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*What is Securitization? And for What Purpose?*¹

Steven L. Schwarcz²

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In *Re: Defining Securitization*,³ Professor Jonathan Lipson attempts to define a “true” securitization transaction,⁴ ultimately characterizing it as “a purchase of primary payment rights by a special purpose entity that (i) legally isolates such payment rights from a bankruptcy (or similar insolvency) estate of the originator, and (ii) results, directly

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² Stanley A. Star Professor of Law & Business, Duke University School of Law, and Founding Director, Duke Global Capital Markets Center; schwarcz@law.duke.edu. I thank Anupam Chander, George Christie, Edward M. Iacobucci, and Jason H.P. Kravitt for excellent comments and Arie Eernisse for valuable research assistance.

³ Jonathan C. Lipson, *Re: Defining Securitization*, 85 S. CAL. L. REV. (forthcoming issue no. 5, 2012).

⁴ *See id.* at [XX] (distinguishing “true securitizations from other transactions that may satisfy existing definitions, but which flunk the definition advanced” in his article).

or indirectly, in the issuance of securities whose value is determined by the payment rights so purchased.”⁵ There is much to admire in Lipson’s attempt but also much to question.

Let me start with the admiration. Lipson’s article is by far the most systematic and thoughtful analysis of what securitization should mean. Importantly, he describes what he sees as the “essential elements of a securitization, its inputs (payment rights), structure (bankruptcy-proof legal isolation), and outputs (securities).”⁶

Dividing securitization into inputs, structure, and outputs is rhetorically if not also conceptually sensible, and indeed in teaching courses about securitization I often have referred to the left-hand-side of the structure—which Lipson more felicitously calls the inputs—and the right-hand-side of the structure—which Lipson (again more felicitously) calls the outputs. To the extent terminology is more intuitively descriptive, it advances understanding. In future courses, I intend to refer to inputs and outputs. I would, however, make one change to Lipson’s use of the term “structure” to describe the portion of a securitization transaction *between* the inputs and the outputs. Because “structure” intuitively means an entire structure—which, in the case of securitization, would also include the inputs and outputs—I suggest using the term “intermediate structure” instead. Thus, I will refer to a securitization transaction’s inputs, intermediate structure, and outputs.

Even with that change, I still have several concerns with Professor Lipson’s definition of securitization. This article will next discuss those concerns, showing that the definition is overly restrictive and potentially inaccurate. The article then will engage Lipson’s article to explore, more normatively, how a financial concept should be defined in light of dynamically changing financial markets and the different perspectives of policymakers and lawmakers, market participants and their lawyers, regulators and judges, and other parties (including the media and the public) interested in or whose

⁵ *Id.* at [XX] (deleting emphasis in original).

⁶ *Id.* at [XX].

interests are impacted by the definition (all such parties hereinafter referred to as the “audience” for the definition).

I. ASSESSING PROFESSOR LIPSON’S DEFINITION

I next use the modified version of Professor Lipson’s helpful categories—inputs, intermediate structure, and outputs—to assess his definition of securitization.⁷

A. Inputs

Lipson’s definition is overly restrictive insofar as it limits inputs to “primary” payment rights. He imposes this limitation because of the possibility, he argues, that reliance on non-primary payments rights “masked the weaknesses” of transactions that relied on such rights.⁸ Thus, he argues that collateralized debt obligations (CDOs) were not true securitizations because they “often relied not on ‘primary payment rights’ . . . but instead on other ‘financial assets’ that may have masked the weaknesses of these transactions.”⁹ He also argues that “Enron’s structured financings” were not true securitizations because, as with CDOs, they did not rely on primary payment rights.¹⁰

The implicit rationale of Lipson’s limitation is that primary payment rights are inherently stronger than non-primary payment rights.¹¹ But he does not explain why relative weakness should be a normative basis for definitional distinctions. I engage that question below.¹² Nor does Lipson explain why primary payment rights are inherently stronger than non-primary payment rights. I believe they are not always stronger. For example, non-primary payment rights can include rights, such as guarantees from

⁷ Recall that he defines securitization as “a purchase of primary payment rights by a special purpose entity that (i) legally isolates such payment rights from a bankruptcy (or similar insolvency) estate of the originator, and (ii) results, directly or indirectly, in the issuance of securities whose value is determined by the payment rights so purchased.”

See supra notes 4-5 and accompanying text.

⁸ Lipson, *supra* note 3, at [XX].

⁹ *Id.* at [XX] (citations omitted).

¹⁰ Lipson, *supra* note 3, at [XX] (citations omitted).

¹¹ *See supra* note 8 and accompanying text.

