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Music Royalty Securitization: Is It Truly a Platinum Investment?

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Music Royalty Securitization: Is It Truly a Platinum Investment?

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Abstract

David Bowie took the securitization market by surprise when he originated the first-ever music securitization deal in 1997. He opened the door for artists to explore the advantages of securitization as a financial tool. Music securitization is the liquidation of music copyright royalties as underlying assets in debt securities. The main purpose of music securitization is to inexpensively raise a large amount of money, while still retaining ownership in the underlying intellectual property.

Music securitization offers a wide variety of benefits to artists, including long-term financing with a large tax break. It offers liquidity for otherwise illiquid and intangible assets, while diversifying the artist's portfolio. Although music securitization has the potential to be a platinum investment for artists, it comes with several costs that must be considered; however, the Bowie Bonds brought light to an advantageous tool that can be used to bring greater liquidity to any industry that relies on intellectual property, including film and sports.

Executive Summary

Securitization was a financial tool to benefit both issuers and investors. For issuers, it allows banks a source of long-term funding to improve balance sheet management. For investors, it allows them to diversify their portfolio. The structure of securitization is quite simple, even in music securitization. Once the investor(s) interested in the deal are solidified and the underlying assets are determined, then the deal proceeds as follows. The investor(s) receive debt securities from the special purpose vehicle (SPV), which are backed by the assets transferred, in this case the music copyrights. Then the proceeds from the sale of debt securities are used to pay the originator for the transferred assets. Then the principal and interest payments on the debt securities issued by the SPV are paid out of the cash flow generated by the receivables.

Securitization does not have the best reputation because financial players have abused the fact that securitization lacks transparency that other financial markets possess. Securitization is a type of off-balance sheet financing, so the underlying assets are kept off the records. Therefore, underperforming assets can be misconstrued to hide the losses and the toxicity of the deal. The vagueness of securitization was abused in the housing and mortgage markets to achieve monetary advances. The toxic bonds in deals that were labelled as high-rated deals, led to the collapse of the housing market. The "Great Recession" in 2008 shed light on the corruption within the securitization market because misaligned incentives led to "excessive risk-taking and socially suboptimal outcome" (Segoviano et al., 2013). The mass amount of corruption hidden within this market was alarming to the public. While there were signals pointing to an economic downturn, people believed the economy was thriving with very few worries about any financial crises leading up to the recession because "consumer spending as a percentage of GDP had risen for 40 years" (Barello, 2014). The Dot-Com bubble burst in the early 2000s had insignificant changes to the economy because it only temporarily effected consumer spending, but it quickly turned around. The key distinction of the Great Recession was the corruption and deception within the securitization market where cheap credit was being disguised as strong and safe investments. Since the 2007-2008 financial crisis, the securitization market has taken on a completely new makeover because regulators and policymakers implemented new rules, specifically the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, to ensure the U.S. economy will never experience déjà vu. To say the least, poor loan investments made prior to the recession will never exist again. Now the securitization market has transformed and even expanded within the past decade.

In this paper, the expansion and rise of new asset securitizations will be discussed. Specifically, the new trend of securitizing intellectual property which gave way for the innovation of music royalty securitization. The music industry historically struggles to keep liquidity within the market, so it prevents companies from signing more artists. Even when an artist is signed to a label, they often are underpaid because most music royalties are never paid out to the proper owner. This issue is known as the black box issue which refers to the pit of unpaid music royalties because most artists lack the knowledge of properly copyright registration. This knowledge gap is preventing artists from receiving these royalties, but securitization can be the solution to this issue. Securitization ensures the artist receives royalties upfront as the music copyrights are sold to a separate entity or SPV, so the artist does not miss out on any payments. The future of music securitization could be the solution the music industry has been looking for. This paper will explore the background of the first music securitization deal, Bowie Bonds.

The Bowie Bonds shed light on a hidden gem within securitization. Music royalties were never thought to be securitized because the cash flows were determined to be unpredictable. Music is largely based on people's preferences and tastes at the time, and it often changes very frequently. The constant change of music trends makes the music industry hard to analyze and predict. Strong predictions are the backbone for securitization deals because they are convincing investors that the underlying assets of the deal will achieve certain revenue streams. When the revenue of the assets does not act as predicted, it leads to bad deals and unsatisfied investors. Securitization markets rely on consistency, so Bowie's deal proved that music has the potential to be a strong investment choice. Since this deal, the music securitization market has continued to grow because more artists are learning how advantageous this financial tool can be for them.

The benefits of music securitization are extensive. Music artists receive money with a large upfront tax break. Securitization is also a tool for long-term financing that protects the artist against bankruptcy with greater returns than traditional financing. It offers artists new and innovative ways to invest their assets while protecting their credit worthiness. The costs of music securitization do exist, so it is important the artist considers them prior to deal origination. As mentioned before, the securitization market historically does not have the best reputation. Music copyrights are highly volatile and vague, so it can be difficult for the artist to prove that the assets are stable enough for investor interest. Securitization requires extensive due diligence that is conducted mostly by third party companies, so it can be very costly to pay these upfront costs. These costs might outweigh the benefits, so it is crucial the artist is aware of all aspects of securitization prior to origination.

