UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

THE LOAN SYNDICATIONS AND TRADING ASSOCIATION Plaintiff, v. SECURITIES AND EXCHANGE COMMISSION and BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM Defendants.	No. 1:16-cv-652 (RBW)

UNCONTESTED MOTION OF THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA FOR LEAVE TO FILE AMICUS BRIEF

The Chamber of Commerce of the United States of America (the "Chamber") respectfully moves to file in this matter an amicus brief the Chamber previously filed in the United States Court of Appeals for the District of Columbia. The Chamber has attached the previously filed brief as Exhibit A. In support of its motion, the Chamber states the following:

1. The Chamber is the world's largest business federation. The Chamber represents 300,000 direct members and indirectly represents the interests of more than three million companies and professional organizations of every size, in every industry, from every region of the country. An important function of the Chamber is to represent the interests of its members in matters before Congress, the Executive Branch, and the courts. The Chamber thus regularly files amicus curiae briefs in cases raising issues of concern to the Nation's business community.

2. The Loan Syndication and Trading Association's (the "LSTA") petition for review is of vital importance to the members of the Chamber, many of which rely on

collateralized loan obligations ("CLOs") as a critical source of capital. The Chamber therefore respectfully submits this brief to assist the Court by providing its "unique [] perspective" regarding the benefits that CLOs provide to the U.S. economy; the costs that the agencies' rules would impose on thousands of commercial enterprises that contribute to the health of that economy; and the failure of the agencies to properly consider the effect of their rules on efficiency, competition, and capital formation within the market. *Jin v. Ministry of State Sec'y*, 557 F.Supp.2d 131, 137 (D.D.C. 2008) (quoting *Ryan v. Commodity Futures Trading Comm'n*, 125 F.3d 1062, 1064 (7th Cir.1997)).

3. Counsel for the Chamber have conferred with counsel for all parties, who have consented to this motion.

For these reasons, the Chamber respectfully requests leave to file its attached amicus brief.

Dated: May 5, 2016

Respectfully submitted,
/s/ Carl J. Nichols________________

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CERTIFICATE OF SERVICE

I certify that on May 5, 2016, I filed the foregoing using the Court's CM/ECF system, which will send notice of the filing to all registered CM/ECF users.

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Exhibit A

ORAL ARGUMENT NOT YET SCHEDULED
Nos. 14-1240 & 14-1304

UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

LOAN SYNDICATION AND TRADING ASSOCIATION,
Petitioner,

v.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION;
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,

Respondents.

On Petition for Review of a Final Order of the U.S. Securities and Exchange Commission and the Board of Governors of the Federal Reserve System

BRIEF FOR THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS AMICUS CURIAE SUPPORTING PETITIONER

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 26.1 of the Federal Rules of Appellate Procedure and D.C. Circuit Rule 26.1, amicus curiae certifies that it has no outstanding shares or debt securities in the hands of the public, and has no parent company. No publicly held company has a 10% or greater ownership interest in amicus curiae.

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GLOSSARY

Board	Board of Governors of the Federal Reserve System
CLO	Collateralized Loan Obligation
LSTA	The Loan Syndications and Trading Association
Commission	United States Securities and Exchange Commission

INTEREST OF AMICUS CURIAE

The Chamber of Commerce of the United States of America ("the Chamber") is the world's largest business federation. The Chamber represents 300,000 direct members and indirectly represents the interests of more than three million companies and professional organizations of every size, in every industry, from every region of the country. An important function of the Chamber is to represent the interests of its members in matters before Congress, the Executive Branch, and the courts. The Chamber thus regularly files amicus curiae briefs in cases raising issues of concern to the Nation's business community.

INTRODUCTION

Collateralized Loan Obligations (CLOs) are investment vehicles made by securitizing large commercial loans generally originated by large banks. CLOs provide a critical source of financing for thousands of U.S. companies—especially those with relatively high levels of debt that lack access to funds from sources available to less-leveraged companies—and comprise a significant portion of the $1.2 trillion leveraged loan market (the market for large loans provided to U.S. commercial enterprises with relatively high levels of debt). Doc.429.6-7. Unlike many other types of securitizations, CLOs are stable and transparent long-term investments that provide U.S. businesses with a consistent and dependable source of financing. And relative to other types of securitizations, CLOs performed

exceptionally well during the financial crisis. CLOs are thus a critical and reliable source of funding for thousands of U.S. businesses, many of which are members of the Chamber.