¹² *See infra* notes 35-36 and accompanying text.

creditworthy third-parties, etc. and two-party paper like bankers acceptances,¹³ that are much stronger than the underlying primary payment rights. And some primary payment rights, such as mortgage payments due on subprime mortgages, are very weak indeed.

Moreover, I question Lipson's examples of CDOs and Enron's structured financings as being distinct from securitization because they did not rely on primary payment rights—and thus had weaknesses. CDO transactions had weaknesses not because they relied, per se, on non-primary payment rights but, instead, because the outputs of some highly leveraged CDO transactions—usually referred to as ABS CDO transactions—consisted of tranches of securities whose repayment was extremely sensitive to cash-flow variations.¹⁴ When the cash-flow assumptions turned out to be wrong, many of these tranches defaulted or were downgraded.¹⁵

Similarly, Enron's structured financings had weaknesses not because they relied, per se, on non-primary payment rights. The weaknesses resulted, instead, from Enron assuming that there was little if any correlation between the value of merchant assets being guaranteed in those transactions and the price of Enron stock supporting those guarantees.¹⁶ When the stock price and merchant-asset value coincidentally fell, those transactions failed, causing Enron's collapse.¹⁷ Nor is Lipson's distinction between primary and non-primary payment rights necessary for distinguishing Enron's structured

¹³ A bankers acceptance is a draft signed by a commercial party, such as an exporter of goods, and accepted by that party's bank. LISSA L. BROOME & JERRY W. MARKHAM, *REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES* 491 (2001). Such acceptance turns the draft into "a secure, no-risk investment due to the bank's absolute obligation to pay upon [the draft's] maturity, regardless of the [party's] ability to pay" *Id.* at 492.

¹⁴ *See infra* notes 53-55 and accompanying text for descriptions of these types of transactions.

¹⁵ *See infra* notes 39-41 and accompanying text.

¹⁶ Iman Anabtawi & Steven L. Schwarcz, *Regulating Systemic Risk: Towards an Analytical Framework*, 86 NOTRE DAME L. REV. 1349, 1359 (2011).

¹⁷ *Id.*

financing transactions from securitization; there were so many basic distinctions between them that few, if any, market participants regarded those transactions as securitization.¹⁸

In any event, Lipson's attempt to limit securitization's inputs to only *strong* rights raises the same normative question indicated above.¹⁹

B. Intermediate Structure

Professor Lipson's characterization of the intermediate structure of securitization is overly restrictive because it excludes certain transactions commonly regarded by market participants as securitizations. For example, he requires legal isolation of the repayment source from a bankruptcy (or similar insolvency) estate of the originator. When the originator is of investment-grade quality, however, many securitization transactions do not necessarily achieve such legal isolation.²⁰

Excluding from a definition transactions commonly regarded by market participants as part of that definition raises a normative question: Should the definition of a type of observed event exclude events that third-party observers generally would expect to be of that type? A definition should help to clarify discussions, but one that runs

¹⁸ Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539, 1574 (explaining that securitization transactions, unlike Enron's transactions, "unambiguously transfer[] risk from the company to third parties" and generally do not involve material conflicts of interest).

¹⁹ See text accompanying notes 11-12, *supra*.

²⁰ Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J. L. BUS. & FIN. 133, 142 (1994) (observing that if the "originator's rating is investment grade, it often can structure the transfer of receivables to the SPV as a sale for accounting but not necessarily bankruptcy purposes"). Subsequent to that observation, the Financial Accounting Standards Board promulgated Financial Accounting Standard (FAS) 140, requiring legal isolation as a condition for accounting-sale treatment. *Statement of Financial Accounting Standards No. 140*, FIN. ACCOUNTING STANDARDS BD. 70-72 (Sept. 2000), <http://fasb.org/pdf/fas140.pdf>. FAS 140 was eventually amended, however, and (at least since a 2005 SEC Staff Report criticizing off-balance-sheet financing) many securitization deals no longer even purport to be accounting sales. *Big Changes to Securitization Accounting*, MAYER BROWN (June 22, 2009), <http://www.mayerbrown.com/publications/article.asp?id=7063>.

counter to common understandings may be confusing.²¹ It appears, however, that Lipson might not intend his exclusion. As I later discuss, he argues that, in commercial finance law, one should look closely and critically at what actually happens in the real world.²²

Professor Lipson's characterization of the intermediate structure of securitization also inverts cause-and-effect. He states that the purchase of the repayment source "(ii) results . . . in the issuance of securities."²³ If anything, the causation is the reverse; it is the issuance of securities that provides the cash proceeds that are used to purchase the repayment source.

