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CROSS-BORDER SECURITIZATION: WITHOUT LAW, BUT NOT LAWLESS

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I. INTRODUCTION

Securitization is uniquely suited to cross national borders. This form of financial intermediation consists of several discrete stages designed and executed in different countries, and then linked to form a desired intermediation scheme.¹ While international transactions are usually designed and completed in one country the parts of cross-border securitization are designed and completed in more than one country.²

The law of cross-border securitization poses two intriguing puzzles.

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1. These stages include making or acquiring debt obligations, assigning these obligations to a specially signed entity, causing the entity to issue to investors securities representing claims against the asset of the entity, securing credit enhancement, seeking ratings for the entity's securities, creating secondary markets for the securities and managing and servicing the assets held by the entity. See TAMAR FRANKEL, SECURITIZATION §2.5.1, at 41-42 (1991); Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 135-36 (1994).

2. See Emil Arca, *Cross-Border Securitisation*, REV. BANKING & FIN. SERVICES, Feb. 14, 1996, at 21 (defining cross-border securitization transactions as those in which: (i) the company originating the asset is in one country; (ii) a trust or other special purpose entity in another country purchases the originator's receivables; (iii) the payors on the receivables are outside the originator's country; (iv) the receivables are largely denominated in the currency of the securities; (v) the trust receives payments directly from the payors and makes distributions directly to investors), available in LEXIS, News Library, Curnws File. On the history of the international markets in mortgage backed securities, see Henry A. Fernandez, *Globalization of Mortgage-Backed Securities*, 1987 COLUM. BUS. L. REV. 357; JOHN K. THOMPSON, SECURITIZATION: AN INTERNATIONAL PERSPECTIVE (1995).

zles.³ First, actors in cross-border securitization seem to work at cross purposes: they compete by creating unique innovative structures, contracts, and country combinations, but then seem to undermine their competitive advantages by cooperating to convert their creations into standard and uniform rules. Why don't financial and legal innovators protect their creations by trademarks, copyrights and patents, and charge users through licensing? How can these innovators reap any rewards for their efforts?

Part II of the Article addresses this puzzle. It starts by introducing cross-border securitization. The process is defined and analogized to the trust-concept in the Anglo-American legal systems, highlighting the way both institutions facilitate market transactions. Part II of the Article also discusses the cross-border aspect of securitization, comparing it with the development of multinational corporations, and examining the conditions and incentives that drive them to "cross-borders." The discussion explains what motivates innovators of securitization law to establish their creations as industry standards, and how they benefit by "giving away" their innovations.

A second puzzle posed by cross-border securitization relates to the nature of the law that governs it. By definition, cross-border securitization is not governed by one or even two legal systems.⁴ The choice of a jurisdiction may depend on how receptive and accommodating a particular jurisdiction is to securitization.

Theoretically, cross-border securitization can take place without a governing country law, or under a very lax, fully enabling, country law. Yet, market and institutional intermediation are unlikely to arise, let alone flourish, without a legal infrastructure that provides uniform, predictable, stable rules of behavior.⁵ Securitization involves both institutional and market intermediation. The process re-

3. Laws affecting the process include borrowers' and creditors' rights, bankruptcy, regulation of financial institutions, and taxation of the entity, the intermediaries involved and the investors. Cross-border securitization may also involve issues that relate to all international transactions such as jurisdiction, choice of law, extraterritorial application of foreign laws, treaties, sovereign immunity and act of state doctrine. See Merritt B. Fox, *The Legal Environment of International Finance: Thinking About Fundamentals*, 17 MICH. J. INT'L L. 721, 729-30 (1996) (book review).

4. See *id.* at 729 ("The distinctive feature about the rules that govern the behavior of parties to cross border financial transactions is the absence of a single, unitary legal system.").

5. See Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643, 1673, 1677 (1996) (emphasizing the need of business actors for established norms and their tendency to cooperate); Tamar Frankel, Essay, *The Legal Infrastructure of Markets: The Role of Contract and Property Law*, 73 B.U. L. REV. 389 (1993).

quires a legally binding assignment of financial assets to a bankruptcy-remote special purpose vehicle, a developed securities market and a regulatory system to support it, as well as regulated intermediaries that inspire investor confidence. Predictable laws are especially important in securitization because the process involves several independent parties.

Part III explains how cross-border securitization arose in the first place without a uniform governing law and why it is spreading quickly to so many countries, including those without the necessary financial and legal infrastructures. This explanation is based on the nature of securitization and on the theory of decentralized lawmaking. Because securitization is an intermediation system combining different components, linked together through markets, actors can pick and choose legal systems in the global "market for laws." In addition, parties can contract to supplement inadequate country laws. These private laws are then repeated and accepted as customs—a modern "law merchant,"⁶ which, in turn are absorbed into model contracts and rules of trade and professional associations, international *ad hoc* and standing committees, and domestic laws that facilitate the securitization process. This development applies not only to the substance of the securitization transactions but also to their enforcement. Private actors' self enforcement are emerging together with enforcement mechanisms provided by trade, business, professional, government, self regulatory and international organizations. In varying degrees, such enforcement mechanisms are prohibitive, regulatory and permissive.

The laws governing cross-border securitization are developed first by decentralized lawmaking "markets," and then absorbed by centralized lawmaking of communities, large intermediaries, and corporations.⁷ However, the laws do not begin in the marketplace and end with centralized domestic lawmaking. In fact, the lawmaking process evolves cyclically with ever increasing pace.⁸ Securitization lawmaking is both decentralized, emanating from market actors, and centralized, established by communities and governments. Even after domestic laws are enacted, private innovators continue to create

6. On the history of the Law Merchant, see 1 E. ALLAN FARNSWORTH, *CONTRACTS* § 1.94 at 29 (2d ed. 1990).

7. See Cooter, *supra* note 5, at 1694 (arguing that law makers should find the business norms and community norms, see whether the norms have been internalized, and enforce the norms that pass the test).

8. See *id.* at 1683.

law. Decentralized and centralized lawmaking interact and counter-balance each other's shortcomings. In addition, continued decentralized lawmaking is triggered by a dynamic and complex environment in which the securitization-intermediation process takes place. This Article argues that this seemingly unpredictable process is more efficient and more effective for experimenting and avoiding disastrous mistakes than *ad hoc* legislation and rule-making.⁹

Is this movement leading to a central lawmaker that would promulgate international law? Although there are calls for such an institution I doubt whether it is likely to arise any time soon. Instead I argue that we will probably see the development of more uniform international norms and a number of market mechanisms for conflict resolution and enforcement. The process resembles a common law on a global scale. Such a process appears when members of a trade or professional group interact to establish their ground rules.¹⁰

Cross-border securitization is a particularly useful subject for examining legal change, especially in a state environment. Actors in securitization have an enormous degree of freedom to choose their theater of operations in an overall changing legal environment. Their "raw material" is capital—a highly transferable commodity—and their theater of operations is the globe. Yet they need predictable rules and standards in order to operate efficiently. The actors can usually utilize existing legal forms and apply them to any one of the discrete components of securitization without necessarily affecting the entire law applicable to the other components in the process. Therefore, the evolution of securitization law may help provide insight into legal change in similar areas.

II. INTRODUCING CROSS-BORDER SECURITIZATION

This Part discusses the main characteristics of securitization, cross-border aspects of securitization, and the main reasons for the emergence of cross-border securitization.