The final rules challenged here, however, ignore the differences between CLOs and riskier securitizations and adopt costly risk retention requirements that would require managers of CLOs to hold 5% of the economic value of a CLO's assets. The agencies recognized that their rules would come with "significant costs on financial markets," Doc.5.77708, and likely would cause "fewer CLO issuances and less competition in this market," *id.* at 77657. The agencies also concluded that their rules would increase costs to borrowers, "either in terms of increased borrowing costs or loss of access to credit." *Id.* at 77708. Indeed, the record before the agencies showed that their rules could reduce the amount of credit available through CLOs by as much as $170-$250 billion, thereby increasing the borrowing costs for U.S. companies by as much as $2.5-3.8 billion per year, with a corresponding negative effect on economic growth and job creation by businesses lacking alternative sources of credit. Doc.429.21.

Although the agencies were well aware of (and indeed recognized) these costs, their justification for imposing them on the market—and for treating CLOs like other types of securitizations—lacked support or any rational basis. For example, the agencies concluded that even if the market for CLOs contracted

substantially (as the administrative record demonstrated), lending might "continue at a healthy rate" because other, riskier types of investors like hedge funds and loan mutual funds "*may* replace some of the supply of credit lost to exit from the market of CLO managers." Doc.5.77657 (emphasis added). But the agencies identified no evidence supporting this conclusion, and failed to address the fact that such alternative sources of credit would be substantially more expensive than CLOs. Perhaps most remarkably, the agencies failed even to address the fact that increased financing from these non-CLO investors would be inconsistent with the very rationale they articulated for the rules in the first place: The introduction of unregulated investors would create a more volatile environment and greater systemic risk than the CLOs they would replace. And although the agencies claimed that the impact of their rules *might* not be as grave as predicted, they again failed to rely on any evidence for this unsupported assumption (and indeed assumed that almost half of existing CLO managers would exit the business).

Perhaps these costs might have been justified if the agencies had established a countervailing benefit. But the only benefit identified by the agencies was the speculative concern that the continued use of CLOs could result in "lower quality commercial loans," which (if it happened) might increase systemic risk to the U.S. economy. Doc.5.77657. In determining that CLOs *might* contribute to increased systemic risk, the agencies arbitrarily dismissed the variety of ways that the

structure of the CLO market—such as transparency to investors, CLO managers' performance-based fee structure, and the active management of CLO assets by CLO managers—makes it less vulnerable to the sort of moral hazards that create systemic risk, and allowed CLOs to prove so stable during the financial crisis. The claimed benefit is also undermined by the differences between stable CLOs and the more volatile investors, like hedge funds and loan mutual funds, that the agencies predict would replace them. And the agencies failed to consider ways that a reduction in systemic risk could be achieved by less costly means, either through alternatives offered by commenters that would be better tailored to the CLO market or more direct forms of agency action such as enhanced underwriting guidelines or improved interest rate policies.

In sum, the agencies failed to satisfy the most basic requirements of administrative rulemaking—"examin[ing] the relevant data and articulat[ing] a satisfactory explanation for [their] action." *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983); *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (agency "acted arbitrarily and capriciously" by failing "adequately to assess the economic effects of a new rule").

LSTA's petition for review is therefore of vital importance to the members of the Chamber, many of which rely on CLOs as a critical source of capital. The Chamber therefore respectfully submits this brief to highlight the benefits that

CLOs provide to the U.S. economy; the costs that the agencies' rules would impose on thousands of commercial enterprises that contribute to the health of that economy; and the failure of the agencies to properly consider the effect of their rules on efficiency, competition, and capital formation within the market.[1]

BACKGROUND

I. THE CLO MARKET

It is a fundamental reality of the modern economy that access to capital is of critical importance to the ability of U.S. businesses, large and small, to conduct and improve their operations, innovate, and hire employees. One significant source of capital in the U.S. economy is the leveraged-loan market, which includes both high-yield bonds and commercial loans from syndicates of banks or individual financial institutions, known as "leveraged loans." (Other sources of capital include the equity markets and tradable investment grade bonds.) In 2013, the total value of outstanding corporate credit in the leveraged finance market was nearly $2.2 trillion. Doc.429.4.