C. Outputs

Finally, Professor Lipson's characterization of the outputs is potentially inaccurate insofar as it requires the "value" of the securities to be "determined" by the source of payment. The source of payment, however, merely determines the likelihood that the securities will be repaid on a timely basis, whereas the "value" of securities depends not merely on their likelihood of timely repayment but also on their interest rate (or rate of return). For example, securities that have the same likelihood of timely repayment are more valuable, other things being equal, if they bear a higher interest rate than if they bear a lower interest rate. Because the rate of return is market driven and extraneous to securitization per se, a more accurate characterization of the outputs would state that collections on the payment rights purchased are the primary source of repayment of the securities.²⁴

II. HOW SHOULD A CONCEPT LIKE SECURITIZATION BE DEFINED?

²¹ See *infra* notes 26-27 and accompanying text. Although in some situations definitions can and should strive to change expectations, such motivations can be counteracted by the confusion and misunderstanding created by an exclusionary or under-inclusive definition.

²² See *infra* notes 28-31 and accompanying text.

²³ See *supra* notes 4-5 and accompanying text.

²⁴ In some securitization transactions, the payment rights/expectations are merely the primary, as opposed to the sole, source of repayment. *Cf.* SEC Rule 3a-7 (recognizing this).

This Part II explores, more normatively, how securitization, a financial concept, should be defined. The primary focus of this inquiry is legal, to define securitization for regulatory purposes. In that inquiry, I recognize “the lack of an agreed upon methodology on how to . . . define legal concepts.”²⁵

A. The Definition Should be Pragmatic

As a starting point, I believe that even a normative approach to defining a financial concept, such as securitization, should be pragmatic, taking into account how the concept is used in the real world. Defining a concept in a new way “may cause misunderstanding and unwanted interpretations.”²⁶ Thus, “[i]f all concerned people understand concepts A, B and C in a specific way due to their foundation in . . . common practice, it is preferable to use them rather than the more abstract concept of D that contains A, B and C.”²⁷

Such a pragmatic definition of securitization could be articulated as follows: A financial transaction in which (i) a special purpose entity issues securities to investors and, directly or indirectly, uses the proceeds to purchase rights to, or expectations of, payment, and (ii) collections on the rights or expectations so purchased constitute the primary source of repayment of those securities.

Professor Lipson’s approach to defining securitization, even though normative,²⁸ is also pragmatic.²⁹ Inspired by Karl Llewellyn’s commercial law realism, reflected in the Uniform Commercial Code, Lipson argues that “[w]hat participants in the legal system

²⁵ Lorenz Kahler, *The Influence of Normative Reasons on the Formation of Legal Concepts*, in CONCEPTS IN LAW 81, 90 (Jaap C. Hage & Dietmar von der Pfordten eds., 2009) (citing D. Patterson, *Dworkin on the Semantics of Legal and Political Concepts*, 26 OXFORD J. LEG. STUDS. 552, 553 (2006)).

²⁶ Kahler, *supra* note 25, at 86.

²⁷ *Id.*

²⁸ Lipson, *supra* note 3, at [XX] (offering his definition “as a tool to organize the process of thinking about what securitization means, normatively”).

²⁹ *Id.* at [XX] (stating that he is attempting to define securitization for “more pragmatic purposes” than epistemology).

and the market actually do should determine how the law works and speaks.”³⁰ From this, Lipson advances a “grounded method of finding meaning in commercial finance law”: to look “closely and critically at what actually happens in the real world.”³¹

I have already shown, however, that Lipson’s definition of securitization only imperfectly reflects its real world definition.³² If Lipson agrees with my observations of how his definition imperfectly reflects reality, presumably he would agree with my conforming changes to that definition.³³

By limiting the definition of securitization to transactions that are paid from primary payment rights,³⁴ Lipson’s definitional approach also implicitly raises a normative question: Should the definition of securitization exclude securitization’s weaknesses? Other than to improve how securitization is viewed, I see no reason why the definition of securitization should necessarily exclude securitization’s weaknesses. To the contrary, I see several reasons why weaknesses should not be excluded.

First, to the extent the definition should reflect how securitization is used in the real world—and Lipson and I both agree it should³⁵—the definition should include weaknesses in that actual use. Second, and more significantly, defining securitization to include its potential weaknesses could have a positive social impact, inviting regulation to limit those weaknesses, whereas defining securitization to exclude potential weaknesses could mislead policymakers and lawmakers. Indeed, a normative definition

³⁰ *Id.* at [XX].

³¹ *Id.* at [XX].

³² *See supra* Part I.

³³ Those changes include recognizing that many securitization transactions involving investment-grade originators do not necessarily achieve legal isolation, clarifying cause-and-effect to explain that it is the issuance of securities that provides the cash proceeds that are used to purchase the repayment source, and clarifying that collections on the rights or expectations purchased do not independently determine the value of the securities.