A. Securitization

1. *Securitization as a System of Intermediation.* Securitization is a new system of intermediation among savers/investors and

9. See *id.* at 1682 (contending that repeated transactions tend to create efficient norms).

10. See Tamar Frankel, *Should Funds and Investment Advisers Establish a Self-Regulatory Organization?*, in *THE FINANCIAL SERVICES REVOLUTION* 447 (Clifford E. Kirsch ed., 1997).

borrowers/issuers, merging traditional intermediation systems of markets and institutions. Securitization can arise when institutional intermediaries are inadequately performing their functions. It can be used to by-pass traditional banks and insurance companies or similar institutions that fail to provide adequate financing or services.¹¹ The United States developed securitization in the 1970s when banks and savings and loan associations did not operate well and did not perform the functions of intermediation effectively.¹²

By merging institutional, in particular banking, and market intermediation, securitization offers many of their advantages while reducing their disadvantages to the parties. Like market intermediation, securitization offers investors liquid securities. Unlike market intermediation, however, borrowers need not issue marketable obligations to the markets; they can borrow from institutions that then securitize the loans.

Like banking, securitization bridges the gap between the demands of borrowers and savers, but it achieves this goal by different mechanisms. For example, the process utilizes rating to reduce information costs to investors, and credit enhancement and diversification of borrowers' loan portfolios to lower investors' risks from borrowers' failures. Further, while banks provide "bundled" services (raising funds, usually through deposits,¹³ originating and servicing loans, and holding them to maturity), securitization has "unbundled" these functions, enabling separate actors to perform one or more of these functions and linking the actors through a sponsor rather than one super-intermediary. This "unbundling" and the use of specialized actors can enhance efficiency.

Securitization has undercut the hegemony of traditional banking. However, it offers banks advantages of reducing their risks by selling loans and increasing gains by fee income. Banks and bank holding companies have entered the securitization arena by providing select services in the process including the market functions.¹⁴

11. See Frankel, *supra* note 5, at 403 (noting that in the securitization process intermediaries direct the flow of funds from savers that do not lend, such as pension funds and insurance companies, to borrowers, and that intermediaries can reduce the enforcement costs of parties, particularly in volatile markets).

12. See Fernandez, *supra* note 2, at 358-59 (describing the development of the mortgage-backed securities market).

13. For an overview of financial systems see Dwight B. Crane & Zvi Bodie, *The Transformation of Banking*, HARV. BUS. REV., Mar.-Apr. 1996, at 109 (securitization separates functions and reintegrates them in different ways).

14. See 1 FRANKEL, *supra* note 1, §§ 4.1-4.17, at 132-56; Robert A. Eisenbeis, *Asset Secu-*

According to neoclassical economics, the securitization process offer global benefits because capital flows to the most productive uses around the globe, providing higher returns for investors. Arguably, however, the process can produce a significant number of losers, especially in those countries that will remain without funding support. Further, cross-border transactions may also facilitate money laundering, tax avoidance, and circumvention of regulatory requirements of particular countries. One example relates to the use of barter to avoid foreign currency restrictions through counter-trades. Thus, U.S. wheat is traded for Soviet vodka, which can be traded to Germany for deutsche marks, which are subsequently exchanged for dollars. Goods and valuables can be bought without using hard currency by "paying" for them with other goods.¹⁵ An example of avoidance of regulation is the movement of U.S. institutional intermediaries to Europe, and the creation of the Eurodollar markets in which U.S. banks engaged in securities transactions in which they were prohibited to engage in the United States.¹⁶ However, the debate about whether securitization is good or bad, and to whom, is beyond the scope of this Article.

2. *The Stages of the Securitization Process.* The process of securitization is divided into discrete stages, each of which can be performed by a different entity: loans are made; the loans are transferred to a special purpose vehicle (a corporation or a trust); the special purpose vehicle issues securities to investors; the risk posed by the portfolio of the vehicle is reduced through various mechanisms for credit enhancement; and the portfolio is serviced by collecting the borrowers' payments and distributing the proceeds to investors after covering costs.¹⁷

Like other forms of intermediation, the process funnels capital from investors to borrowers. Unlike banking and market intermedia-

ritization and Internationalization: Themes for the Future of the Financial Services Industry, 1990 ANN. REV. BANKING L. 347, 349-50.

15. See Robert D. Kase, *Petroleum Perestroika; Oil and Gas Free Market in the Soviet Union*, COLUM. J. WORLD BUS., Jan. 1992, at 16, available in LEXIS, News Library, Arcnws File.

16. The problem of regulation and taxation avoidance and especially of money laundering is outside the topic of this Article. It is mentioned, however, as recognition that not all aspects of cross-border securitization can be viewed as positive. Governments have become more active since technology and financial systems facilitate cross-border money laundering, and have cooperated in efforts to avoid sheltering and helping such activities. Clearly, the efforts are not fully effective, but the very cooperation may be seen as a positive development.

17. See Schwarz, *supra* note 1, at 135-36.

tion, however, the process consists of discrete functions or services that can be performed by different entities in different combinations, and these services are available in the markets.

3. *Securitization and Trust as Innovations.* A comparison of securitization with the concept of “trust” highlights the innovative aspect of securitization and its special qualities. The innovation of securitization is similar to the innovation of the trust in the Anglo-American legal system in a number of ways.

First, both mechanisms use a “splitting technique.” The trust splits property rights in a unique way separating control and benefits and vesting them in different parties. Securitization splits property rights in a similar way, and, in addition, splits the institutional functions usually performed by banks and similar intermediaries, and allows different parties to perform one or more of these functions.

Second, both mechanisms put property in a kind of suspended animation. During the trust period, the trustee acts for the benefit of the would-be owners but he is not subject to their control. Nor is he subject to the control of the previous owner. And even though the trustee controls the property he is not the owner either. A similar situation occurs in securitization. The sellers of the financial assets are no longer the owners. The buyers are only beneficial owners, and the trustee controls the assets but does not benefit from them (except by fees). This trust mechanism is an integral part of securitization.

Third, both trust and securitization encourage market transactions. Trust maintains the simplicity of property law by vesting in the trustee legal ownership towards third parties, yet allows the creation of *in personam* property rights in the beneficiaries. The property rights of the beneficiaries *vis a vis* the trustee are very flexible and can be designed by the trustor (with the trustee’s consent) in almost infinite ways. Thus, while market transactions by the trustee can be effected through the simple and fixed legal property estates the rights of the beneficiaries against the trustee can be highly complex and varied.

Similarly, securitization splits the loan or obligation transaction. Borrowers are obligated under certain terms. Investors, however, are entitled under other terms. Through the process, the whole or parts of the borrowers’ obligations can be converted into securities. For example, assume that a portion of certain financial assets has the equivalent of a treasury bond’s zero credit risk. The residual financial assets represent risk above this benchmark zero risk. By using a

special purpose vehicle (a trust or a corporation), sponsors are able to isolate the part that represents zero risk from the rest of the risks, securitize these separate parts and sell either or both in the securities markets. As a result, securitization can be extremely complex in creating rights that are subject to sale in the markets. However, when these rights reach the markets they can be offered in the form of simple, standardized and predictable instruments, *i.e.*, securities, which lend themselves better to efficient trading in the markets. Thus, securitization requires a trust mechanism to convert illiquid financial assets (assets of the special purpose vehicle) to liquid assets (obligations of the vehicle).

Fourth, both trust and securitization allow for terms that fit the special needs of the beneficiaries/investors. Trust allows for flexible arrangement among the beneficiaries and trustees and can also be used in different business contexts. Securitization allows for terms that fit the special needs of the investors; it is also sufficiently flexible to accommodate the desires of borrowers, and can also be used in different business contexts.

Fifth, trust and securitization are also used for similar purposes. Historically, the trust was used to by-pass prohibitions on devising assets by inheritance and imposition of taxes; today trusts continue to be used for such purposes.¹⁸ Likewise cross-border securitization can be utilized to avoid taxes and regulation because the activities and the payments can be placed outside a taxing country.