David Bowie opened the door for music securitization as well as all intellectual property owners. Many other industries have dabbled in securitization, including the film and sports industries. These industries both deal with high costs, whether that is producing a new movie or hosting and broadcasting a soccer game. Either way, these industries suffer from insufficient funding, so securitization is a tool that provides immediate capital for future market growth. Securitization is a tool that has the potential to bring greater liquidity to a variety of markets; therefore, it is critical that people become more knowledgeable about this market.

The following introduction provides further detail into the securitization market as a whole and the history of music royalty securitization. By the end of the paper, the reader will have a better grasp on securitization, and its potential to expand the intellectual property markets.

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Securitization Introduction

The financial industry is constantly evolving through the creation of new and innovative solutions to improve processes, to fuel economic growth, and to match the needs of the ever-advancing technological society. Securitization is one of the solutions that began with the hope of promoting the secondary markets in mortgages by increasing the liquidity for mortgage lenders.

Securitization, or commonly referred to as structured finance, is not a new concept. In the late 17th and early 18th centuries, the idea of utilizing special purpose vehicles (SPV) to securitize debt was invented when the British Empire utilized mercantilist corporations as SPVs of sovereign debt securitization (Ross, 2022). This solution took off in Great Britain so much that by 1720 it reached its climax. About 80% of the country's national debt was being held by three corporations, the Bank of England, the South Sea Company, and the East India Company. The companies were utilized as SPVs for the British treasury; however, people began to question the safety of this solution due to the fear of monopolization overpowering the financial markets (Quinn, 2008). Great Britain began to slowly transfer the debt from the SPVs back into the bond market because the benefit of securitization was determined to be exhausted at that point (Quinn, 2008). The securitization market went dormant for almost 200 years until the United States originated the first mortgage-backed securitization deal. In 1970, the first securitization deal in the U.S. was originated by the government agency Ginnie Mae (GNMA), setting the pathway for the next major financial solution. In 1975, the first securitization deal centered around debt receivables was created by Sperry Corporation when it securitized its computer lease receivables (Kothari, n.d.). Fannie Mae advanced debt securitization to the next level in 1983 with the first collateralized mortgage obligations (CMO) deal (Ross, 2022). This type of deal is part of the mortgage-backed securities market; however, it incorporates diversification through the implementation of tranches and pooling. Since then, the securitization market expanded to other income-producing assets and receivables, such as student loans, auto loans, and credit card receivables.

The securitization market has been utilized to hide abusive behavior within the financial markets for monetary benefits, such as the Enron scandal and the Great Recession in 2008. Theses financial crises exposed the lack of regulation within the securitization market because it has only been in practice for about five decades. With the constant implementation of regulation, the securitization market is becoming an advantageous tool. Structured finance has great potential to create more liquidity in areas that need it the most, including the music industry.

Music Royalty Securitization Introduction

Historically securitization deals were centered around physical assets. As technology advances the value of non-physical property, it expands the amount of intellectual property which in today's age may be worth more than a physical asset. Intellectual property is a centuries old concept that dates to the ancient Greeks, and it has evolved over time into matters we think of today, such as copyrights and patents (Moore at al., 2022). In the United States, "the Statute of Monopolies granted fourteen-year monopolies to authors and inventors and ended the practice of granting rights to 'non-original/new' ideas or works already in the public domain" (Moore at al., 2022). The purpose of copyright within the music industry is to protect the ownership of each part of music for every party involved in the creation of it. The music industry has ideal assets to securitize because music royalties are a steady stream of revenue that continues to be collected over time. Securitization creates larger liquidity for the owners of those music rights, and David Bowie was the first one to take advantage of this lucrative opportunity.

The market for royalty securitizations began in 1997 with the first ever music royalty securitization deal called "Bowie bonds" (Kerr, 2000). Since the creation of the first deal, the music securitization market took off. In 2018, the music securitization market totaled $6.725 billion and continues to gain value each year (Misher et al., 2019). The music securitization has the potential to be the next gem within the financial industry. The rise in technology continuously expands the amount of income sources for music artists due to new innovations, such as streaming platforms, bringing in new revenue streams of royalty payment. The potential for securitization does not stop at music copyrights, rather this tool can be utilized in all types of intellectual property.

