market dynamics and private incentives also assure the quality of fund-intermediated credit. Indeed, fund managers have strong reputational incentives to invest in high-quality credit. Poor-quality investments that are too risky or too sloppy will dissatisfy investors, diminish the institution’s reputation and, consequently, harm its ability to raise future funds.²²⁵ For that self-preserving reason, asset managers naturally tend to have more “skin in the game” with their credit investments than, for instance, banks.²²⁶

Again, ensuring the appropriate incentives are in place could be another aspect for the securities regulator to consider in assessing the suitability of the fund for retail investments.

3. Education

Finally, funds should effectively inform the retail investor about the nature of private debt or credit investments. Here, innovation and technology can play a productive part. A range of fintech platforms now offer meaningful investor advice and education—often targeted to the retail investor—that could improve these investors’ ability to ‘fend for themselves’ in private debt markets.

BlackRock, among the leaders in this space, offers a range of retail-investor tools for assessing one’s perceived risk appetite, behavioral psychology toward the markets, and financial capacity to diversify.²²⁷ For now, these

²²⁵ Cf. PEPPER HAMILTON LLP, *Going the Distance, The Expanding Life Cycle of Private Equity Funds* 12 (2017), <https://www.pepperlaw.com/resource/29086/23G2> (discussing the life cycle of the PE fund).

²²⁶ See Dodd-Frank Act § 941 (amending section 15G of the Exchange Act), 79 Fed. Reg. 77,602, 77,611, 77,613 (Dec. 24, 2014).

²²⁷ See, e.g., *How to Choose an ETF*, BLACKROCK, <https://www.ishares.com/uk/individual/en/ishares-etfs-explained/how-to-choose-an-etf> (last visited Aug. 10, 2017); *Tools and Cal-*

sorts of “robo-advising” platforms are geared mainly toward retail investors, who are likely focused on investing in registered mutual funds and ETFs.²²⁸ However, one can readily appreciate their potential to adapt to an environment of retail investment in alternatives, by facilitating information dissemination, comprehension, and tailored advice in that private space.

Asset managers have also pioneered fintech solutions in the risk-management area, with BlackRock again as a major leader. Its proprietary platform “Aladdin”—which touches nearly \$20 trillion in assets—serves as an investment and risk management system for BlackRock as well as a range of other institutional investors globally.²²⁹ Here, too, there is potential to help credit and debt funds manage risk—including, if and when necessary, stress testing portfolios to assess leverage risk.

There are a number of ways that market authorities, like the SEC, could incentivize such innovation for the benefit of retail investors who might be interested in these private funds. The definition of accredited investor could, for instance, be keyed or scaled to a fund’s use of such fintech education platforms; their resources would be helpful in supplementing whatever information is provided through the usual disclosures.²³⁰ (Regulators could also, on a more general level, promote fintech innovation simply by not suppressing it—taking a “sandboxing” type approach that allows new technological products and services to develop with some latitude before they are regulated as new forms of investment advice.²³¹)

C. *Modifying Regulatory Tools*

The final issue to consider is how best to operationalize this new framework. Specifically, what is the optimal way to modify securities law and regulation in order to open private fund investing to the retail investor while, at the same time, provide the SEC with the legal power to control which kinds of funds have access to that investor pool? The balance of this Article discusses two legal approaches as well as a few of their pros and cons.

culators, BLACKROCK <https://www.blackrock.com/investing/resources/tools> (last visited Aug. 10, 2017).

²²⁸ *Viewpoint*, BLACKROCK, <https://www.blackrock.com/corporate/en-at/literature/white-paper/viewpoint-digital-investment-advice-september-2016.pdf> (last visited Aug. 10, 2017); see also Simon Jessop & Trevor Hunnicutt, *BlackRock Gets into European ‘Robo Advice’ As it Leads €30 Million Investment in Scalable Capital*, BUS. INSIDER, (June 20, 2017), <http://uk.businessinsider.com/blackrock-robo-advice-investment-scalable-capital-fintech-2017-6>.

²²⁹ BlackRock 10-K, *supra* note 92, at 10; see also Attracta Moony, *BlackRock Bets on Aladdin as Genie of Growth*, FIN. TIMES, May 22, 2017, at 6; *Aladdin Platform Overview*, BLACKROCK, <https://www.blackrock.com/aladdin/offerings/aladdin-overview> (last visited Aug. 10, 2017).

²³⁰ See *infra* Part III.C.