The high yield bond side of the leveraged-finance market is relatively inflexible and generally subject to strict rules. As a result, it tends to provide capital to large, brand-name borrowers. Smaller, less-established borrowers, as

[1] All parties have consented to the filing of this brief. Counsel for the Chamber certifies that no counsel for a party authored this brief in whole or in part and that no person, other than amicus, its members, or its counsel, made a monetary contribution to the preparation or submission of this brief.

well as highly leveraged borrowers, are generally unable to raise capital through bond issuances, or would have to do so at highly unfavorable terms. Doc.429.4.

Such companies instead turn to leveraged loans, which offer companies the ability to take on debt that typically has more flexible terms and that is better customized to the companies' specific economic needs. Leveraged loans are typically syndicated loans: because the loans tend to be very large (usually too large to be held by one lender), the funding for the loan is "syndicated" among a group of lenders. One or more lenders serves as an "arranger" for the loan, usually based on a relationship with the borrowers. Doc.142.5.

Certain specialized investment vehicles provide the vast majority of investment dollars in the leveraged loan market. These investment vehicles, which are managed by professional investment managers, pool funds from end-investors that would be otherwise unable or unwilling to shoulder the range of operational and administrative burdens required of lenders. Doc.429.4-5.

CLOs are a type of specialized investment vehicle designed to invest in leveraged loans. Doc.429.6-7. CLOs are similar in structure to mutual funds, and generally work as follows. A CLO investment manager—usually a regulated investment adviser under the Investment Advisers Act of 1940 (Doc.467.46) who has agreed to act as an agent for the CLO (Doc.8.17)—accepts money from investors and then selects syndicated loans (or portions of syndicated loans) to

purchase as part of the CLO's loan portfolio.[2] The loans in which CLOs invest are generally senior secured syndicated loans made by large banks to U.S. companies. The manager then actively manages that portfolio for the life of the CLO.

The characteristics, credit risk, and performance of the underlying loans are highly transparent, and the typical CLO portfolio contains just 100-150 loans. These characteristics allow a CLO manager to easily manage the CLO's portfolio and to track the individual loans in the portfolio, deciding to buy or sell loans given the needs of the CLO and the individual circumstances of a particular loan. These characteristics also allow investors to be fully informed about the assets in which they are investing. Doc.142.5-6; Doc.564.88-89.

The investment structure of a CLO typically involves the pooling of the income stream (payments of interest and repayments of principal) generated from the underlying loans and the creation of classes (usually called "tranches") of securities with differing priorities over that stream of income. Conservative investors, such as banks, invest in the senior-most CLO tranches, which provide the lowest risk and the strongest likelihood of repayment. Investors seeking higher returns in exchange for increased risk, such as hedge funds, invest in the junior CLO tranches. This structure allows for the matching of risk characteristics with

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[2] Amicus uses the term "CLO" to mean the "open market" CLOs at issue in the LSTA's petition, as distinguished from so-called "balance sheet" CLOs. The distinction between the two is set forth in Petitioner's Opening Brief at 7.

investors' risk appetites, thereby reducing the overall cost of credit to the economy and allowing companies that otherwise would have been excluded from the markets to access much needed credit and financing. Doc.429.9.

It is therefore not surprising that CLOs performed exceptionally well during the financial crisis, especially relative to other types of securitizations, due to a number of characteristics inherent in their structure:

- One of the central concerns arising out of the financial crisis was lenders' practice of originating loans with the expectation that any credit risk associated with the loans would be immediately transferred through complex securitizations, the so-called "originate-to-distribute model." Petitioner's Br. 17. Open market CLOs do not fit that model because CLO managers neither own nor originate loans and receive no fees relating to the origination of a loan. *Id*. at 13 (citing Doc.146.24-26; Doc.245.58-60).

- As regulated investment advisers under the Investment Advisers Act of 1940, CLO managers have fiduciary duties to CLOs and CLO investors. *Id.* (citing Doc.467.46; Doc.488.21-22).

- CLO managers largely earn their fees based on how the CLO's assets perform and receive much of their compensation after investors have been paid. *Id.* at 13-14 (citing Doc.142.6-7).

- CLO managers actively manage the portfolio of assets in a CLO, allowing them to adapt to changing market conditions. *Id.* at 16 (citing Doc.496.93-94).

- The underlying loans of CLOs are leveraged loans often issued to large, publicly listed companies and rated by ratings agencies, and are the result of extensive due diligence and negotiation by originators. Further, the loans are purchased and sold on the secondary market, which provides pricing information on a daily basis. *Id.* at 15 (citing Doc.245.59).