This past summer I interned within the structured finance department at Ernst and Young (EY) global organization. This opportunity gave me insight into the different types of securitization deals. As I was on the asset-backed securities (ABS) team, I got exposure to the many different assets that were securitized, including solar panels, credit cards, and car loans. I remember one day we were looking at the most unique deals that the team had worked on. The example that stuck out to me the most was David Bowie's deal because it seemed so odd for intellectual property to have such a great value that it could be used in a deal. The deals we studied had an average value of about $50 million, so I could not fathom the idea of music copyrights being valued to that degree. To my disbelief, Bowie was able to solidify a $55 million deal (Kerr, 2000).

Securitization proves to be a strong tool for investing high-value assets, especially for artists who lack financial stability but have the potential to achieve it. The average music artist is still strapped for money because "U.S. musicians only take home one-tenth of national industry revenues" (Wang, 2018), so it seemed like more artists should be taking advantage of this tool. These artists often do not receive their royalty fees because of the black box issue. The black box refers to a "pit of unpaid money that hasn't yet made its way to artists because of faulty metadata or bad communication amongst the various services" (Wang, 2018). This pit is estimated to be worth billions of dollars, but securitization has the potential to alleviate this issue. To better understand how securitization can give artists the proper revenues without any delay, we must first analyze the process of creating a music securitization deal.

Process of Creating a Music Royalty Securitization Deal

The first step of the process is to determine the assets being securitized. In this case, the music copyrights are the assets, so it is important to first understand the structure of music copyrights. The Copyright Act of 1976 went into effect in 1978, so all music produced after January 1978 is protected under this ruling (Hull, 2009). For music to be considered protected under this act, it must be original and “fixed in a tangible medium of expression” (Hull, 2009), meaning that the work must be formed further than an idea. The form it takes on can be very flexible as sheet music, video or audio recording, or digital file are all acceptable. All music that fits these criteria are considered copyright protected without requiring physical registration, but it is beneficial for the artist to file it with the copyright office to ensure the royalties are paid to the correct owner.

Music copyrights can be complex since they can involve many different parties or individuals, so it is critical to determine the ownership of the rights prior to confirming the deal—especially for the originator of the deal. For music copyrights, there are two sets of copyrights: one for the musical composition and one for the actual sound recording, which can belong to the same individual or many different parties. The composition copyright includes “the underlying musical composition: the arrangement of notes, melodies, and chords in a specific order” (Pastukhov, 2020). The composition is typically held by the songwriters or composers, and it can be managed by their music publishers who would then also own part of the composition copyright. While the master copyright includes the sound recording or “master recording” which is a series of musical, spoken, or other sounds fixed in a recording medium, called a “phonorecord” that is created by the performer and the producer of the recording (Pastukhov, 2020). Both parties have the same rights covered under section 106 of the Copyright

Act; however, the most fundamental interest are those that belong to the master copyright because they typically own the right to sell the song (Pastukhov, 2020). This tends to be the record company, the publisher, and the artist earning royalties from the record company based on the given contract.

Within the composition and master copyrights, there are numerous sources of royalties, including mechanical royalties, performance royalties, digital performance royalties, and master recording royalties. The owners to the musical composition copyright receive mechanical royalties every time that song is reproduced through recording, manufacturing, and distributing the work. In addition, owners to the musical composition copyright receive performing royalties when the music is performed publicly, whether on a radio, streaming service, or in a concert. While the digital performance royalties that are the royalties paid on streams is given to the master copyright owner, which is typically the record label company. The master recording royalties are also part of the master copyright. These royalties are incurred when the master recording is streamed, downloaded, or physically purchased. Since music can involve a variety of different parties or individuals, it is critical to determine the rights to which each party has in the agreements. The bottom line for the investors is to ensure that the originator owns the right to receive the royalty payments from the assets being securitized.

Another aspect to check is the maturity of the copyright contracts. The originator's copyright must not expire by law or by contract prior to the maturity of the transaction. According to the Copyright Act of 1976, the copyright's life was extended to the life of the artist plus 70 years, so music does have an expiration but has been extended to last a significant period (Hull, 2009). Once the investor understands the assets being securitized, the originator's ownership, and the copyright's maturity, then the investor can proceed with the deal.

The next process is valuing the cash flows and the overall assets comprising the deal. There are three cash flows present in a music royalty securitization deal: the royalty income from the copyrights, the liquidation income from the copyright's sale, and any credit enhancements (Damron and Labbadia, 1999). The copyrights must prove to have been generating significant and stable revenues over 10-20 years to be securitized, preferably those with trends of rising revenue (Damron and Labbadia, 1999). Different cash flow stress tests will be conducted to ensure the deal is stable enough to be securitized and to determine the growth rate of the assets. For example, if the assets prove to be consistent over the years, then a 0% growth rate will be assumed. If the earnings from the assets are inconsistent over the life of the transactions, then a negative growth rate will be assumed to create a better stress test (Damron and Labbadia, 1999).