²³¹ See generally FINANCIAL CONDUCT AUTH. (U.K.), FINALISED GUIDANCE (2017), <https://www.fca.org.uk/publication/finalised-guidance/fg15-01.pdf>.

1. Accredited Investor Definition

For some time now, prominent academics, policymakers, and regulators have supported a proposal to amend the definition of “accredited investor” so as to allow a greater swath of retail investors access to private fund investments.²³² The scope of the definition is significant, as certain exemptions from the securities law hinge on the definition.

Federal securities laws require that, absent an exemption, all offers and sales of securities must be registered with the SEC before they can be offered to investors.²³³ In 1953, however, the Supreme Court held that “[a]n offering to those who are shown to be able to fend for themselves is a transaction not involving any public offering.”²³⁴ From that case, the notion that only a “sophisticated investor” could be sold alternative investment products developed.²³⁵

In 1982, the SEC developed Regulation D, which included the term “accredited investor.”²³⁶ Accredited investors are defined as individuals that meet a certain income or net worth threshold.²³⁷ Many institutions qualify as accredited investors as well, though under a separate set of standards.²³⁸ The intent in developing the definition of and criteria for an accredited investor was to include in private markets only those who could “bear the economic risk” of investing in unregistered securities.²³⁹ Regulation D provides a number of different exemptions from the registration requirements of the Securities Act of 1933, some of which pertain to offerings and sales made to accredited investors.²⁴⁰ In particular, Rule 506(b) provides an exemption where an offer and sale of securities is made only to accredited investors and up to 35 non-accredited but sophisticated investors.²⁴¹

The logic of the accredited investor definition—with its anchor around income—has been questioned in recent years. The prior SEC Chair, Mary Jo White, once opined that “the rule needs changing” because “the net worth and income criteria by themselves are [not] a very good or at least not

²³² See SEC, INVESTOR BULLETIN: ACCREDITED INVESTORS 1–2 (2013), https://www.sec.gov/files/ib_accruitedinvestors.pdf (explaining the term accredited investor).

²³³ The Securities Act of 1933, 15 U.S.C. § 77e (2018); see also JOHN C. COFFEE, JR., HILLARY A. SALE, M. TODD HENDERSON, SECURITIES REGULATION CASES AND MATERIALS (13th ed. 346–47 (2015)).

²³⁴ *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) (internal citations omitted).

²³⁵ See *Securities Act of 1933: Business Experience and Access to Corporate Records Required for Private Offering Exemption*, 1971 DUKE L.J. 1017–23 (1971).

²³⁶ Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251, 11,252, 11,262 (Mar. 16, 1982).

²³⁷ See SEC, *supra* note 232, at 1.

²³⁸ *Id.* at 1–2.

²³⁹ *Id.* at 1.

²⁴⁰ See *Regulation D Offerings*, U.S. SEC. EXCH. COMM’N, <https://www.sec.gov/fast-answers/answers-regdhtm.html> (last visited Jan. 3, 2019); see also COFFEE ET AL., *supra* note 233, at 376–77 (providing an overview of Regulation D exemptions).

²⁴¹ See *Rule 506 of Regulation D*, U.S. SEC. EXCH. COMM’N, <https://www.sec.gov/fast-answers/answers-rule506htm.html> (last visited Jan. 3, 2019).

optimal proxy for who doesn't need the protections [of the Securities Act], [and] who can fend for themselves in the marketplace."²⁴² Former Acting Chair Michael Piowar similarly remarked that the accredited investor definition is "[l]ike something out of the *ancien régime*," where "investors lucky enough to earn \$200,000 or more in annual income or with a net worth of more than \$1 million have available to them myriad investment choices, both public or private. By contrast, les Misérables on the other side of the line are severely restricted in their investing options."²⁴³ Expanding the definition has also been supported by certain factions in the U.S. Congress²⁴⁴ and by the U.S. Treasury Department.²⁴⁵

To be sure, expanding the definition of accredited investor would increase the amount of investment capital flowing into private credit and debt funds and, accordingly, the base of countercyclical capital available to assist in economic recovery. In terms of feasibility, not only is the proposal to change the definition widely supported by government and industry alike,²⁴⁶ the SEC already has the legislative delegation from Congress to do so. The Dodd-Frank Act requires the SEC to review the accredited investor definition every four years to determine whether the definition should be modified "for the protection of investors, in the public interest, and *in light of the economy*."²⁴⁷

In its 2015 review, the SEC considered (but did not ultimately recommend) whether the definition could be made more flexible. Its view was that amendments could "expand the pool and categories" of investors eligible to partake in private fund offerings in order to "reflect changes in the marketplace that have occurred since the adoption of Regulation D."²⁴⁸ Specifi-

²⁴² Mary Jo White, Chair, Sec. & Exch. Comm'n, Keynote Session at the 43rd Annual Securities Regulation Institute (Jan. 26, 2016), <https://www.sec.gov/news/speech/securities-regulation-institute-keynote-white.html>.