³⁴ *See supra* notes 8-19 and accompanying text. On a more technical, non-normative level, I disagree with Lipson’s observation that weakness necessarily turns on the distinction between primary and non-primary payment rights. *See id.*

³⁵ *See supra* note 31 and accompanying text.

should strive to achieve an optimal regulatory or other clarifying purpose,³⁶ otherwise the definition is merely an academic exercise.

There is also a more pragmatic reason why the definition of securitization should not exclude securitization's weaknesses: it is difficult to categorically assess securitization's strengths and weaknesses.³⁷ Recall that I have questioned whether Lipson's distinction between primary and non-primary payment rights necessarily reflects a distinction between strength and weakness.³⁸

Finally, Lipson himself does not pursue the logic of his distinction, applying it solely to inputs (payment rights) and not to outputs (securities). The output side of securitization often consists of multiple, sometimes numerous, classes (or "tranches") of securities, each class having relative priority of repayment compared to other classes and, in certain cases, being repayable from specific cash flows (such as interest-only or principal-only securities).³⁹ This type of tranching can create weaknesses. For example, the more highly rated tranches are leveraged on the more subordinated tranches, which are relatively small and thus sensitive to cash-flow variations.⁴⁰ Tranching also can create weaknesses by creating conflicts of interests for servicers of the underlying financial assets—such as where a servicer cannot feasibly restructure the terms of an underlying

³⁶ Cf. Jongho Kim, *From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events*, 13 FORDHAM J. CORP. & FIN. L. 705 (2008) (exploring how the financial concept of a "credit event" should be interpreted for purposes of improving regulation of swap agreements).

³⁷ Kahler, *supra* note 25, at 85 (questioning whether legal definitions should use evaluative criteria).

³⁸ See *supra* note 9 and accompanying text.

³⁹ Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 377-78 (2008).

⁴⁰ FRANK J. FABOZZI, *FIXED INCOME ANALYSIS* 327 (2d ed. 2007) (explaining that asset managers must satisfy certain principal repayment tests for tranches in a CDO to maintain credit ratings for the senior and mezzanine tranches and that the unrated subordinate or equity tranche merely receives the residual cash flow); Michael S. Gibson, *Understanding the Risk of Synthetic CDOs* 25-26 (July 2004), available at <http://www.federalreserve.gov/pubs/feds/2004/200436/200436pap.pdf>.

loan because reducing interest would prejudice holders of interest-only securities whereas reducing principal would prejudice holders of principal-only securities.⁴¹

B. The Definition Should Recognize Audience Perspectives

Lipson recognizes the importance of at least one audience group, lawmakers, observing that because “securitization is likely here to stay,” the “important question will then be how to regulate it”—and in order to do that, “one important question will be how to define it.”⁴² Lawmakers, however, are not the only members of the audience. In order to define securitization, one should take into account the perspectives of all audience groups affected by the definition.

I next examine the perspectives of four audience groups: policymakers and lawmakers; transactional lawyers and their clients, the market participants; judges and regulators; and the media and the public. Definitions provide value to the extent they enable audience members to focus on characteristics relevant to them.

1. *Policymakers and Lawmakers.*

Policymakers, who often include lawmakers, need to understand what it is about securitization that could create externalities, so they can examine whether society should require those externalities to be internalized. This requires a broad definition of securitization,⁴³ and certainly not one that limits the term to only those manifestations of securitization that are “relatively benign.”⁴⁴ For this reason and others, I oppose a definition that would leave out securitization’s potential weaknesses.⁴⁵

Once policymakers determine which externalities should be internalized, lawmakers need to define securitization, for regulatory purposes, in a way that at least

⁴¹ *Protecting Financial Markets*, *supra* note 39, at 393.

⁴² Lipson, *supra* note 3, at [XX].

⁴³ This definition is not yet, technically, a legal definition but rather an *ex ante* working concept of what securitization encompasses.

⁴⁴ Lipson, *supra* note 3, at [XX].

⁴⁵ *See supra* notes 33-41 and accompanying text.

captures those potential externalities. An under-inclusive definition can lead to an inadequate regulatory response.⁴⁶ Lawmakers also need that definition to be, at the same time, sufficiently broad so that market participants cannot find regulatory loopholes and sufficiently clear and precise to preserve the definitional clarity needed to enforce the law and minimize the intended externalities.⁴⁷

2. Transactional Lawyers and their Clients, the Market Participants.

Transactional lawyers and their clients, the market participants, need to be able to determine, based on the definition, whether the clients are subject to regulation incorporating that definition. From that perspective, the definition should not be overly broad.⁴⁸ Moreover, the definition ideally should be consistent with market expectations, which help to signal whether market participants might be subject to the regulation.⁴⁹

Market participants, in my experience, currently view one if not two, and possibly as many as three, types of transactions as securitizations. The first such type is obvious: a basic securitization transaction in which a special purpose entity (“SPE”) issues

⁴⁶ Cf. Timothy E. Lynch, *Derivatives: A Twenty-First Century Understanding*, 43 LOY. U. CHI. L.J. 1, 10 (2011) (arguing that the under-inclusiveness of common definitions of financial derivatives leads to an inadequate regulatory response).