Once the value of the cash flows is determined, then valuation is compared to the price of the repayment of the bonds. If the cash flow valuation is less than the amount needed to repay the bonds, then the proceeds from the liquidation of the music collection being securitized will be analyzed. The overall portfolio is the most important valuation and determining the multiplier necessary to liquidate the assets and pay the bonds in full. Once the multiplier is determined, it is applied to the most recent earnings or the average of the last five years of earnings to calculate the portfolio value (Damron and Labbadia, 1999). Often an independent party will calculate a separate estimate to ensure the value of the portfolio in relation to the potential buyers and to the open market because the credit rating company creating the deal may not have enough information to accurately calculate the value with those specific factors in mind; however, this valuation of the portfolio is only necessary if the cash flow valuation is less than the amount needed to pay off the bonds in a timely fashion, otherwise that step is not necessary for the deal to be securitized.

Now that the cash flows are determined and calculated, the structure of the deal must be formed. For securitization deals, a special purpose vehicle (SPV) is utilized to transfer the assets being securitized into a separate entity. The purpose of the SPV is to protect the investors from the risk of the artist going bankrupt because it separates the ownership from the originator. For example, Bowie had to transfer his royalty rights and licensing income into the SPV for the length of the deal, which removes the assets from Bowie's ownership through a true sale. A true sale transaction means the originator sells the assets being securitized to the SPV for the purchase price of the receivables (Kerr, 2000). Bowie sold his royalty and licensing rights for a value of $55 million that was estimated by valuing the royalty income from the "copyrights, the music publishing licenses, and the record sales from Bowie's 25 record catalogue of his earlier works" (Kerr, 2000). Unlike most securitization deals, the assets in this case are intangible and copyrights are protected by the federal government, so the federal law obstructs the state law and requires both a federal filing with the U.S. Copyright Office and a UCC filing to perfect the security interest. These filings prove that the SPV has a "first-priority perfected security interest in the assets for the benefit of the noteholders" (Damron and Labbadia, 1999).

The next steps are critical to ensure the deal is not too risky of an investment. The lawyers for the originator need to provide letters of opinion and other documentation, including title searches, tax returns, officers' certificates, and UCC filings. These documents ensure that there will be zero default payments and that the SPV holds clear, independent ownership from the originator. In addition, the deal must be rated by a reputable credit rating agency to provide insurance that these bonds are of a high investment grade. Credit enhancements can be provided by an external source to guarantee the payment on the bonds in the event the royalties drop below a certain threshold. From my personal experience working as a structured finance intern at

EY, our role was to ensure the credibility of the underlying assets by conducting various stress tests and quality control calculations, including tying out stratification tables and E-ticking rep-lines. These tests are then compiled into a document, called an AUP—Agreed Upon Procedures, that are shown to the potential investors to provide quality and safety insurance in the given deal.

Music royalty streams tend to be inconsistent, so structural features can be added to enhance the security of the bonds. For example, a cash reserve can be created to ensure the interest payments and the principal payment are completed in a timely manner. Another feature that can be implemented to protect the tax payments generated on the royalty and licensing revenues is a tax reserve. This feature is important if the seller's tax is seen as debt for tax, meaning the sellers own taxes on the generated revenues. The sellers may not have the ability to pay the taxes at the time of obligation; therefore, it is important to ensure that the sellers or the originators have the financial ability to pay these tax obligations in a timely manner. Once all credit and structural enhancements are completed, the bonds in the deal are then available for purchase.

The process of payment for the investor and the originator is quite simple, even in music securitization. Once the investor(s) interested in the deal are solidified, then the deal proceeds as follows. The investor(s) receive debt securities from the SPV, which are backed by the assets transferred, in this case, the music copyrights. Then the proceeds from the sale of debt securities are used to pay the originator for the transferred assets. Then the principal and interest payments on the debt securities issued by the SPV are paid out of the cash flow generated by the receivables.

In the Bowie Bonds example, all the securities were bought by a single investor, Prudential Insurance Group through a private offering. The deal did not have to undergo registration with the SEC because it was a private offering that was completed by an accredited investor that is deemed to be a “qualified institutional buyer” (Kerr, 2000). The Bowie deal was a monumental deal for the structured finance industry because it was the first music royalty securitization deal and the first securitization deal that involved privately held intellectual property rights (Kerr, 2000). It laid the foundation for other artists, authors, actors, and owners of intellectual property to explore the offerings of the securitization market. Since the Bowie deal, the music industry has become far more complex, especially with the introduction of new technologies including streaming services. This change raises the question: are music royalty securitization deals worth it for today’s artists?

The Benefits of Music Royalty Securitization

Music royalty securitization allows artists to receive their deserved earnings upfront and in a timely fashion with little risk to the artist. The key issue with music royalties is that often artists do not receive the payments on-time or in some cases ever. As mentioned prior, the black box issue refers to the royalties that cannot be traced or located because poor copyright data management and the lack of copyright knowledge for many artists. Majority of today's artists are unaware of the ways to properly register copyrights and collect royalties (Brown, 2023). Today the total amount of uncollected royalties is estimated to be around $427 million, and a total of $1 billion of unclaimed royalties have been paid out to rights holders (Christman, 2019). The major issue for artists is that many do not register with the Copyright Office, so it is difficult to assign royalties to the proper recipients. This issue has worsened in recent years with the introduction of streaming platforms, allowing new artists to easily release their music with less barriers.