²⁴³ Michael S. Piowar, Acting Chair, SEC, Remarks at the "SEC Speaks" Conference 2017: Remembering the Forgotten Investor, (Feb. 24, 2017), <https://www.sec.gov/news/speech/piowar-remembering-the-forgotten-investor.html>.

²⁴⁴ H.R. 2187, Fair Investment Opportunities for Professionals Act, 114th Cong. (2015-2016). The Bill would allow individuals to qualify as accredited "by virtue of their education and job experience." SIFMA, Letter to Hon. Jeb Hensarling & Hon. Maxine Waters, from Andy Blocker, Exec. Vice Pres. Public Pol'y & Advocacy, SIMA (Oct. 10, 2017), <https://www.sifma.org/wp-content/uploads/2018/06/H.R.1585-Fair-Investment-Opportunities-for-Professional-Experts-Act.pdf>.

²⁴⁵ U.S. TREASURY DEP'T, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: CAPITAL MARKETS 44 (2017) (recommending "that amendments to the accredited investor definition be undertaken with the objective of expanding the eligible pool of sophisticated investors").

²⁴⁶ In an earnings call in April 2017, Blackstone COO Tony James noted that, in the current environment, many have trouble saving adequately for retirement and that returns on standard savings accounts would not "catch them" up. See Earnings Conference Call, The Blackstone Group, First Quarter 2017 Earnings Investor Call (Apr. 20, 2017), https://s1.q4cdn.com/641657634/files/doc_financials/2017/q1/BLACKSTONE-Q1-2017-Investor-Call-Transcript.pdf. The returns available from investing in alternative funds, meanwhile, could meaningfully help prepare some investors for retirement. *Id.*

²⁴⁷ Dodd-Frank Act § 413(b)(2)(A), 15 U.S.C. § 77b (2018) (emphasis added).

²⁴⁸ *Id.* at 71.

cally, the SEC considered whether the definition could “scale” along with, for example, funds’ voluntary disclosure of additional information.²⁴⁹ It also considered a contextual approach, whereby “a more flexible approach could involve a contextual evaluation of an investor’s attributes with respect to a particular offering.”²⁵⁰ This latter approach would mean that the SEC could ensure that investors were accredited for some offerings and not others.²⁵¹ Adopting this approach, the SEC, through notice and comment rulemaking, could key the definition of “accredited investor” both to the type of information and education provided by a private fund as well as its structural features—as just discussed.

One possible drawback of this approach may be its breadth. Unless a contextual approach were taken, where accredited investors were defined *ex ante* in regard to those offers and sales made by funds demonstrating certain structural criteria, the SEC would have little *ex-post* authority to vet the private funds according to their suitability. At best, the SEC could rely on a combination of its existing information-gathering power and conflicts-of-interests rules. With some narrow exceptions, the Dodd-Frank Act requires that investment advisors to private funds register with the SEC on Form ADV.²⁵² Form ADV requires these private fund advisers to report information about their funds’ organization and operations.²⁵³ Registered private fund advisers are also accountable to the SEC’s fiduciary duty rules.²⁵⁴ Thus, the SEC could in theory bring enforcement actions against funds that marketed their investment vehicles to retail investors which investments were against those investors’ “best interests.”²⁵⁵ However, in practice this method of sorting suitable funds from unsuitable funds would not be the ideal modality of regulation—invariably, sorting funds into regulatory winners and losers is bound to create friction between regulator and industry along with unanticipated costs.²⁵⁶

²⁴⁹ SEC, REPORT ON THE REVIEW OF THE DEFINITION OF ACCREDITED INVESTOR 7, 68, 71 (2015).

²⁵⁰ *Id.* at 70.

²⁵¹ *Id.*

²⁵² See Mary Jo White, Chair, SEC, Keynote Address at the Managed Fund Association: Five Years On: Regulation of Private Fund Advisers After Dodd-Frank, Keynote Address at the Managed Fund Association (Oct. 16, 2015), <https://www.sec.gov/news/speech/white-regulation-of-private-fund-advisers-after-dodd-frank.html>.