⁴⁷ This tension is sometimes expressed as the tension between principles and rules. Although the principles-rules dichotomy has been much discussed in the context of financial regulation, commentators are often imprecise in distinguishing principles from rules. Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of “Principles-Based Systems” in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1411, 1420-22 (2007) (observing that the exact manner of classifying provisions of law as principles or rules is contested).

⁴⁸ The expansive definition of “securities,” for example, has prompted concern whether particular types of investments can be classified as securities and regulated as such. See Bradley D. Johnson, Note, *Discretionary Commodity Accounts as Securities: An Application of the Howey Test*, 53 FORDHAM L. REV. 639 (1984) (examining whether the broad legal definition of “securities” includes discretionary commodity accounts); George A. Burke, Jr., *Limited Liability Companies and the Federal Securities Laws: Congress Should Amend the Securities Laws to Avoid Coverage*, 76 IND. L.J. 749 (2001) (examining whether the broad legal definition of “securities” includes limited liability company (LLC) interests).

⁴⁹ I recognize, of course, that the definition itself can change those expectations.

mortgage-backed securities (“MBS”) or asset-backed securities (“ABS”).⁵⁰ MBS are securities whose payment derives principally or entirely from mortgage loans owned by the SPE.⁵¹ ABS are securities whose payment derives principally or entirely from financial assets, *other than mortgage loans*, owned by the SPE.⁵² It is generally agreed that market participants regard this basic transaction as securitization.⁵³

Market participants also often regard CDO transactions as securitizations.⁵⁴ CDO securities are backed by—and thus their payment derives principally or entirely from—a mixed pool of mortgage loans and/or other financial assets owned by an SPE.⁵⁵ Fewer market participants, however, regard ABS CDO transactions as securitizations. These transactions, often referred to as “re-securitization,” are backed by a mixed pool of ABS and/or MBS securities owned by the SPE, and thus their payment derives principally or entirely from the underlying mortgage loans and/or other financial assets ultimately backing those ABS and MBS securities.⁵⁶

The definition of securitization should therefore include basic securitization transactions and CDO transactions and might also include ABS CDO transactions. Schematically, the distinctions among these types of transactions can be portrayed as follows:

⁵⁰ JOHN DOWNES & JORDAN ELLIOT GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* at 35 & 630 (7th ed. 2006).

⁵¹ *Id.* at 434-35.

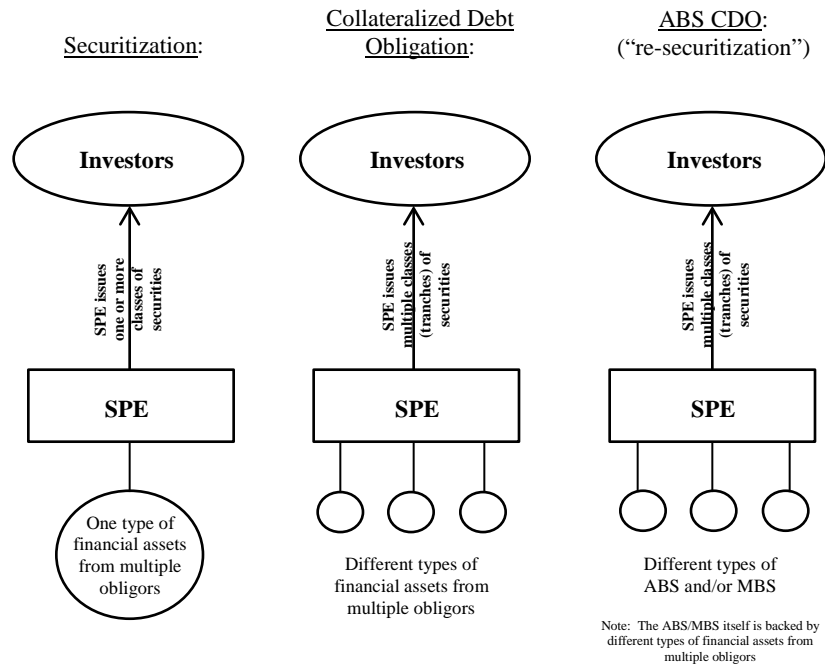
⁵² *Id.* at 35.