Sixth, trust and securitization are intermediaries. The trust intermediates between beneficiaries and issuers of the obligations in which the trust invests. Similarly, securitization intermediates between investors and borrowers.

Trusts and securitization are also different. As compared to securitization, trusts are established and managed with fewer separate links. In securitization, borrowers may borrow from lenders and lenders may pass the borrowers' obligations to special purpose vehicles, which raise funds from investors and allow these funds to pass through to the lenders to borrowers. In a trust, there are only two distinct links: the trustee issues certificates representing claims against the trust's portfolio and invests the funds in financial instruments. The trust resembles only the part of the securitization process that uses the special purpose vehicle.

18. See WILLIAM M. MCGOVERN JR., ET. AL., WILLS AND ESTATES §8.1 at 297-300 (1988).

In contrast to a private trust, securitization eliminates or weakens the personal relationships between the various participants. This characteristic is a function of the number of investors, and explains why the Massachusetts business trust,¹⁹ serving a large numbers of investors, is similar in this respect to securitization.²⁰

B. Cross-Border View: Not Only International and Multinational, But Cross-Border

Securitization offers actors opportunities to develop expertise in parts of the process, or draw on expertise available in the global markets. Similarly, the process offers actors opportunities to structure transactions in locations around the globe that provide a receptive environment, and avoid those with a less welcoming and a more costly environment. Further, cross-border securitization allows for efficient and cost reducing credit enhancement mechanisms to lower the cost of capital. For example, foreign investors' cost of evaluating domestic borrowers is higher than the cost of utilizing a credible domestic institution that can provide credit enhancement to investors. The savings can be then divided among the sponsors, borrowers, and investors.²¹ The segmented nature of securitization allows for cross-border design that can optimize efficiency through expertise and cost avoidance.

To be sure, large institutions could perform all parts of the securitization process since they may have internally the required expertise and domestically an attractive operating environment. If the institutions are multinational, they may take advantage of the environment or expertise that is offered elsewhere. However, if cross-border opportunities outside the institution are more attractive,²² such institutions may still take advantage of these opportuni-

19. A Massachusetts business trust is an organization that functions similarly to a corporation but is organized as a private trust. See Sheldon A. Jones, et. al., *The Massachusetts Business Trusts and Registered Investment Companies*, 13 DEL. J. CORP. L. 421, 439 (1988) (noting that shareholders hold the beneficial interest in the trust property but trustees manage the property).

20. See *id.*

21. This idea was triggered by Professor Hill's article on reduction of political risks through securitization. The same idea can be applied to other situations in which domestic actors can reduce the costs of foreign investors. See Claire Hill, *How Investors React to Political Risk*, 8 DUKE J. COMP. & INT'L L. 283(1998).

22. See *Reducing the Risks of Outsourced IT*, FIN. TIMES, Feb. 20, 1998, § 4 (Survey-Mastering Global Business), at 2 (discussing major trends in IT outsourcing, including offshore outsourcing); *Strategies for Global Outsourcing*, FIN. TIMES, Feb. 20, 1998 § 4 (Survey-Mastering Global Business), at 5 (discussing reasons for global sourcing, types of sourcing rela-

ties.

Securitization should be contrasted with a unitary financial institution that combines under one roof most or all financial services, from lending and funding to insurance and distribution of marketable securities. The difference between the two is the extent to which central control and planning plays a part. The securitization regime allows one or more entrepreneurs to perform particular services and combine them through market intermediation. Loans, insurance (credit enhancement), distribution of securities, management of pools of financial assets, loan servicing, and legal and accounting services can all be bought in the markets. Although there are many combinations of in-house and out-sourced services in both cases, securitization does not require a guiding or governing hand throughout the process. In that sense it is more market than institution oriented. Securitization leaves more freedom to entrepreneurs and initiators than institutional planning would.²³

Cross-border securitization allows each link in the process to be performed in a different country. One way in which to understand the process is by analogy to multinational corporations. For example, United States corporations have long exported their products to foreign countries. In that sense the corporations were engaged in international business. At some point, however, these corporations become multinational.²⁴ The transition occurred when the managements of these corporations began to view the whole globe as their theater of operation. They no longer assumed that their manufacturing, marketing, or purchasing should be located exclusively in the U.S. Instead, they established various parts of their operations in different countries. This global view has changed the strategies of the corporations in a fundamental way. No longer were the U.S., its plants, employees and currency the starting points of management planning. A decision on where to build a plant required a survey of the globe in terms of cost, transportation, markets, political stability, and other environmental factors, as well as the relationship between other globally dispersed parts of the enterprise.

tionships, and factors considered in choosing between them); Jai Shanker, *IBM Goes after Global Outsourcing Market*, NEW STRAITS TIMES, Nov. 3, 1997, at 5 (noting growth in global outsourcing market).

23. This is true generally. However, institutions have different degrees of centralized planning and control. While some may be tightly controlled centrally, others may constitute a loose network of divisions of entrepreneurs.

24. See PETER MUCHLINSKI, *MULTINATIONAL ENTERPRISES AND THE LAW* 19-32 (1995) (explaining the origins of multinational corporations).

Cross-border securitization reflects a similar method and view, whether the decision makers are intermediaries, investors or borrowers. The main actors, however, are the sponsors. A decision to securitize across particular borders depends on (i) opportunities to create an inventory of financial assets by originating, buying, or selling; (ii) optimal regulation and tax laws;²⁵ (iii) various risks and their levels; and (iv) absence or presence of an institutional or legal infrastructure. In such a case, cross-border securitization serves as an alternative to missing laws or appropriate intermediaries.

In cases where the domestic legal, tax or regulatory accounting framework makes securitization difficult, but where the law permits transfers of title, an alternative may be to structure a transaction in an "offshore center" and to launch the issue in the Euro-markets For countries whose currency is not widely used internationally and which do not intend to function as major international financial centers, this may be an efficient means of gaining the benefits of securitization without major changes in domestic infrastructure.²⁶

Offshore securitization can be condemned as a means of avoiding regulation, tax rules, and currency exchange restrictions. Cross-border securitization also can be praised as a valuable tool for using the best combination of securitization actors and activities around the globe. The judgment depends on the viewers' point of view.

Cross-border securitization develops when the optimal conditions for securitization are absent in the country where investors, originators or borrowers reside. Optimal conditions include a business and legal infrastructure to support the securitization process and absence of taxes or regulation that sponsors of the process find burdensome. Thus, when legal systems do not allow, or put burdens on, assigning or selling financial assets, they create an almost insurmountable barrier to securitizing assets in their jurisdictions. For example, there are gaps in Italy's legal and regulatory framework, in-

25. See Cecile Gutscher, *Commercial Banks Flock to Ireland Seeking Tax Breaks*, WALL ST. J. EUR., Jan. 15, 1997, at 19, available in WESTLAW, WSJ-EURO Database.

26. *Securitisation: An International Perspective*, FIN. MARKET TRENDS, June 1995, at 33, 57 ("[A] considerable volume of cross-border securitization is taking place, mainly in the form of sale of receivables to offshore SPVs. Securities created in this matter [sic] are marketed to the international investor community. Some cross-border securitization is undertaken by institutions based in countries where domestic securitization is relatively easy. At the same time, even when domestic infrastructure renders securitization impractical, market participants have found cross-border activity to be a means of engaging in securitization. Thus, many non-financial companies in several countries have used offshore companies to issue ABS and MBS in cases where domestic systems made such operations impossible."), available in LEXIS, News Library, Arcnws File.

cluding the lack of specific legislation, problems involving taxation, and legal aspects involving transfer of title that impede securitization in that country.²⁷ European countries do not have a trust concept.²⁸ That makes it difficult to establish a special purpose vehicle.