- CLO investors and managers often agree to certain limitations on the CLO's portfolio, such as limiting the CLO's assets to large company

loans or requiring that most of the loans have a priority claim on the borrower's assets. In addition, CLO loan portfolios are often diversified across industries and borrowers. *Id.* at 15-16 (citing Doc.467.47-48).

- CLOs often have performance-based triggers that protect investors in the lowest-risk tranches. *Id.* at 16 (Doc.229.App.A-12; Doc.496.93-94).

Due to these characteristics, no managed CLO triggered an event of default during the crisis, and losses were limited. Doc.229.90-91.

Of the more than $1.2 trillion in presently outstanding leveraged lending in the United States, CLOs provided nearly $300 billion. Doc.429.4-5, Doc.488.15; Doc.587.5. The companies that rely on this source of funding represent a broad swath of corporate America and "include companies from the health care, energy, retail, entertainment, and telecommunications sectors." Doc.89.4; Doc.564.93 (chart of industries that receive financing from CLOs). This includes companies such as Aramark, Cablevision, Chrysler Group, Delta Airlines, Ford Motor Company, Goodyear Tire, Rite Aid, SuperValu Stores, Toys R Us, and US Airways. Doc.200.App. A (list of Top 500 Companies in U.S. CLO Portfolios). It has been estimated that the companies that rely on CLOs for their funding employ more than five million people.[3]

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[3] *Hearing on The Dodd-Frank Act's Impact on Asset-Back Securities Before the Subcomm. on Capital Markets and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 113th Cong. (2014) (testimony of Meredith Coffey), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-mcoffey-20140226.pdf; *see also* Doc.587.5 ("The CLO market enables … companies to create and preserve millions of American jobs.").

II. THE AGENCIES' RISK-RETENTION RULES

Section 941 of the Dodd-Frank Act directed several financial regulatory agencies—including Respondents, the Securities and Exchange Commission ("Commission") and the Board of Governors of the Federal Reserve System ("Board")—to "jointly prescribe rules to require any securitizer to retain … not less than five percent of the credit risk for any asset" subject to securitization. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 941, 124 Stat. 1376, 1890 (codified at 15 U.S.C. § 78*o*-11) (the "Act"). The Act defines the term "securitizer" as either "an issuer of an asset-backed security," or "a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer." *Id.* § 78*o*-11(a)(3). The Act also expressly required that the agencies "shall" provide "a total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors," from the credit-retention obligation, *id.* § 78*o*-11(c)(1)(G), and granted the agencies the authority to "adopt or issue exemptions, exceptions, or adjustments" to their regulations, including "exemptions, exceptions, or adjustments for classes of institutions or assets relating to the risk retention requirement." *Id.* § 78*o*-11(e)(1). The Act identified various factors to be considered in granting any exemption, exception, or adjustment, including

"improv[ing] the access of consumers and businesses to credit on reasonable terms." *Id.* § 78*o*-11(e)(2)(B).

A. The Agencies' Rulemaking

As relevant here, the agencies conducted their rulemaking in three stages: a notice of their initial proposal on which they requested comment, Doc.1; a revised proposal on which they requested further comment, Doc.3; and a final order, Doc.5.

With regard to CLOs, the agencies first stated—in a single footnote in the notice of initial proposal—their view that the statutory credit risk requirement applied to CLOs and CLO managers. Doc.1.24098 n.42. Numerous commenters challenged that conclusion, explaining, *inter alia*, that CLOs have a number of features (including those discussed above, *see supra* pp. 8-9) that distinguished them from the sort of asset-backed securities that led to the financial crisis, and also that the CLO managers had a number of incentives to ensure that CLOs invested in quality loans. *See, e.g.*, Doc.142; Doc.89. Commenters also proposed various alternatives to the agencies' rules that better fit the structure of the CLO market. *See, e.g.*, Doc.8.

In their re-proposal, however, the agencies held to their original position, rejecting the proposed alternatives and setting forth what they call the "lead arranger" alternative (discussed below). *See generally* Doc.3.57961-57964. After

a further comment period, during which the agencies received comments questioning the feasibility of the agencies' proposed "lead arranger" alternative (Doc.587.4 (describing the alternative as "unworkable")) and proposing additional alternatives to the agencies' rules (Petitioner's Br. 51-52 (summarizing alternatives)), the agencies issued final rules that, in all relevant respects, were essentially the same as the proposed rule.