⁵³ *Id.* at 630.

⁵⁴ *See, e.g.*, INTERNATIONAL MONETARY FUND, *GLOBAL FINANCIAL STABILITY REPORT: NAVIGATING THE FINANCIAL CHALLENGES AHEAD*, Ch. 2, at p. 5 (Oct. 2009) (referring to CDOs as a subset of securitization). *Cf. supra* note 9 and accompanying text (discussing CDO transactions, which Professor Lipson does not regard as securitizations).

⁵⁵ DOWNES & GOODMAN, *supra* note 50, at 121.

⁵⁶ *Protecting Financial Markets*, *supra* note 39, at 376-77.



3. Judges and Regulators.

Judges and regulators—the latter term meaning persons interpreting and administering the law, as opposed to persons making the law (whom I call lawmakers⁵⁷)—need definitional clarity in order to know how to apply and enforce the law. Unclear definitions can lead to hard-fought court battles over seemingly minor semantic issues.⁵⁸ Having an easily applied definition of securitization may help to avoid courtroom clashes and regulatory gridlock.

I recognize that courts and regulators can themselves refine the legal definition of financial concepts.⁵⁹ But for technical concepts such as securitization, that might

⁵⁷ See *supra* Part II.B.1.

⁵⁸ See, e.g., *Mammoth Cave Production Credit Assoc. v. York*, 429 S.W. 2d 26, 29 (1968) (litigation on the meaning of language in Uniform Commercial Code section 9-108(a) that requires descriptions of personal or real property to “reasonably identify what is described”).

⁵⁹ As Professor Lipson notes, the U.S. Supreme Court has construed the term “security” broadly to include “countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.” Lipson, *supra* note 3, at [XX] (referring to *Marine Bank v. Weaver*, 455 U.S. 551, 555 (1982), and also to *Randall W. Quinn &*

introduce elements of uncertainty. There should be less need for refinement if the definition is clear and straightforward in the first place.

4. *The Media and the Public.*

The media need to define securitization in a way that is both descriptive and accessible to the public. This need not be a legal definition. But media descriptions of financial concepts, such as securitization, can influence lawmakers, in turn influencing how those concepts are legally defined.⁶⁰ Correlatively, legal definitions of financial concepts, such as securitization, can influence how the media talks about those concepts.⁶¹

C. The Definition Should Recognize Financial Market Evolution

Finally, a financial concept, such as securitization, should be defined in light of dynamically changing financial markets. Financial concepts, like securitization, are not fixed in time; they evolve in response to changing financial market conditions. Therefore, the greater its precision, the less likely a definition will continue over time to describe a financial concept. It therefore appears prudent to strive for a definition of securitization that is broad enough to minimize definitional obsolescence.

III. DEFINING SECURITIZATION

Paul Gonson, *Development of the Securities Law in the Supreme Court: The Definition of "Security" and the Implication of Private Rights of Action*, 35 HOW. L.J. 319 (1992) (tracing the development of how the Supreme Court has construed the term "security").

⁶⁰ See, e.g., Floyd Norris, *The Upside of Reviving Securitizing*, N.Y. TIMES, Oct. 1, 2010, at B1 (suggesting that regulators should enhance monitoring efforts to ensure that mortgage-backed securities are not "viewed as so safe that investors need not be careful"); Ken Bensinger, *Investors Place Big Bets on Buy Here Pay Here Used-car Dealers*, L.A. TIMES, Nov. 1, 2011, available at <http://www.latimes.com/business/buy-here-pay-here/la-fi-buyhere-payhere-day-two-20111101,0,2598239,full.story> (characterizing "buy here pay here" auto loan securitization transactions as "subprime mortgages" and noting the potential for another financial crisis).

⁶¹ See, e.g., Nick Timiraos, *Securitization Industry Set to Defend Practices*, WALL ST. J., Nov. 15, 2010, available at <http://online.wsj.com/article/SB10001424052748703670004575617013450703800.html?KEYWORDS=securitization> (discussing the legal aspects of securitization in response to criticism of mortgage-backed securities).

Based on the foregoing, how should securitization be defined? I originally advanced a pragmatic definition of securitization: A financial transaction in which (i) a special purpose entity issues securities to investors and, directly or indirectly, uses the proceeds to purchase rights to, or expectations of, payment, and (ii) collections on the rights or expectations so purchased constitute the primary source of repayment of those securities.⁶² How should that definition change in light of the more normative considerations of audience perspectives and financial market evolution?