Where such barriers exist, financial assets originated in one country are often structured in another country. For example, London is the location of major sponsors that package assets originated in other countries and distribute the securities backed by these assets. The securities are structured to meet the demands of investors in particular markets; for example, the European market. The special purpose vehicles used to securitize these assets, however, are often located not in London but in other financial centers, such as the Channel Islands.²⁹

Similarly, because infrastructure is inadequate, no mortgage backed securities have been issued in Italy "but a small number of car loans and leases have been securitized, mainly using offshore SPVs."³⁰ The process of building an infrastructure is sometimes piecemeal. For example, Japan's government allowed leasing and consumer credit companies to sell receivables to offshore special purpose vehicles before it allowed securitization in Japan.³¹ Cross-border securitization will follow after Japan accommodates the securitization process.

Sometimes developing countries seek foreign investors to help modernize and discipline their domestic intermediaries and borrowers (including issuing enterprises).³² If, for example, banks in a particular country do not perform their lending functions prudently, others can perform their functions. The new lenders can be other domestic institutions, but even more importantly, they can be foreign entrepreneurs, provided the country's government accepts foreign lenders.

27. *See id.* at 49.

28. *See* Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, N.Y.U. L. REV. (Forthcoming 1998).

29. *See* *Securitisation: An International Perspective*, *supra* note 26, at 49. The publication also states that not all countries have accepted securitization or changed the laws that are necessary for securitization to flourish. For example, France decided to develop its own laws, and Norway determined not to use securitization as a remedy to its banking problems. *See id.* at 48, 50.

30. *Id.* at 49.

31. *See id.* at 51.

32. For example, on December 4, 1997, the government of Malaysia hosted a conference concerning securitization in which many OPEC members states, especially from the Pacific Basin, participated.

Markets can discipline domestic banks even absent foreign lenders. If the domestic banks desire to sell their loans abroad, the underwriting standards and specifications will be dictated to a large extent by the buyers. For instance, in the United States, GNMA, Fannie Mae and Freddie Mac, which are the largest mortgage buyers, virtually establish the underwriting standards for mortgage lending, and thereby affect the prudence standards of U.S. banks that are mortgage lenders.³³

Interestingly, the buyers have an incentive to reduce the costs of origination. Based on the statistical data that they have accumulated, they have reduced the information that they require the borrowers to provide. While small banks may continue to demand of their borrowers detailed information and spend their resources verifying the information, Freddie Mac needs only the information that is relevant to its enormous pool of mortgages. Details that constitute a "wash" or are not statistically significant can be eliminated. Originating lenders, whether banks or mortgage bankers or others, can reduce their information costs which lowers the transaction costs and ultimately the borrowers' costs.

Securitization has exposed lending banks to competition from other lenders that used to finance their operations by borrowing from banks, thus incurring higher cost of capital. If these lenders have available to them buyers of the loans, they need less capital, or only interim capital to make the loans and assemble loan portfolios for sale. These non-bank lenders, with lower cost of operations, pose serious competition to banks.

In such cases, the government's regulatory role is reduced because sophisticated buyers who have power to demand loans made prudentially. Thus, these buyers impose on lenders market discipline and relieve the government of the regulatory burden. Market buyers and competition sanction banks for adopting lax underwriting standards in violation of the regulatory standards.

A similar idea was voiced in the 1997 conference: Comparative Study of Internationalization of Emerging Markets and Its Application to China, Beijing, China. At this conference, it was suggested that even if China does not necessarily need foreign currency it needs foreign investors to exercise market discipline on state enterprises that are privatized by issuing securities to investors. For example,

33. See Jane Schulkoske, *The Evolving Paradigm of Laws of Lead-Based Paint: From Code Violation to Environmental Hazard*, 45 S.C. L. REV. 511, 551 (1994) (noting Fannie Mae's role in setting underwriting standards).

foreign investors could insist that these issuers adopt internationally acceptable accounting systems.³⁴ Today, countries have incentives to cooperate in regulating securitization and other forms of intermediation because high capital mobility can make each country's investors hostage to the other countries' policies.

Although the sponsors of securitization do not necessarily make it their priority, they serve some countries by offering an alternative to ineffective institutional intermediaries in these countries. Sponsors that realize the benefits they bring in this respect use these benefits to support their request for entry and changes in the legal infrastructure of the countries.

Cross-border securitization encourages foreign investments. Investors have a "home bias,"³⁵ because foreign investments pose risks related to lack of information, foreign exchange, and government actions.³⁶ Nonetheless, investors are attracted to foreign investments by the promise of higher returns. Cross-border securitization offers them risk diversification, and an alternative to investments in foreign projects that is more liquid.³⁷

C. Innovators in the Area of Cross-Border Securitization Seem to Give Away Their Innovations Instead of Creating Property Rights in Them. How Are the Innovators Compensated For Their Investments and Efforts? Why Are They Interested in Standards Based on Their Creations?

Presumably, those who create innovative cross-border securitization models expect to recoup their costs and reap rewards. They invest time and creativity (which may be a limited resource). They assume the risk that their innovation would not be marketable, or will not receive the necessary government approval, or that their innovations will have a short life span.

1. *Why Don't Innovators Try to "Propertize" Their Innovations?* One way in which innovators could reap rewards is by seeking trademarks, copyrights and patents to propertize their innovations and extract payments from those who would wish to use or copy them. Yet, it seems that innovators in domestic and cross-border

34. See Comparative Study of Internationalization of Emerging Markets and Its Application to China (1997) (notes on file with the Author).

35. See Fox, *supra* note 3, at 724-25.

36. See *id.*

37. See *id.* at 724.

securitization, like those in the financial services area, rarely resort to these measures.³⁸

2. *Giving Innovations Away.* By and large, innovators seem to give away their innovations. In some cases they have no choice. When innovators need to obtain regulators' approvals for their structures, they "give away" their ideas to competitors when approvals are publicized. But innovators give away their unique creative structures voluntarily by advertising in law review articles³⁹ and on the Internet.⁴⁰ They compete for a chance to speak at conferences attended by lawyers.⁴¹ They work with peers on uniform contracts and model laws in trade and professional associations,⁴² United Nations projects,⁴³ and other international organizations.⁴⁴

Presumably, advertising their innovation and participating and leading movements to design a uniform law bestows on the innovators prestige and enhances their reputation. Standardization and publication of a proven innovation allows innovators to "sit on their laurels," at least for a while. It also allows them to meet other movers and shakers in their area and learn from them. There is a great satisfaction in having an impact on the law of countries and the work and life of many persons. However, these activities generate costs

38. For example, the creators of the "hub and spoke" structure for mutual funds have taken a trademark and patent on the name and structure. See *infra* note 46.

39. See Meredith S. Jackson, *Leap of Faith: Asset-Based Lending to Asset-Backed Securities - A Case Study*, 2 STAN. J.L. BUS. & FIN. 193 (1995).

40. See e.g., Chapman Tripp, *Securitisation: A Beginner's Guide* (visited March 31, 1998) <<http://www.chapmantripp.co.nz/publish/fl180697.htm>> (explaining securitization, posted by a New Zealand law firm); Jason H.P. Kravitt, *Coping with Cross-Border Securitisation*, (visited Nov. 13, 1997) <<http://demo.iii.com:106/search/akrafft+susan/-5,-1,0,B/frameset&a+kravitt+jason+h+p&1,6,-1>>.

41. See, e.g., AMERICAN LAW INSTITUTE - AMERICAN BAR ASSOCIATION COMMITTEE ON CONTINUING PROFESSIONAL EDUCATION, INVESTMENT MANAGEMENT REGULATION (ALI-ABA Course of Study Materials No. CA10 1995).