The Music Modernization Act created a solution to alleviate the black box issue with the formation of the Mechanical Licensing Collective (MLC). The MLC is a nonprofit organization created with the purpose of administering "blanket mechanical licenses to eligible streaming services in the U.S., and to pay resulting royalties to songwriters, composers, lyricists, and music publishers" ("Blanket License," n.d.). The main mission of this group is to hold streaming platforms accountable for distribution of music royalties to the proper recipients. With the introduction of music streaming, the way we listen to music has transformed. The music streaming market was estimated to be worth $29.5 billion and is expected to continue to grow at an annual rate of 14.7% through 2030 (SiriusXM Music for Business, 2023). It is time for artists to receive the proper royalties for their music without the fear of losing money to the black box. Music royalty securitization can be the ideal solution for many artists.

Music royalty securitization allows artists to receive their money upfront with a large tax break. The key difference for securitization deals in comparison to a regular bank loan is that the loans are of greater value because banks are much more conservative in giving personal loans. Banks normally lend about “10% of the liquid assets of the borrower” (Kerr, 2000). The securitized bonds are non-recourse, unlike personal loans, so “the bondholders cannot force the artist into bankruptcy if cash flows don’t meet expectations” (Kerr, 2000). The investors are at risk if the royalties are less than predicted and the bonds collapses, but the artist can only lose the catalogue itself without the risk of the bondholders going for their personal assets. This feature is a major benefit because artists tend to own valuable personal assets. These loans benefit both the artist and record label companies because normally artists will go to their record labels to receive advances against the royalties, but instead the labels do not have to pay advances because the artist will receive the cash flows upfront as part of the deal.

Another benefit is that the securitization deals provide long-term financing. In comparison to bank loans, the loans have a maturity of one to five years, while securitization deals are set to have an average life of 10 years (Kerr, 2000). In addition, the interest rate on securitized loans is a fixed rate, so they will not be affected by fluctuations in the market. While bank loans provide a floating rate, so if the interest rate increases, then the artist will be responsible for paying the higher interest rate with additional points for the bank fee (Kerr, 2000). The yield of a securitization deal is much higher than the yield of a bank loan. Securitization deals yield about 10 times the amount of a bank loan (Chen, 2000). Securitization provides the artist with a major monetary advantage because “the benefits of securitization translate into at least 20 percent extra income for the artist” (Chen, 2000).

Asset securitization provides tax advantages because securitization deals are non-taxable. The artist can defer taxes on the investment; however, if the artist simply sold their catalog, they would be taxed about 50% of the sale and receive only half of the sale. The reason these deals are free from income tax is because the artist sells the catalog or music assets being securitized to the SPV, so the artist is essentially borrowing money from the SPV and paying it back through future royalties. When transferring the assets to the SPV, the true sale is structured as a loan of cash upfront to avoid the income tax; however, the artist still must pay taxes on the music royalties. The SPV is structured as single-purpose subsidiary of the originator to avoid separate entity-level taxation. The investors in the deal will be taxed like normal debtholders, so the interest earned on the securities will be taxed as regular income (Chu, 1998).

Securitization offers the artist greater liquidity and portfolio diversity because it provides immediate cash for an otherwise illiquid asset. The artist can utilize the cash flows from the deal in a variety of other ways, including making other investments, producing more music, or using the cash for personal reasons. For example, Bowie utilized his capital to obtain all copyright interest in his works by purchasing his manager's interest (Kerr, 2000). Another way securitization creates diversification is through the ability of structuring the deal to include sub-streams to better meet the needs and preferences of each investor. For example, one sub-stream can be comprised of royalties from earlier years while another sub-stream can be comprised of royalties from later years. This structuring method allows for there to be greater diversity in the level of risk and predicted return for each sub-stream. The purpose of the structure is to attract a wide range of investors to the deal. Music royalty income can be split into many sub-streams with ranging complexities to create the desired amount of diversification. Securitization deals in nature are great tools for diversification because of the different tranches that are created in each deal. For example, a regular asset-back securities deal (ABS) typically has three tranches: A, B, and C. The A tranche, senior tranche, "almost always the largest tranche and is structured to have an investment-grade rating to make it attractive to investors" (Chen, 2023). While the B and C tranches have increasingly higher risk, they also yield higher potential returns. Each tranche within a given deal appeals to a certain type of investor, so the diversification encourages a wider range of investors. Diversification within securitized products "leads to the sum of parts being greater than the whole itself" (Solomon and Bitton, 2014).