Recall that policymakers need a broad definition of securitization in order to understand its externalities and examine which externalities should be internalized.⁶³ My pragmatic definition is broad, indeed broad enough to encompass all of the types of transactions that arguably could be called securitization. It certainly encompasses basic securitization transactions.⁶⁴ It also encompasses CDO transactions because its reference to “rights to, or expectations of, payment” would include any mixed pool of mortgage loans and/or other financial assets.⁶⁵ And it additionally encompasses ABS CDO transactions because “rights to, or expectations of, payment” would also include any mixed pool of ABS and/or MBS securities.⁶⁶

Recall also that lawmakers need a broad definition, so long as it is sufficiently clear and precise to preserve the definitional clarity needed to enforce the law. The pragmatic definition should be sufficiently clear and precise for that purpose because it deconstructs securitization into a few simple but distinctive characteristics. By the same token, the pragmatic definition should provide sufficient definitional clarity—subject to the need for the addition proposed below⁶⁷—to enable judges and regulators to know how to apply and enforce the law. They would only have to ask a sequence of easily

⁶² See *supra* notes 27-28 and accompanying text.

⁶³ See Part II.B.1.

⁶⁴ See *supra* notes 50-53 and accompanying text.

⁶⁵ See *supra* notes 54-55 and accompanying text.

⁶⁶ See *supra* notes 55-56 and accompanying text.

⁶⁷ See *infra* notes 70-74 and accompanying text.

answerable questions to determine whether a given transaction is, legally, a securitization: is there an SPE?; does the SPE issue securities (a term already defined under securities law⁶⁸) to investors?; does the SPE use the proceeds to purchase rights to, or expectations of, payment?; do collections on the rights or expectations so purchased constitute the primary source of repayment of the issued securities?⁶⁹

Additionally recall that transactional lawyers and their market-participant clients need to be able to determine from the definition whether the clients are subject to regulation. Ideally also, the definition should reflect market expectations. The pragmatic definition certainly reflects market expectations since it tracks to the types of transactions that market participants either generally (in the case of basic transactions), often (in the case of CDO transactions), or at least sometimes (in the case of ABS CDO transactions) regard as securitizations.⁷⁰ Furthermore, the pragmatic definition's clarity and precision, illustrated in the prior paragraph, should enable transactional lawyers and their clients to determine whether the clients are subject to regulation—subject to one exception. The pragmatic definition is so broad that it might include investment companies, which are SPEs (such as mutual funds) that issue securities to investors and use the proceeds to purchase investment securities.⁷¹ Investment securities can include investments consisting of rights to, or expectations of, payment.⁷²

⁶⁸ Although note 59, *supra*, recognizes a concern that the term “securities” may be too expansively defined for regulatory purposes under securities law, the reference to “securities” in a definition of securitization should embrace an expansive definition; it is intended to include any investment interest that the SPE issues.

⁶⁹ In practice, however, actual legislation should clarify two aspects of these questions: what is an SPE, and what is a “purchase.” For a discussion of possible clarification choices, see STEVEN L. SCHWARCZ, *STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* (3d ed. 2003 & supps.) (clarifying in Chapter 3 what should constitute an SPE and clarifying in Chapter 4 what should constitute a purchase).

⁷⁰ See *supra* Part II.B.2.

⁷¹ Investment Company Act of 1940, Pub. L. No. 768, ch. 686, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a *et seq.*). See 15 U.S.C. § 80a-3 (2006) (defining investment company).

⁷² *Id.* § 80a-2(36) (defining “security” and including various investment vehicles that involve rights to, or expectations of, payment).

The difference between investment-company SPEs and securitization SPEs is that the return to investors in the former is, unlike the return to investors in securitization SPEs, based on speculation in the rights to and expectations of payment purchased.⁷³ The pragmatic definition of securitization therefore should be clarified—at least insofar as its audience is lawmakers, transactional lawyers, and market participants—to avoid any confusion between these SPEs. To that end, I will add to the definition of securitization, for purposes of the audience members indicated, that the SPE does not speculate in the rights to, or expectations of, payment that it purchases.⁷⁴ This clarification also will help more clearly to distinguish securitization from similar structures, such as hedge funds and limited purpose joint ventures, that a vaguer definition might (Lipson observes) inadvertently include.⁷⁵

Recall finally that financial concepts, like securitization, are not fixed in time but evolve in response to changing financial market conditions. Any definition therefore should strive to minimize definitional obsolescence. I believe the pragmatic definition, with or without the clarification, should be sufficiently robust for that purpose. Indeed, that definition not only would cover the very first securitization transactions to be identified as such, which took place in the early 1970s,⁷⁶ but also would cover the most recent transactions identified as securitization.⁷⁷

⁷³ STRUCTURED FINANCE, *supra* note 69, § 6:1.3, at 6-9.