42. See, e.g., U.C.C. (1995); RESTATEMENT (SECOND) OF TORTS (1977). American Law Institute Transnational Insolvency Project; International Statement of United States Bankruptcy Law Tentative Draft (Apr. 15, 1997).

43. See, e.g., *United Nations Commission on International Trade Law, Working Group on International Contract Practices, Twenty-Seventh Session, New York, 23 June-3 July, 1997, Receivables Financing* (on file with author).

44. See, e.g., UNCITRAL MODEL LAW ON ELECTRONIC COMMERCE (1996); PRINCIPLES OF EUROPEAN CONTRACT LAW (1997). This behavior is prevalent in other areas of the financial services. J.P. Morgan has developed a software to track the risk level of investment portfolios and offered the software free. See Peter Heap, *J.P. Morgan Gives an Answer to Problem of Measuring Risk*, BOND BUYER, Mar. 21, 1995, at 8, cited in THE FINANCIAL SERVICES REVOLUTION 333, 348 (Clifford E. Kirsch, ed., 1997).

rather than monetary rewards for work done.

The answer to this puzzle seems to contain both the negative aspects of attempting to create enforceable copyright, patent, and trademark rights, on the one hand, and the far more fruitful and profitable results of giving the innovation for free. In the area of financial services, recapturing of the costs and reaping the monetary rewards from innovative structure through trademarks, copyrights and patents has been unsuccessful. First, the name of the product is rarely unique, and other descriptive names are abundant. For example, the creators of the "hub and spoke" structure for mutual funds have taken a trademark and patent on the name and structure.⁴⁵ However, other lawyers and the regulators chose "master-feeder funds" to describe essentially the same structure, thus by-passing the trademark issue. Later, the patent was not recognized.⁴⁶ Today, computerized investment management systems are of "suspect value."⁴⁷ Second, the innovative structure itself can be used with sufficient variations that would distinguish it from the original. Third, it is very difficult to shelter financial innovations under existing laws. Fourth, copyright protects software code, but not the ideas underlying the code, allowing competitors to duplicate the ideas by designing different codes that achieve the same result.⁴⁸

45. See *infra* note 46.

46. See Exemption for Open-End Management Investment Companies Issuing Multiple Classes of Shares, Investment Company Act Release No. 19,955 (Dec. 15, 1993), 58 Fed. Reg. 68,074, 68,075-76 & n.3 (Dec. 23, 1993) (referring to funds as "master-feeder" and referring to "Hub and Spoke" service mark only in footnote); *State Street Bank and Trust Co. v. Signature Fin. Group, Inc.*, 927 F. Supp. 502 (D. Mass. 1996); *U.S. Court Strikes "Hub and Spoke" Trademark*, FUNDS INTL., Apr. 1996, at 9 (noting that other firms have trademarked similar structures), available in LEXIS, News Library, Curnws File.

Further, in 1996 a federal district court invalidated the patent for the accounting system for managing the Hub and Spoke structure. The court ruled that the subject matter is unpatentable as the system is a "mathematical algorithm" involving no "physical transformation," and a "business method." See *State St. Bank & Trust Co. v. Signature Fin. Group, Inc.*, 927 F. Supp. 502 (D. Mass. 1996). If the decision is affirmed on appeal, it will indicate that patents for financial and investment management systems are of "suspect value." See Steven B. Pokotilow & Andrew G. Isztwan, *Court Casts Shadow on Patenting Financial Software*, INTELL. PROP. STRATEGIST, June 1996, at 7, available in LEXIS, News Library, Curnws File. Similarly, Merrill Lynch has trademarked the name of its Cash Management Account. See *Merrill Enhances CMA*, WALL ST. LETTER, Dec. 21, 1992, at 3, available in LEXIS, News Library, Arcnws File. The product is also patented. See CW Staff, *Intelligence Files*, COMPUTERWORLD, Feb. 22, 1993, at 67, available in LEXIS, News Library, Arcnws File. However, it has become a "commodity product" because most other securities firms offer similar products. See Randall Smith, *Merrill's Once-Revolutionary CMA Is Losing Its Edge*, WALL ST. J., Jan. 7, 1993, at C1.

47. See Pokotilow & Isztwan, *supra* note 46, at 7.

48. See generally Himanshu S. Amin, *The Lack of Protection Afforded Software Under the Current Intellectual Property Laws*, 43 CLEV. L. REV. 19 (1995).

Clearly financial innovators incur substantial costs in creating new products and bear the risk of losing their competitive edge if these innovations can be easily and quickly copied by others. Therefore, unless protected by copyright and patent laws, these costs and risks may dampen the incentives of innovators to innovate. In response there is also a suggestion that current laws provide some protection for such innovations, and that innovators should take advantage of the laws.⁴⁹ More importantly, it seems that innovations in the financial area, including securitization, are abundant, suggesting that there is little need to provide innovators more incentives to produce novel products.

In contrast, and paradoxically, “giving away” an innovation provides many monetary benefits. To begin with, these giveaways may not be complete. Unlike disclosure in applications for patents, disclosures of innovations in advertising, presentations or professional publications are not as complete and detailed. Certain experiences, drawbacks and danger points are likely to be omitted. Some say that following cookbooks of famous chefs rarely seems to produce dishes that taste as the chefs’ dishes do. That is not necessarily done by intentionally avoiding an important ingredient from the recipe (although some cooks would be tempted to do so). In a complex area with different actors, it is difficult to transfer fully information in such publications so that the reader can replicate the activity without hands on guidance. Just as the water, cooking utensils, and ingredients may not be identical to those used by the author-chefs, so will the quality of the financial assets, the type of clients and the legal environment of the transactor differ from those of the innovators. These differences may produce difficulties for the novices.

Second, to be valuable, innovations must be recognized and followed. Innovation can be costly to users because there is less information about their effects; their novelty produces uncertainty that may result in failure and losses. The greater the use of the innovation, the lower the users’ risks would be, and the more users will be willing to adopt it. A broad adoption of an innovation verifies and enhances its value, thus proving the success of the innovation. Therefore, innovators may initially give away their innovations to produce

49. See STEPHEN JUDLOWE, CHRISTOPHER PETRUZZI, & MARGUERITE DEL VALLE, PATENT AND COPYRIGHT PROTECTION FOR INNOVATIONS IN FINANCE (Salomon Bros. Center Working Paper 1988) (arguing that innovators who seek copyright and patent laws’ protections for financial innovations may reap rich rewards while those who neglect to protect themselves may lose these rewards “forever”).

broader adoption.

Third, if potential clients are convinced of the value of the innovation, they seek the innovators' services. Repeat performance is far less costly to the innovators than to their competitors. Even as compared to peers, innovators have an advantage during the learning period of their competitors. Some service providers would be happy to resort to the innovators because their cost of learning outweighs their benefits if their clients seldom seek these services. Thus, innovators benefit from peers' referrals.

Fourth, innovators reap the rewards of prestige from enhancing their reputation. For some people, these rewards may be the main driver.

Some of the advantages described above are not available except under certain conditions: First, the innovation must be complicated. Otherwise the innovation can be easily replicated, and novices will be less eager to pay innovators for guidance. Second, the recipients of the innovators' services must be peers, colleagues, and clients. They have an interest in maintaining this system and would support one actor to obtain reciprocal support later. Third, the system will work best in a specialized industry. Repeated transactions tend to produce efficient industry norms, and, as the discussion in the following section demonstrates, in a specialized business, the maintenance of these norms is valuable to all members.⁵⁰

In some cases, if an innovation is prepared for a client that values the advantage of being "the first" or if the transaction is very large, the client is usually able to reward the innovator because the expected profits are very high. In this case the client may preclude the innovator from giving the innovation away, at least until the client reaps the value of the innovation. The creator, however, is fully compensated at the outset.