In particular, the agencies concluded that CLO managers fall within the statutory definition of "securitizers" because, the agencies claimed, CLO managers "organize and initiate" the sale or transfer of the underlying assets of the CLO by selecting the portfolio loans that will be purchased by the CLO itself. In doing so, the agencies declined to give effect to statutory terms that would have excluded CLO managers from the definition because a CLO manager does not originate, own, or even possess a single loan, and therefore cannot be the "issuer" of a security based on a loan and cannot "sell[] or transfer[]" an interest in a loan. *See* 15 U.S.C. § 78*o*-11(a)(3).

The agencies also refused to exercise their exemption authority to adjust the rules to permit CLO managers to meet the risk retention requirement by holding a specific percentage of the CLO's most subordinate securities (i.e., the portion of the CLO with the highest degree of risk). Several commenters had proposed an alternative in which CLO managers meeting certain investor-protective criteria

would be deemed to satisfy the risk retention requirement if they purchased 5% of the CLO's equity. Doc.424. As compared to the agencies' rules, these alternatives would have allowed many CLO managers to remain in the market because they would need to secure and commit less capital. Nevertheless, the agencies declined to adopt any of the alternatives, and did so without a finding that the credit risk reflected in the proposed alternatives was insufficient or even defending the very high levels of credit that CLO managers would have to retain under the agencies' rules.

As a result, the final rules require CLO *managers* to hold 5% of the "credit risk" of the CLO, with "credit risk" being based on the "fair value" or economic value of the assets, rather than being based on the risk of default. This 5% fair value interest must be held in a "vertical" form (a 5% pro rata holding of each tranche of issued security); in a "horizontal" form (comprised of only the most subordinate securities, amounting to 5% of the economic value of all the assets supporting the securitization); or in any combination of vertical and horizontal holdings amounting to 5% of that economic value.

The final rules also include the so-called "lead arranger" alternative, which would excuse certain CLO managers from the risk-retention requirement only if each financial institution that served as the "lead arranger" of each syndicated loan underlying the CLO retained a 5% interest in that loan. Doc.5.77651. To qualify

for this exception, the lead arranger for every syndicated loan held by a CLO would have to retain that interest for the entire life of each loan. *Id.*

B. Expected Effect Of The Risk-Retention Rules On The CLO Market

Throughout the rulemaking process, commenters informed the agencies of the substantial cost that these rules would have on the leveraged loan market and the ability of U.S. companies to access this important source of capital. For instance, an expert economic analysis demonstrated that the risk-retention rules threaten to reduce the CLO market by as much as 60 to 90%. Doc.429.14. This analysis concluded that only those CLO managers affiliated with a large insurer or a very large alternative asset manager could feasibly meet the rules' risk retention requirement, but only 10 of the 30 top CLO managers—estimated to represent roughly only 27% of the then-current CLO assets under management—met that criterion. Even many of those managers, however, were unlikely to retain 5% fair value based on the economic, managerial, and operational burden that the risk-retention requirement would impose. As a result, this analysis concluded, CLO capacity would be reduced by 60 to 90%, with a reduction of $170 to $250 billion in the credit available to U.S. businesses provided by CLOs to the leveraged-loan market. *Id.* at 14-15.

Other evidence before the agencies showed that their rules would cause CLO managers to exit the business. For example, in response to a survey requested by

the agencies (and developed and distributed by the LSTA), 35 CLO managers—representing 509 individual CLOs—estimated that, faced with the agencies' rules, they would be able to maintain fewer than 60 CLOs, resulting in a decline in total CLOs in the market of more than 80%. In response to the same survey, 85% of the CLO managers estimated that the CLO market would contract by 75% or more. Doc.6.3-6.

This substantial reduction in the CLO market would dry up a significant source of funding for many U.S. businesses. With fewer CLOs to provide capital and market liquidity, borrowers would be forced to seek other sources of financing, and such financing would come at a significant cost. Over half of the total investment in CLOs, concentrated in the lowest-risk portions of CLO investment structure, comes from global banks; but banks are unlikely to continue to provide credit to such corporate borrowers through non-CLO channels, given the restrictions on the risk and liquidity profiles for securities held in bank investment portfolios. Doc.429.16.