⁷⁴ *Cf.* SEC Rule 3a-7 (issued pursuant to SEC Investment Company Act Release No. 19,105 (Nov. 19, 1992) and codified at 17 C.F.R. § 270.3a-7) (avoiding confusion between SPEs engaged in securitization transactions and SPEs used as investment companies by requiring that securitization SPEs “acquire or dispose of receivables . . . not for the primary purpose of recognizing gains or decreasing losses resulting from market value changes . . .”).

⁷⁵ *Cf.* Lipson, *supra* note 3, at [XX] (suggesting that the Federal Reserve’s definition of securitization is too vague in this way).

⁷⁶ These transactions involved pools of mortgage loans originated by savings and loan associations. These institutions needed to turn their mortgage loans into cash in order to finance local housing demands. To achieve this, the Government National Mortgage Association (Ginnie Mae) facilitated securitizations through SPEs in the form of trusts that held mortgage-loan pools and issued to investors securities in the form of certificates. *See* STRUCTURED FINANCE, *supra* note 69, § 1:2, at 1-7 – 1-8.

⁷⁷ *See supra* notes 64-66 and accompanying text.

I therefore propose the pragmatic definition as the legal definition of securitization,⁷⁸ clarified as indicated insofar as its audience is lawmakers, transactional lawyers, and market participants. That definition, however, is probably too abstract—and not sufficiently descriptive and accessible—to serve as a definition for purposes of the media and the public. Nonetheless, it could be made more descriptive and accessible by being worded more concretely. For example, securitization could be defined for media purposes as a transaction in which a special purpose entity, such as a trust, (a) issues certificates, promissory notes, or other securities to investors; (b) uses the cash received from the investors to purchase mortgage loans or other similar assets on which payments are expected to be made; and (c) ultimately uses those payments, if and when received, to repay the investors.

IV. CONCLUSIONS

Lipson's article is an excellent and thoughtful inquiry into the meaning of securitization. My article engages Lipson's, exploring how securitization should be legally defined. As a starting point, even a normative approach to defining a financial concept should be pragmatic, taking into account how the concept is used in the real world. The definition also should take into account dynamically changing financial markets and the different perspectives of policymakers and lawmakers, market participants and their lawyers, regulators and judges, and other members of the "audience" affected by the definition.

Based on these factors, I would initially define securitization as a financial transaction in which (i) a special purpose entity issues securities to investors and, directly or indirectly, uses the proceeds to purchase rights to, or expectations of, payment, and (ii) collections on the rights or expectations so purchased constitute the primary source of repayment of those securities. To the extent the audience members consist of lawmakers, transactional lawyers, and market participants, I would add that the special purpose entity does not speculate in the rights to, or expectations of, payment that it purchases. I also

⁷⁸ See *supra* notes 27-28 and accompanying text (articulating that definition).

would further modify the definition for the media and the public to make it more accessible.

This audience-adaptive approach to defining securitization is proposed merely as a starting point. Some audiences may wish to make further refinements. Thus, in considering the amount of reserves that banks should be required to hold against investments in asset-backed securities, a regulator might wish to consider, among other factors, the extent to which the securitization transactions underlying those securities have legally isolated the payment risk from risks associated with the originators.⁷⁹

In advancing an audience-adaptive approach to defining securitization, I share Professor Lipson’s caution—expressed regarding his own definition, but now I’m applying that caution to mine—that it may not be “the best or only way to redefine securitization.”⁸⁰ Furthermore, I applaud and admire Professor Lipson’s humility and intellectual integrity insofar as he offers his definition merely “as a tool to organize the process of thinking about what securitization means, normatively.”⁸¹ Thus, he would not “expect bank or securities regulators, who have generated the bulk of definitions of securitization, to replace their jargon with” his.⁸² In light of these qualifications, however, I find Lipson’s reference to his definition as that of a “true” securitization hard to square.⁸³

⁷⁹ *Cf. supra* note 20 and accompanying text (arguing that a broad definition of securitization should not necessarily require, as does Lipson’s definition, such legal isolation).

⁸⁰ Lipson, *supra* note 3, at [XX].

⁸¹ *Id.* at [XX].

⁸² *Id.* at [XX].

⁸³ I also find it hard to square the existence of a “true” securitization, however defined, with the reality that what constitutes a securitization is at least partly market driven and partly judgmental. Lipson might have been inspired to adopt the term “true” securitization from the concept of a “true sale,” which often occurs in the intermediate structure of a securitization. A “true sale,” however, describes something objective in law—a transfer of financial assets that removes those assets from the originator’s bankruptcy estate under section 544 of the Federal Bankruptcy Code. *See* STRUCTURED FINANCE, *supra* note 69, § 4:1, at 4-2 – 4-3 (discussing true sale under 11 U.S.C. § 544).