The question is whether we need to shelter the innovations through property law. The main reason for sheltering innovations is to provide innovators with incentives, monetary or otherwise, to spend their energies on such innovations. When such incentives are missing, the imposition of financial barriers on the use of innovations and the free flow of ideas may be justified. Yet innovative designers in the securitization area seem to have ample incentives to continue

50. See Cooter, *supra* note 5, at 1680 ("Specialized business is often organized so that efficient norms emerge from repeated transactions."). Those players that cheat on industry norms are likely to be those with short time horizons. *See id.*

to innovate, as is demonstrated by the extent to which securitization and cross-border securitization have spread all over the world. Until the creativity of these innovators dries up for lack of incentives, there is little justification to impose barriers on the free use of these innovations.

In sum, innovators in the securitization area are rewarded by advertising their innovations and sharing them with their peers. This method of reward is crucial to the development of the law of cross-border securitization, and to the process by which this law is created. This topic is discussed in the following Part.

III. HOW CAN CROSS-BORDER SECURITIZATION EXIST WITHOUT A UNIFORM LAW?

By definition, cross-border securitization is not governed by one legal system.⁵¹ Securitization may take various shapes and forms and have different effects on participants depending on which of its parts resides on which countries' shores. Theoretically, cross-border securitization transactions can be effected with no governing country law, or under a very lax fully enabling country law.

Yet, neither market nor institutional intermediation can be created, let alone flourish, without uniform, predictable, stable rules of behavior that govern their participants' activities. How, then, did cross-border securitization arise in the first place? And how come it is spreading so fast to so many countries, including those without the full financial and legal infrastructure that securitization requires?

A. Creating Securitization Law

The law of cross-border securitization consists of many country laws, usually chosen by private actors. Therefore, the identity and substance of these laws are not uniform. Two general related questions arise in this context: When is uniform, standardized law preferred to non-standard law of the parties' choices? A related question is: how should decentralized markets and centralized authorities interact as lawmakers and enforcers? This section highlights these difficult issues in the context of cross-border securitization, and helps understand why a less uniform law is effective in this area.

51. See Fox, *supra* note 3, at 729 ("The distinctive feature about the rules that govern the behavior of parties to cross border financial transactions is the absence of a single, unitary legal system.").

1. *Uniform Law v. The Parties' Choices: Decentralized Markets v. Central Authorities.* The issue of imposed uniform law versus parties' choices is closely related to the issue of the interaction of market and central authorities as lawmakers for business transactions. Professor Robert Cooter has argued that the "law merchant" designed by parties in a lawmaking decentralized market is more efficient than, and therefore preferable to, law enacted by a central power, such as a community, or a government. In Professor Cooter's opinion, central lawmakers should absorb the substance of laws created in a market process, generally in a permissive rather than mandatory mode.⁵²

Uniform centralized law and market laws of the parties' choice pose costs and offer benefits.⁵³ Uniform laws are more predictable, reducing the parties' costs of information, uncertainty, and learning. In contrast, less predictable market-unique arrangements require parties to engage in continuous inventing, and to incur higher negotiation and enforcement costs because the behavior of others is not subject to default rules, and is less predictable.

Uniform laws, however, increase the parties' costs by imposing one size on many transactions, regardless of fit or parties' needs; by limiting experiments and innovations; and by delaying quick adaptation that is crucial in volatile situations. Further, uniform laws established by a centralized lawmaker are not likely to be as efficient as market laws. Centralized laws present compromises necessary to reach acceptance by a larger number of stakeholders with different, and perhaps conflicting, incentives and agendas.

Most legal systems develop through both centralized and market lawmaking. Cross-border securitization, however, provides an example of a leading decentralized lawmaking where the predominant forces that shape the law are anchored in *ad hoc* market transactions. There are a number of reasons for this development.

First, cross-border securitization is an innovation that allows actors to greatly minimize, if not fully escape, centralized country laws, in favor of alternative legal systems. Just as securitization reduces the costs of doing business under inefficient intermediation systems, cross-border securitization reduces the costs of doing business under inefficient country laws. These costs seem to be greater than the costs of non-uniform applicable law.

52. See Cooter, *supra* note 5.

53. See Cooter, *id.*

Second, especially in its initial stages, cross-border securitization requires that parties be free to design the applicable law, even at the expense of uniformity. That allows parties to experiment, and to reduce their learning costs by contracting on applicable domestic laws.⁵⁴

Third, securitization in general is less sensitive to the benefits of uniformity. Because securitization is fragmented, the law governing the process can be fragmented as well, to fit the actors' needs. For example, for public distribution of asset-backed securities sponsors are likely to choose a jurisdiction with active securities markets, such as the United Kingdom or the United States whose laws are adequate to accommodate this aspect of securitization.⁵⁵ For private placement of securities to large sophisticated investors, sponsors may seek jurisdictions that do not strictly regulate securities issuance and sales, because these investors may choose to require of sponsors the information they need.

Fourth, because securitization is a "wholesale" business involving large amounts, the cost of non-uniform law can be distributed over a large number of ultimate investors.

2. *The Quest For Uniformity.* While actors continue to create ad hoc unique transactions, they also gradually work towards more uniform laws. Accepted and repeated designs or contracts become "vanilla" documents, emerging as customs, which, in turn, are adopted as model contracts and rules by trade and professional associations, organizations of intermediaries, international ad hoc and standing committees, and regulators' organizations. All these represent a modern "law merchant," eventually absorbed into domestic laws that facilitate securitization.⁵⁶

54. Private actors can compete for recognition and leadership in designating applicable country laws, usually the country of their main residence and legal expertise.

55. In the event that these laws are not initially fully accommodating, they are fairly promptly amended to do so. *See, e.g.,* 2 FRANKEL, *supra* note 1, §13.5.5-13.6, at 71-73 (preemption of state laws).

56. The modern international law merchant is being developed in the area of swaps. Most swaps transaction participants use a single "master agreement" for all their transactions with a particular counterparty. The International Swap & Derivatives Association, Inc. (ISDA) publishes two standardized contracts for documenting interest rate and currency deals. Participants may choose either the ISDA Multi-Currency—Cross Border Master Agreement or the ISDA Currency—Single Jurisdiction Master Agreement, depending on the nature of their counterparty and the transactions contemplated.

The first mentioned contract is used for swaps of U.S. dollar interest rate. By its terms, this contract is governed by New York law. The second mentioned contract is used for swaps of international currency and interest rate. Under this contract the parties may choose the appli-

The movement to unification has appeared on various fronts. Regulators are fostering unification on the international level;⁵⁷ others are advocating alternatives to uniform substantive securities regulation by reducing investors' information costs through private actors such as rating agencies and investment company managers.⁵⁸ A number of countries have amended their laws along the models of private and international models.⁵⁹ Puerto Rico has recently adopted the Uniform Commercial Code.⁶⁰ Some countries have adjusted their laws in light of the models.⁶¹ Some have adopted foreign laws in full, directly or by reference.⁶² Some countries chose to maintain their

cability of New York or English law.

The two ISDA master agreements are substantively identical, except for language necessary to denote the cross-border environment in the second mentioned agreement. See Adam R. Waldman, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance into the Abyss?*, 43 AM. U.L. REV. 1023, 1060-61 & nn.257-58 (footnotes omitted) (citing Daniel P. Cunningham & Paul Michalski, *Enforceability Under Various Bankruptcy Laws of the Automatic Termination and Netting Provisions of the ISDA Standard Form Agreements*, in ADVANCED SWAPS AND DERIVATIVE FINANCIAL PRODUCTS, at 227, 231 (PLI Corp. L. & Prac. Course Handbook Series No. 746, 1991); see also David Crowling, *Cross-Border Insolvencies: Building a Framework*, AUSTRALIAN ACCT., Aug. 1997, at 48 ("The insolvency community has begun trying to fill the vacuum [concerning insolvency of multinational enterprises] stepping up their efforts to establish a protocol for resolving issues that arise when companies with worldwide operations and assets go under.").