As a result, replacement financing could cost corporate borrowers $2.5-3.8 billion per year in additional interest costs. Doc.429. 21. This increase in credit costs would directly impact the ability of these companies to develop and innovate, slowing job creation and stifling growth and expansion. Doc.415.3. In particular, an increase in the cost of capital will reduce the efficiency of capital markets and

force companies to resort to more volatile and expensive alternatives as a replacement. It will also require businesses to build up cash reserves, removing productive capital that provides the dynamism and efficiency necessary for a growing economy. Distressed businesses may lose their only means of raising capital at all, shutting them out of capital markets all together. The result will be more expensive products for consumers, fewer jobs for workers, and decreased dividends for investors.[4]

C. The Agencies' Economic Analysis

The costs on competition and capital formation of the agencies' rules, therefore, were clear and well-supported. Indeed, even the Commission recognized that the rules "could impose significant costs on the financial markets," and acknowledged that borrowers "could face increased borrowing costs, or be priced out of the loan market, thus restricting their access to credit." Doc.5.77708.

The analysis of these costs in the joint portion of the final rules, however, was limited. The agencies acknowledged that applying the risk retention requirement to CLO managers could result in "fewer CLO issuances and less competition in this market." Doc.5.77657. But their response was a mere note that "other entities, such as hedge funds and loan mutual funds, also purchase

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[4] *Hearing on The Impact of the Volker Rule on Job Creators, Part 1, Before the H. Comm. on Financial Services*, 113th Cong. (2014) (statement of U.S. Chamber of Commerce), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-113hhrg88521/pdf/CHRG-113hhrg88521.pdf, at 15-16.

commercial loans" and the belief that "the market will adjust to the rule and … lending to creditworthy commercial borrowers … will continue at a healthy rate." *Id*.

The Commission itself—in a separate economic analysis that prompted criticism from a dissenting Commissioner for the "glaring" absence of economic analysis from the other rulemaking agencies[5]— recognized that fewer CLO issuances "may increase cost to leveraged loan[] borrowers, " Doc.5.77728; and that increased costs for CLO managers, which do not currently retain risk "would likely be passed on to borrowers, either in terms of increased borrowing costs or loss of access to credit," *id.* at 77708.

Faced with substantial evidence that the rules would impose substantial costs on the U.S. economy, the agencies questioned these negative effects in two ways. *First*, the Commission stated that "CLO managers with lower cost of funds and capability to satisfy the risk retention requirements *may* replace some of the supply of credit lost due to exit from the market of CLO managers with higher cost of funds." Doc.5.77728 (emphasis added); *see also id*. at 77727-77728 (Commission criticizing the economic analysis in record for assuming that CLO managers have

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[5] Commissioner Michael S. Piwowar, Dissenting Statement at Open Meeting Regarding Final Rule on Credit Risk Retention (Oct. 22, 2014), *available at* http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370543243405#.VRrH2vlWrTA.

no economically feasible way to remain in the market and that originators would not use the lead arranger option, but providing no record evidence to the contrary).

The Commission also conceded that it was "unable" to directly measure the potential costs of capital necessary to satisfy the rules, or to determine the "relative portion" of the CLO market that would no longer be able to sponsor CLOs "as a result of the increased costs." Doc.5.77729. Instead, by merely splitting a list of 111 "known" CLO managers into two general categories, the Commission determined that an estimate of the impact of the rules would be the exit of 48% of CLO managers, a 39% reduction in CLO issuances, and a 37% reduction in capital formation. *Id*. at 77729-77730.

Second, the Commission—following the agencies' bare prediction that hedge funds and loan mutual funds might replace CLOs in the market, Doc.5.77657—posited that "non-CLO investors" such as "hedge funds, loan mutual funds, and insurance companies" "*might* invest more capital given the right incentives" or, "instead of purchasing leveraged loans on the secondary market, would join in as part of the syndication." *Id*. at 77728 (emphasis added); *see also id*. at 77730 ("Mutual funds, private equity funds, private equity mezzanine loan funds and credit funds … currently invest directly in the leveraged loan market and *may* increase their direct purchase of leveraged loans if smaller CLO managers exit the market." (emphasis added)); *id*. at 77657 (same). The Commission further

suggested that the 20% of CLO investors who invest in the tranches with the highest risk would continue to supply capital through alternative channels of investment. *Id*. at 77730. The agencies supported their assumption, however, with neither data nor empirical evidence—and based on their assumption, concluded that "the market will adjust to the rule and … lending to creditworthy commercial borrowers … will continue at a healthy rate." *Id*. at 77657; *see also id.* at 77726-77727 (questioning that rules would cause "a significant reduction in liquidity to a critical sector of the U.S. economy" as "assum[ing] that other lenders will not enter the market with sufficient capital to compensate for the loss of bank capital in the event that large banks curtail their involvement in the CLO sector.").