Beyond securitization being a tool for diversification, it provides off-balance sheet financing. The artist benefits from the fact that securitization deals are off the originator's balance sheet. A regular bank loan appears on the liability side of the balance sheet for the borrowing person or party; however, securitization deals are seen as the replacement of assets, avoiding the addition of any liabilities. Securitization deals replace future royalty streams with liquid money through the utilization of an SPV. The future royalties from both the record and publishing rights are transferred to the SPV through a pre-sale in most cases, so the transaction does not appear as debt on the originator's books, unlike a bank loan. The major benefit to this type of financing is that it "does not increase debt-to-equity ratio and as a result has no negative impact on the originator's creditworthiness" (Solomon and Bitton, 2014).

Another major benefit of securitizing music royalties is that the rights of the music catalog are kept to their respective owners. Once the bonds of the securitization deal are repaid, then the music royalty income is given back to the original owner of the rights. The artist then does not need to be concerned with losing the rights to their music, which is a critical factor in intellectual property because the owner of the rights can utilize their rights while licensing parts of it to others. Historically, intellectual property owners generally had to sell her copyrights to obtain an advance, so the owner would no longer be able to receive future royalties. For example, if the catalog was worth twice the original valuation given in the deal, then the owner gets to reap the benefits of greater, future music royalties. MLC holds streaming services accountable for distributing proper royalties, so music copyrights have greater opportunity to grow in value. Therefore, it is pivotal that the owner maintains full rights to reap these future proceeds. Music royalty securitization is a financial tool that can offer artists a multitude of benefits; however, the artist must decide if the positives outweigh the negatives.

Challenges of Music Royalty Securitization

Music royalty securitization is a complex process with many factors to consider prior to deal origination. Historically, the securitization market does not have the best reputation because it has been abused by large financial players, in turn, resulting in two major economic crises. The securitization market is an ideal tool to hide malpractice within the finance industry because there is gap between the investors and the deal holders. The gap is largely in part of the usage of SPVs because they are off-balance sheet financing tools, so companies can easily hide the true numbers of the deal.

On December 2, 2001, Enron one of the largest companies in United States at the time disintegrated into nothing overnight due to the misuse of securitization. The company "was the seventh largest corporation in the United States" (Solomon and Bitton, 2014), and at its peak the shares of the company were valued at $90.75 (Segal, 2023). Enron utilized SPVs to hide its actual balance sheet numbers to misconstrue the public into thinking it had higher profits with few losses. The SPVs were created with the "purpose of conducting transactions that were intentionally misclassified and misrepresented in its financial reports" (Solomon and Bitton, 2014). Enron was able to keep their losses off the books because the projects with lower expected revenue were transferred to a SPV. The losses were then off-the-books, so it went unreported and allowed Enron to "write off unprofitable activities without hurting its bottom line" (Segal, 2023).

Once the scandal was publicized, people began to be concerned that SPVs were encouraging immoral actions and needed to be further regulated before this tool can be trusted again. In July 2002, the Sarbanes-Oxley Act was signed into law to better regulate the securitization market and promote accurate financial reporting. The act set out further reformation and regulation in four key areas within the financial industry: corporate responsibility, increased criminal punishment, accounting regulation, and new protections. There are three sections within the act that highlight the most important provisions within this lengthy legislation. Section 302 of the act "mandates that senior corporate officers personally certify in writing that the company's financial statements comply with SEC disclosure requirements" (Kenton, 2022). This section has the power to imprison corporate officers if they certify false financial statements. In section 404 of the act, it states that "management and auditors establish internal controls and reporting methods to ensure the adequacy of those controls" (Kenton, 2022). This section has specific requirements for companies to uphold sufficient reporting controls; however, these rules have sparked controversy because it is costly for publicly traded companies to establish and maintain these controls. These rules are necessary for these companies to be exact in their reports to ensure another Enron scandal does not occur in the future. Lastly, section 802 of the act contained three rules to prevent falsification of records, to establish strict rules for the retention period of record storage, and to outline the specific records that must be stored. This act did not prevent the securitization market from being abused for financial incentive because the financial crisis of 2008 took the Enron scandal to a greater level.

The crash of 2008, known as the Great Recession, brought to light more scandalous behavior hidden behind the securities market. The housing market prior to the crash experienced a decade-long expansion period that began in the 1990s and even survived the 2001 recession—the Dot-Com Bust. The market was seeing records highs because the "home ownership in this period rose from 64 percent in 1994 to 69 percent in 2005, and residential investment grew about 4.5 percent of US gross domestic product to about 6.5 percent over the same period" (Weinberg, 2013). The housing market expansion led to an expansion in the home mortgage market with the increased offering of sub-prime mortgages. The securitization market allowed for these sub-prime mortgages to be bundled into MBS and CDO deals that were given AAA ratings but were mostly comprised of junk bonds. Home prices began dropping, and people were stuck with homes that were worth less than what they paid for them. Some of the subprime borrowers were obligated to pay for mortgages they could not afford, forcing them into bankruptcy. The housing market began to crash in 2007 because financial institutions were faced with toxic MBS deals that were being valued at trillions of dollars, but the assets were worth nothing. By March 2008, the U.S. economy was in a recession with major stock indices suffering the worst losses to date.