57. See, e.g., TRANSNATIONAL INSOLVENCY PROJECT; INTERNATIONAL STATEMENT OF UNITED STATES BANKRUPTCY LAW (Tentative Draft 1997). For example, while historically, the United States sought to extend its strict laws beyond its borders, in recent years it changed course, and has increased cooperation with other regulators. See Kellye Y. Testy, *Comity and Cooperation: Securities Regulation in a Global Marketplace*, 45 ALA. L. REV. 927, 955-56 (1994) (noting that SEC's acceptance of comity and cooperation "represents a profound philosophical shift and one that recognizes the globalization of the world's securities markets"); Gregory K. Matson, *Restricting the Jurisdiction of American Courts over Transnational Securities Fraud*, 79 GEO L. J. 141, 165 n.125 (1990) (noting U.S. agreement with Canada to cooperate in investigation and prosecution of securities fraud and informal agreements with Japan, Great Britain and France expressing desire to cooperate in investigation of securities fraud).

58. See Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 FORDHAM L. REV. 1855 (1997).

59. See *Securitisation: An International Perspective*, supra note 2.

60. See RICHARD E. SPIEDEL, ROBERT S. SUMMERS, & JAMES J. WHITE, *SALES AND SECURED TRANSACTIONS - TEACHING MATERIALS* 7 (5th ed. 1993).

61. See *Securitisation: An International Perspective*, supra note 26.

62. See *id.* The purpose and form of absorbing other countries' laws in full or in part differ. Countries may absorb foreign concepts, or specific laws, or institutions, apply such laws to classes of people or transactions. Absorption may be driven by a desire to attract foreign actors who prefer the foreign laws because they are more protective or more familiar, or because such laws facilitate the country's economic growth. See Ugo Mattei, *Efficiency in Legal Transplants: An Essay in Comparative Law and Economics*, 14 INT'L REV. L. & ECON. 3 (1994); ALAN WATSON, *LEGAL TRANSPLANTS* (1974).

laws rather than accommodate the securitization process⁶³ but have allowed domestic actors to securitize financial assets by transferring the assets to offshore centers.⁶⁴

Organizations like the National Law Center for Inter-American Free Trade are preparing model forms and laws.⁶⁵ A 1995 publication of the Organization for Economic Co-operation described the trend of securitization stating "the pattern of transference has been for techniques first perfected in the United States to be introduced in the euro-markets and thence in other national markets."⁶⁶ The International Institute for Unification of Private Law (UNIDROIT) and the United Nations Commission on International Trade Law (UNCITRAL) are working to create uniform rules for cross-border assignments.⁶⁷ The United Nations too has established a working group preparing a law to facilitate securitization.⁶⁸

While financial merchants are creating model laws, countries and other organizations are preparing securitization laws that are more creditor and investor-friendly. The Organization of American States is drafting a model law on secured transactions.⁶⁹ So is the EBRD (European Bank for Reconstruction and Development), an institution⁷⁰ that helps countries in Eastern Europe to privatize their enterprises and in the process securitize their financial assets as well.⁷¹ Thus, the law of securitization is being developed in the markets, by

63. See *Securitisation: An International Perspective*, *supra* note 26.

64. See *id.* This method will not be effective if long-term securitization becomes truly an accepted intermediation more. Short-term, until we see where the securitization movement is going, this attitude can be an effective strategy for some countries. See *id.* (suggesting that such a policy is likely to be most effective if securitization remains confined to the United States and a few offshore markets, but if it characterizes the markets of many OECD countries, other changes will be necessary).

65. See National Law Center for Inter-American Free Trade, *Secured Financing* (visited Nov. 13, 1997) <<http://www.natlaw.com/secfin.htm>>.

66. *Securitisation: An International Perspective*, *supra* note 24.

67. See United Nations Commission on International Trade Law, *Working Group on International Contract Practices*, *supra* note 43; Harold Burman, *Public International Law*, 31 INT'L LAW. 685 (1997).

68. See U.N. *Drafting Trade Rules that Would Aid ABS*, ASSET SALES REP., Apr. 28, 1997, at 1, available in LEXIS, News Library, Curnws File; *supra* note 55 (describing development of modern international law merchant in area of swaps).

69. See Burman, *supra* note 67.

70. See Don Wallace, Jr., *International Initiatives to Harmonize the Law of Secured Transactions* (Bus., Econ., & Regulatory Law Working Paper Series) (forthcoming 1997) (on file with author).

71. When country laws lack concepts used for securitization such as recognized assignment of financial assets or trust, the accommodation of securitization may be more problematic.

communities, and by governments. Even after domestic laws are enacted, private innovators continue to innovate. Arguably, the reactive effect of law merchant on centralized lawmaking optimizes the efficiency of law.

Some countries have enacted specific laws regulating securitization.⁷² The United States did not enact such a law, but legislated to meet particular problems in the tax, securities regulation and commercial law areas.⁷³ Arguably, this method allows markets to develop the securitization process, and the government to interfere whenever a problem arises. Yet, it lacks uniformity and a cohesive treatment of the subject.

The process of unification is not necessarily smooth especially on an international level; problems may stem from the very nature of securitization, the conversion of illiquid financial assets into liquid financial assets, and from the different approaches taken by the various actors.⁷⁴

3. *Enforcement of Securitization Law.* Securitization law is enforced both by government apparatuses and by private parties. In the international arena, as the reach of government regulators is

72. See *Jordan Outlines Emerging Markets*, ASSET SALES REP., Apr. 22, 1996, at 6 (noting that Japan recently passed a law recognizing asset-backed securities and that Chile is in the process of changing its laws), available in LEXIS, News Library, Arcnws file.

73. See, e.g., Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 671, §§ 860A-860G, 100 Stat. 2085, 2308-18 (codified as amended at 26 U.S.C.A. §§ 860A-860G (West supp. 1998)) (providing pass-through tax treatment to certain mortgage pools); Small Business Job Protection Act of 1996, Pub. L. No. 104-188, sec. 1621, §§ 860H-860L, 110 Stat. 1755, 1758-68 (codified at 26 U.S.C.A. §§ 860H-860L (West supp. 1998)) (providing pass-through tax treatment to other financial asset pools); Securities Acts Amendments of 1975, Pub. L. No. 94-29, §30, 89 Stat. 97, 169-70 (codified at 15 U.S.C. §77d(5) (1994)) (exempting certain mortgage-backed securities from regulation under the Securities Act of 1933); Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (codified as amended in scattered sections of 12, 15 U.S.C.) (encouraging participation of private sector in issuance and secondary markets in mortgage-backed securities); Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, §501, 94 Stat. 132, 161-63 (codified as amended at 12 U.S.C. §1735f-7a (1994)) (preempting state laws limiting interest rates on certain federally related loans); Garn- St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, §341, 96 Stat. 1469, 1505-07 (codified as amended at 12 U.S.C. §1701j-3 (1994)) (preempting state laws prohibiting due-on-sale clauses with respect to real property loans).

74. For example, the guiding principles of professions, such as accountants, may not always be compatible with the business purposes and financial structures of financial institutions. Securitization may profoundly change asset evaluation of institutions that currently hold liquid asset backed securities but traditionally held illiquid assets on which these securities are not based. While the accounting profession prefers market pricing, these institutions object to such pricing which would render their balance sheets far more volatile. See John Evans, *U.K. Bankers Vow to Fight ABSA Accounting Plan*, GLOBAL GUARANTY, Sept. 9, 1991, at 1.

reduced, various forms of private enforcement are playing a greater role.