²⁵³ *Private Fund Adviser Overview*, U.S. SEC. EXCH. COMM’N, <https://www.sec.gov/divisions/investment/guidance/private-fund-adviser-resources.htm> (last visited Dec. 22, 2018).

²⁵⁴ See *Information for Newly-Registered Investment Advisers*, SEC <https://www.sec.gov/divisions/investment/advooverview.htm> (last visited Jan. 7, 2019).

²⁵⁵ See generally SEC, IA-4889, PROPOSED COMMISSION INTERPRETATION REGARDING STANDARD OF CONDUCT FOR INVESTMENT ADVISERS; REQUEST FOR COMMENT ON ENHANCING INVESTMENT ADVISER REGULATION (2018).

²⁵⁶ See Christina Parajon Skinner, *Regulating Nonbanks: A Plan for SIFI Lite*, 105 GEO. L.J. 1379 (2017) (making this argument in the context of the FSOC designation process).

2. Regulation D

A second legal path to a similar outcome would be to expand the exemptions in Regulation D. Specifically, the SEC could add a category of exemption to the existing Rule 506 of Regulation D for offers and sales of any dollar amount, irrespective of investor-typed (accredited or sophisticated) where the private fund (i) is a credit or debt fund and (ii) can demonstrate or self-certify certain structural criteria concerning its liquidity management systems, incentives programs, and approach to investor education. The outcome would not be dissimilar from the context-based approach to defining accredited investor (i.e., defining “accredited” with respect to the type of offering and fund at issue). Yet it would be an alternative to modifying the actual definition of accredited investor, which, again, restricts the type of investor to whom private funds can offer and sell securities. And it might be more straightforward for the SEC to allow some kinds of private funds to access retail investments, rather than attempting to “accredit” investors for certain offerings and funds but not others.

One possible downside to this approach is its feasibility. The SEC does have authority under § 3(b) of the Securities Act to make additional exemptions from the Act’s registration requirements if it finds that the registration of the securities are not necessary in the public interest and for the protection of investors, considering, among other things, the “limited character” of the public offering.²⁵⁷ Yet it is unclear how such proposed rulemaking would be publicly received given its relatively niche scope.

* * *

The SEC may well wish to expand the definition of accredited investor for other social and economic reasons. For purposes of this paper’s discussion, however, either a contextual-based approach to defining accredited investor, or an expansion of Regulation D exemptions, would be optimal. The outcome would be to expand the amount of capital certain private credit and debt funds can access, to deploy in countercyclical ways, while giving the SEC the power *ex ante* to establish which kinds of funds would be suitable for retail investors. Importantly, the SEC would not then be responsible for making case-by-case decisions about which funds can access retail capital in the name of financial stability, thus seeming to select regulatory winners and losers. Instead, the SEC, through rulemaking, would set across-the-board criteria for funds’ eligibility to accept retail investments.

Finally, it bears noting that an ancillary benefit of this proposal is broader financial inclusion. While a proper study of the securities law’s impact on financial opportunity is a subject for further research, one would be remiss in not pausing to reflect briefly on the distributive value of opening private fund investing to retail. As the wealth gap in America continues to

²⁵⁷ See COFFEE, SALE & HENDERSON, *supra* note 233, at 367.

widen, leveling the opportunities for investing—between those in the top 40% of income and those in the bottom 60% of income—could have a meaningful impact on bridging that gap and supporting middle and low income households' ability to save for homeownership, education, and retirement.²⁵⁸ As such, while serving the social-economic goal of financial stability, regulatory intervention to facilitate capital flows into private credit and debt could also serve the ends of financial access, opportunity, and democratization.

CONCLUSION

This Article has highlighted a relatively new nonbank market for credit—credit that is intermediated by private investment funds—which now exists in the financial system alongside banks and the capital markets. Through its theoretical and descriptive accounts, this Article has shed new light on a key way in which private nonbank credit can promote economic resilience—by smoothing the credit cycle with a steady supply of countercyclical capital. As such, this Article has urged the securities law to open private fund investing to the retail investor, to serve both the macroprudential goal of economic resilience as well as that of broader financial inclusion.

²⁵⁸ See generally TERESA GHILARDUCCI & TONY JAMES, RESCUING RETIREMENT (2018); Jeff Cox, *Hedge Fund King Ray Dalio: Middle Class Needs 'Wealth Transfers' To Bridge Income Gap*, CNBC (Oct. 23, 2017), <https://www.cnbc.com/2017/10/23/ray-dalio-middle-class-needs-wealth-transfers-to-bridge-wealth-gap.html>.