In response to the 2008 crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 were created to help restore the economy. The Dodd-Frank Act created "new government agencies tasked with overseeing the various components of the law and, by extension, various aspects of the financial system" (Hayes, 2023). The SEC Office of Credit Ratings was established to prevent credit rating agencies from giving out "misleading favorable investment ratings" (Hayes, 2023) because it led to people believing they were making safe investments when the securitization deal was comprised of mostly junk bonds with great risk of collapsing.

These two major financial events have proven that the securitization market is a risky tool that was maliciously used to gain monetary benefits; however, the government continues to amend its legislation with the purpose of bringing more regulation and transparency to securitization. The securities market allows for the liquidation of assets that are otherwise illiquid, but the risk is that the players in this market have proven to manipulate the rules to better themselves.

Securitization historically does not have the strongest reputation, but it has the potential to help the intellectual property industry because the deals provide a diverse and strong investment for artists and music companies alike. The financial crisis dealt with deals whose underlying assets were home mortgages which are completely unrelated to intellectual property. It is believed that "IP rights will continue to be used as an acceptable tool for raising credit, especially in an age when they are becoming a significant component in the economies of developed countries" (Solomon and Bitton, 2014).

Although IP rights may be seen as a strong asset for securitization deals, the copyright cash flows tend to be highly volatile. IP rights are valued based on the majority's tastes and preferences which are difficult to determine. People may stay consistent or change their mind rapidly when it comes to music and other intellectual property because it is highly affected by fads, trends, technological changes, or by the legal environment. These factors deal with people's psychological reasoning, which is hard to analyze and predict. Therefore, it makes valuing deals unpredictable and risky.

Intellectual property deals with patents and copyrights which have been scrutinized for vagueness due to the many flaws within the patent system. These concerns of validity within IP patents and copyright affects the feasibility of securitization because the rules lack specificity. New rules and regulation have been put in place since the Copyright Act of 1976, including the Music Modernization Act. This act like many other amendments to the Copyright Act create explicit rules for statutory licensing. They are meant to create greater fairness and clarity within intellectual property, especially with the constant rise in technological innovations.

Another issue driven from the rise of technology is copyright infringement. It is more difficult for regulators to detect and enforce IP infringement, in turn, "widespread infringement significantly affects the value of IP rights and the expected returns" (Solomon and Bitton, 2014). As more regulation is put into place to alleviate IP violations through the internet, this problem will subside in the future.

The cost of creating a securitization deal is another factor to consider for artists. The transaction involves a wide variety of parties due to the number of laws it involves, including securities, bankruptcy, copyright, and corporate law. The process of originating a deal is lengthy and requires a lot of analysis to ensure the deal is viable and strong. During my internship experience, the structured finance department within EY could spend up to several months analyzing a deal and ensuring the quality of it. The AUP report, the product of our work, was only one piece within an intricate process of analysis necessary to create securitization deals. These steps are vital to the origination process due to the past abuse within the securities industry. As mentioned before, there are greater regulations to prevent future risk within this market, which comes with a greater cost to the originator. The artist is responsible for these fees including legal fees, underwriting fees, rating agency fees, etc. The Bowie Bonds' fees were valued at about "ten percent of the cost of the funds over the life of the bonds" (Kerr, 2000). The artist or originator of the deal must be willing to pay for these upfront costs to reap the future benefits of the investment.

Although the ownership of the intellectual property rights is maintained by the original owner, the sense of full ownership is lessened because "you're dealing with third parties that have to make sure the loan gets liquidated" (Kerr, 2000). The owner may have to be less particular when it comes to who it licenses its music to because the cash flows of the rights need to meet certain expectations to pay off the bond at maturity. The owner faces this issue only during the deal because they will maintain full ownership post-deal. Another key factor is that the artists still have the final decision at the end of the day, so they can still voice their opinions.

Securitization for artists in today's music industry may not be as easy as the artists before them. For example, David Bowie sang, performed, composed, and played an instrument, so he essentially owned the all the rights to his music. Today, many artists rely on others to compose, write the lyrics, play the instrumental, and produce the music, so they end up have very little rights to their music. Today's music is often seen as a fad that will be forgotten in a year from now, unlike Bowie whose music is still being enjoyed today.