Even though the Commission "acknowledge[d] that risk retention may generate significant upfront costs to the CLO and the leveraged loan market relative to current practices or the proposed alternatives provided by commenters," Doc.5.77728, it rejected various alternatives suggested by commenters. The Commission faulted both current practices and the proposed alternatives for "not do[ing] enough to align incentives between sponsors and investors which, in the long term, *could* impose larger costs on the market than the risk retention requirements of the final rule." *Id.* (emphasis added); *see id.* ("The Commission believes that commenters' alternative suggestions do not create sufficient incentive

alignment, or 'skin in the game,' for sponsors to ensure that originators maintain high underwriting standards").

As against these costs, the only benefit of the rules identified by the agencies was the supposed avoidance of "poorly underwritten loans" that "could generate systemic financial risks." Doc.5.77657-77658. Relying on stray statements from various agency reports, the agencies maintained that the recognized "impacts on the CLO market are justified" by their "concerns about recent activity in the leveraged loan market." *Id.* at 77657. And despite evidence submitted by commenters showing that CLOs did not contribute to the financial crisis, the agencies nonetheless concluded that their rules "will help ensure the quality of assets purchased by CLOs, promote discipline in the underwriting standards for such loans, and reduce the risk that such loans pose to financial stability." *Id.*

ARGUMENT

The Chamber agrees with, and joins, LSTA's arguments that the agencies misconstrued the statutory term "securitizer," 15 U.S.C. § 78*o*-11(a)(3), to include CLO managers. The Chamber also agrees with, and joins, LSTA's argument that the agencies misinterpreted the term "credit risk" to require that the interest that must be retained be based on economic value rather than credit risk. The Chamber does not, however, address those arguments here.

Instead, this brief addresses the agencies' failure both to assess the costs and support the purported benefit of their rules. Because the agencies did not thoroughly "examine the relevant data" and "articulate a satisfactory explanation" for their rules, *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983), and because the Commission failed "adequately to assess the economic effects" of the rules, *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011), the agencies acted arbitrarily and capriciously, and their action should be set aside.

I. THE AGENCIES MUST CONSIDER THE EFFECT OF THEIR RULES ON THE MARKET

It is well established that agency action must be set aside unless the agency has "examined the relevant data and articulated a satisfactory explanation for [its] action including a rational connection between the facts found and the choices made." *Business Roundtable*, 647 F.3d at 1148 (internal quotation marks omitted). In addition, as required by statutory provisions the Commission has recognized apply to this rulemaking, Doc.5.77705, the Commission is under the "unique obligation," *Business Roundtable*, 647 F.3d at 1148, to consider "whether the action will promote efficiency, competition, and capital formation," 15 U.S.C. § 78c(f), and the Commission may not adopt a "rule or regulation which would impose a burden on competition not necessary or appropriate in furtherance of the purposes of this chapter," *id.* § 78w(a)(2). *See also American Equity Inv. Life Ins.*

Co. v. SEC, 613 F.3d 166, 167-168 (D.C. Cir. 2010); *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005).[6]

As a result, the Commission may not "inconsistently and opportunistically frame[] the costs and benefits of [a] rule," "fail[] adequately to quantify … certain costs or to explain why those costs [can]not be quantified," "neglect[] to support its predictive judgments," "contradict[] itself," or "fail[] to respond to substantial problems raised by commenters." *Business Roundtable*, 647 F.3d at 1148-1149. Thus, as here, the Commission's "failure to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation makes promulgation of the rule arbitrary and capricious and not in accordance with law." *Id.* at 1148.