One effective form of private self-enforcement appears in dealings among few actors that interact and depend on each other long-term.⁷⁵ This relationship fosters trust and reduces the cost of verifying members' assertions and promises because, over time, their behavior becomes more predictable. Interdependence provides self-enforcing sanctions against violators of this trust. Self-regulatory organizations perform in a similar fashion, among a larger number of members, and are especially effective if membership is required in order to practice a trade or profession or use special benefits that the organization offers.⁷⁶

Reliable, regulated intermediaries also provide an effective private self enforcement, especially for interaction among strangers. Intermediaries create an "impersonal trust"⁷⁷ for such strangers—a trust in the system that the intermediaries would enforce. Intermediaries have been performing this function for centuries, for example, by paying on presentation of bills of lading and more recently honoring credit card charges.⁷⁸ Similarly, intermediary money managers play a crucial role in cross-border investments, where investors need trusted representative most.⁷⁹ Finally, a semi-private enforcement arises when parties choose the country forums for their dispute resolutions.

75. See Cooter, *supra* note 5.

76. See *id.*, at 1688-89 (discussing how norms are made by intermediate institutions; organizations make rules for members and create advantages for them); *id.* at 1682 ("Specialized business is often organized so that efficient norms emerge from repeated transactions." If a player cheats on industry norms it will be someone with a short time horizon.); Lisa Bernstein, *Merchant Law in A Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996); Frankel, *supra* note 5.

77. "Impersonal trust" refers to reliance on third parties, whether fiduciaries, escrows, or other "guardians" and their monitoring and controls of other parties to a transaction. Efficient financial systems are based on trust; that is, reduced verification. However, while personal trust requires information about the other party to the transaction, impersonal trust relies on intermediaries to reduce the information costs and verification regarding the other party to the transaction. For example, international trade is advanced by bank letters of credit, and in the domestic markets, the ordering of goods by telephone from catalogs with the aid of credit cards demonstrates "impersonal trust" through the intermediation of banks. In addition, parties use legal rules as a substitute for trust in other parties to reduce their monitoring costs. See Maxwell J. Mehlman, *The Patient-Physician Relationship in an Era of Scarce Resources: Is There a Duty to Treat?*, 25 CONN. L. REV. 349, 377 (1993) (citing Susan P. Shapiro, *The Social Control of Interpersonal Trust*, 93 AM. J. SOC. 623, 634 (1987)).

78. See *id.* (citing Shapiro, *supra* note 76).

79. Historically, money managers became important as reliable when investors sought attractive investments abroad but needed reliable people to select and manage these investments. See 3 TAMAR FRANKEL, *THE REGULATION OF MONEY MANAGERS* 2 (1980).

However, these private enforcers may be unable to cope with the growing number of actors. Hopefully, in time, domestic legal systems and the community of international intermediaries will absorb the modern international "law merchant."

IV. CONCLUSION: LEGAL CHANGE

Maintaining existing law, on the one hand, and changing the law, on the other hand, involve costs and benefits. As compared to the status quo, change is costly in terms of learning and adaptation, and greater uncertainty.⁸⁰ However, as new problems arise and the environment changes, existing laws must respond and adapt. For example, securitization was invented to address problems caused by a transformed environment that existing institutions failed to solve. Cross-border securitization was invented to address problems caused by existing legal and business environments that failed to accommodate the securitization process.

There is an on-going tension between maintaining existing laws and changing them. In principle, an efficient change is that in which net gains from new arrangements exceed net gains from existing arrangements, which the new may destroy. Such a calculation, even if possible, is outside the scope of this Article.

Law can be changed by central lawmakers, such as government, and acquire the force of law upon passage. Law can be changed by markets—piecemeal and incrementally—and acquire the force of legal custom upon substantial following or adoption by central lawmakers. Cross-border securitization law starts in market lawmaking, which seems appropriate. Introducing a new financial process in a volatile environment requires experimentation, and substantial following. Markets offer more freedom from institutional constraints and require at the outset fewer risk-takers and lower consensus.⁸¹ Lawmaking markets produce a greater variety of responses to problems, and limit the adverse effect of unsuccessful experiments.⁸²

Private sector actors have incentives to both innovate and standardize the law. Securitization, domestic and cross-border, offer in-

80. See, e.g., JOSEPH ALOIS SCHUMPETER, *BUSINESS CYCLES* 88 (1st ed. 1939).

81. See Cooter, *supra* note 5, at 1666 ("[A] consensus will arise in the community about how agents ought to act. Such a consensus will convince some members of the community to internalize the norm. . . ."); *id.* at 1664 ("[I]nternalization of norms is the ultimate decentralization of law.").

82. In fact, some of the arguments against federalizing corporate and commercial laws and for vesting in the states the residual powers to make such laws are based on similar grounds.

centives for these actors to innovate. The subject matter of the law is sufficiently complex, so that numerous other actors find it less costly to resort to the innovators rather than learn the area and master the innovation. Also, the dollar amounts involved in the innovative transactions are sufficiently large to cover the innovators' development costs. These rewards are generally higher than licensing fees from trademark, copyright and patent protections. Therefore, in securitization and similar cases lawmaking develops in decentralized markets.

If these conditions are not met, innovative lawmaking is likely to develop by a central authority, such as a government or a large private sector corporation, and market law is likely to follow. However, in both cases market and central lawmaking complement each other. Standards follow unique innovations. Private sector innovators take active part in introducing standards that culminate in rules, and countries pass laws that accommodate securitization (by special laws addressing the process or by adjusting existing laws that hinder the development of securitization). This process has the earmarks of the common law "muddling-through,"⁸³ experimenting, adapting, and adjusting. Uniformity, however, is close by.

It is unlikely that the law of cross-border securitization will be enacted and enforced by a central international lawmaker any time soon, even though calls for such an institution have been heard.⁸⁴ Instead, uniformity in international norms will probably emerge through mechanisms such as the International Monetary Fund, the World Bank, cooperating governments and regulators,⁸⁵ regional markets seeking a more homogeneous institutional and legal infrastructure,⁸⁶ bodies developing principles and models of law,⁸⁷ and pri-

83. See, e.g., the Italian experience codifying and defining insider trading as compared to the American experience. See Eugenio Ruggiero, *The Regulation of Insider Trading in Italy*, 22 BROOKLYN J. INT'L L. 157 (1996) (demonstrating an ineffective codification).

84. See, e.g., John H. Chun, *Annual Survey Issue: International Insolvencies: Note "Post-Modern" Sovereign Debt Crisis: Did Mexico Need An International Bankruptcy Forum?*, 64 FORDHAM L. REV. 2647 (1996); Peter E. Millspaugh, *Global Securities Trading: The Question of a Watchdog*, 26 GEO. WASH. J. INT'L L. & ECON. 355 (1992).

85. See Rochael M. Soper, *Other International Issues: Promoting Confidence and Stability in Financial Markets: Capitalizing on the Downfall of Barings*, 7 DUKE COMP. & INT'L L. 651 (1997); Charles A. Samuelson, *The Fall of Barings: Lessons for Legal Oversight of Derivative Transactions in the United States*, 29 CORNELL INT'L L.J. 767 (1996) (posing the issue of regulation transfer from states to international arena).

86. See, e.g., Caroline Bradley, *The Case of Financial Services*, 12 J. INT'L L. BUS. 124 (1991).

87. See, e.g., Maria A. Volarich, *Note: Easing the Regulation of a Pan-European Securities*

vate agreements feeding customary laws that, like precedents, gain coercive momentum as they are replicated over time. Cross-border securitization is indeed without law in the traditional sense, but it is not lawless.