Another factor to consider is the new trend of digital sampling that has infiltrated most genres of music today. Digital sampling is "the process used by artists to include previously recorded portions of another artist into a new recording" (Kerr, 2000). Those who include digital sampling pay the original artists royalties a portion of the royalties they earn according to the Copyright Act, so the sampling causes the royalties to be limited. For securitization to be profitable for artists, they must own a sufficient portion of the royalties. As part of creating a securitization deal, the artist must obtain a clear title to all potential royalty streams, so the cost of it may outweigh the benefit of securitization.

Most artists struggle to become a mainstream star for a long period of time because "very few can get pass the sophomore jinx, much less, a third or fourth album" (Kerr, 2000). Securitization deals require the artist to have a strong track record for about thirty years to be an eligible candidate because investors need historical data that proves to be steady and reliable. David Bowie's catalog had existed for about twenty to thirty years, providing sufficient historical data to prove that the deal would be viable for the investors and that the bond would be paid off in full at maturity. Otherwise, securitization may not be feasible for many artists today because the average artist career length is estimated to be 17 years (Lamere, 2011).

The costs of securitizing music royalties are not unreasonable because all securitization deals incur high fees. The major consideration for artists is determining whether the music catalog that is being securitized earns sufficient and stable cash flows for over a reasonable period to create a strong deal that is appealing to potential investors. If the artist believes this to be true, then it is a promising financial tool that will create upfront cash flows and diversify her portfolio.

The Future of Intellectual Property Securitization

Bowie opened the doors for artists and owners of intellectual property to have a chance at advancing their financial portfolio with securitization. Since the Bowie Bonds deal in 1997, many other music royalty securitization deals have occurred. The second music royalty deal was completed by the same businessman, David Pullman—the founder, chairman and CEO of the Pullman Group, a principal investment bank and specialty finance company. He raised $30 million for the Motown writing trio, Holland-Dozier-Holland, whose assets were valued at over $100 million (Chu, 1998). He continued to create deals for other infamous artists, including James Brown and Ashford & Simpson. With his great success, the industry coined the bonds after Pullman, naming them "Pullman Bonds" (Chen, 2000) because unlike his competitors, he has formulated guidelines when it comes to creating a music royalty securitization deal. Pullman looks for artists that are legendary and are earning royalty income for a sustained period. For example, "with Ziggy Stardust it's nearly 30 years later and we *know* if it's still producing income 30 years later—remember with artists, 90 percent of the income comes in the first 6 months after release—so if this song's producing this 30 years out, that's what it should be doing forward" (Chen, 2000).

Although many critics believe this criterion limits the potential for music royalty securitization to expand, this asset class is still in its infancy. Similar to auto loans and credit card security, "asset-backed securities were brand new, [but] it kept evolving" (Chen, 2000). The major reason music securitization will persevere is that the deals benefit both parties, the record companies and bond firms. It provides capital for the record companies to sign more artists and it brings a new market of securitization for the bond firms. Since Pullman Group has established their reputation within music securitization, other companies have investigated other intellectual property deals, including film and sports.

Film companies benefit greatly from securitization because each film requires large amounts of capital. Major film companies have created securitization deals, including DreamWorks. DreamWorks raised $1 billion “backed by a portfolio of live action and animated films” with the purpose to “remove film production risk and to reduce exposure to film performance risk” (Townsend, 2002). The underlying assets of film deals are the future revenue from movies that are currently unreleased and complemented with cash reserves from past movies of the film company. The deal provided more opportunities for DreamWorks because it reduced its cost of borrowing and extended the company’s access to debt funding. The success of the deals proved that the film industry has the potential to be a strong asset class for securitization.

Another industry that was introduced to securitization was the sports industry. Many soccer leagues around the world needed funding after the stock market’s interest in soccer shares diminished due to “the clubs’ inability to keep their costs under control” (Harverson, 1999). In 1999, the first ever securitization deal within the soccer industry for the Newcastle United league. They utilized “its gate and hospitality receipts for the sum of £55 million” (Weston, 2002). After this initial deal, many other clubs have followed in their footsteps to generate more capital and pay off the high costs associated with running a soccer league. The advantages of securitization provided the necessary funding needed for these teams to survive, and it sparked greater investor interest back into the game.

Conclusion

Securitization is a financial tool that has the potential to bring greater liquidity to intellectual property markets. The music industry was taken by storm when David Bowie created the first-ever music securitization deal in 1997. This deal was a prime example that music copyrights have the viability to be used as underlying assets within a securitization deal.

Securitization historically has been abused for monetary advantages, as seen in the Enron scandal and the Great Recession in 2008. These two scandals caused concern and fear within securitization markets because the off-balance sheet financing hides toxic bonds within the market; however, the market has been increasingly regulated, and it will continue to be improved in the future.

The extensive benefits discussed in this paper prove the worthiness of securitization, while there are costs associated with this tool. Music securitization opened the door for other intellectual property markets to reap the benefits of securitization. The increased liquidity in these markets allows for further creative innovation within society. It is critical that owners of intellectual property are knowledgeable of securitization as an investment instrument.

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