II. THE SUBSTANTIAL COSTS OF THE AGENCIES RULES RENDER THEM ARBITRARY AND CAPRICIOUS

The agencies were presented with clear evidence demonstrating that their risk-retention rules would impose significant costs on certain borrowers and would have a substantially adverse effect on the U.S. economy. In particular, the record showed that the number of CLOs in the market would dwindle as a result of the

[6] Under the Riegle Community Development and Regulatory Improvement Act (the "Riegle Act"), the Board (along with the federal banking agencies) was also under a statutory obligation to "consider … any administrative burdens that [the] regulations would place on … customers of depository institutions," and "the benefits of such regulations." 12 U.S.C. § 4802(a); *see also* Doc.418.2-3 (noting failure of Board and other agencies to conduct cost-benefit analysis under the Riegle Act).

agencies' rules; that such a reduction of CLOs would decrease credit availability and increase borrowing costs to the Chamber's corporate members; and that, as a result, borrowers—including many of the Chamber's members—would be forced to "cut back operations or forgo expansion," leading to "reduced employment, business efficiency, capital formation, domestic and international competition, innovation, and product development." Doc.8.21. Indeed, in extreme situations, companies that rely on CLOs for refinancing could face liquidity crises and even bankruptcy because of the agencies' rules. *Id.* at App.C-6.

The agencies essentially acknowledged these negative consequences, but determined to set them aside for two reasons: their claimed belief that other entities might replace the CLOs exiting the market, and their assumption that the decrease in CLO lending might not be as dramatic as suggested. These claims, however, are unsupported by the record and undermine the very benefit the agencies relied on to justify the rules.

A. Non-CLO Entities Would Be An Inadequate Substitute For CLOs

The agencies predicted that the reduction in lending and capital formation by CLOs might be offset by "other entities, such as hedge funds and loan mutual funds," that would step in to "purchase commercial loans." Doc.5.77657. But the agencies provided *no* reasoned basis whatsoever to support that prediction. *See Business Roundtable*, 647 F.3d at 1150 (Commission acted arbitrarily by relying

on "prediction" that "had no basis beyond mere speculation"); *International Ladies' Garment Workers' Union v. Donovan*, 722 F.2d 795, 822 (D.C. Cir. 1983) (agency making predictive judgment must "identif[y] all relevant issues, g[i]ve them thoughtful consideration duly attentive to comments received, and formulate[] a judgment which rationally accommodates the facts capable of ascertainment and the policies slated for effectuation."). Indeed, the record before the agencies demonstrated that a sizable part of financing from the CLO market—that supplied by global banks—is irreplaceable, and the agencies did not address this evidence.

In any event, even if the agencies' prediction happened to be correct, sources of capital like hedge funds and loan mutual funds would be substantially more expensive than the CLOs they would replace. Doc.488.15. Even under conservative assumptions, credit from these sources would cost 100 basis points or more than CLO-supplied credit. Doc.429.18. The Commission's only response to this estimate was to fault the underlying study, but it failed to conduct its own assessment of the increased costs of these alternative credit sources.[7] The

[7] The Commission faulted the study for equating elasticity of supply with elasticity of demand, resulting in a "significantly inflated" estimate. Doc.5.77728. To be sure, the analysis recognized that price elasticity of supply is "an under-explored area in the research literature" and therefore "very difficult to estimate robustly." Doc.429.17-18. But substituting elasticity of demand was used as just "a framework" to provide a basis to test the impact of "plausible elasticity values" on borrowing costs. *Id.* at 18.

Commission's naked assumption that costs would not increase (at least substantially) thus failed to satisfy any standard for reasoned rulemaking. *See Business Roundtable*, 647 F.3d at 1150 (criticizing Commission for failing to "estimate and quantify the costs").

Perhaps most remarkably, the agencies' reliance on the fact that entities like hedge and loan mutual funds might replace CLOs undermines the only benefit articulated by the agencies for their rules. As discussed below, the agencies justified the rules on the ground that systemic risk would be reduced by requiring CLO managers to retain "skin in the game" through a 5% retention of the economic value of the CLO. But the rules impose no credit-risk requirement on hedge funds, loan mutual funds, or similar entities, which will therefore lack exactly the sort of "skin in the game" that the agencies' rules purport to promote. Petitioner's Br. 55-56. Indeed, long-term, stable investors like CLOs introduce significantly less systemic risk than volatile, short-term investors like hedge funds and mutual funds. Doc.496.91 (explaining that, "unlike" hedge funds and loan mutual funds, "CLOs do not contribute significantly to price and market volatility or the systemic risk resulting from such volatility"); Doc.564.94-95 (same). The agencies' reliance on these alternative investors was thus wholly arbitrary and capricious. *See Business Roundtable*, 647 F.3d at 1153-1154 (rejecting as arbitrary "internally inconsistent" cost analysis).

B. The Agencies Failed Properly To Assess The Effect Of Their Rules On The Size Of The CLO Market

The agencies also purported to conclude that the CLO market itself might not contract as a result of their rules. For instance, the agencies stated, "because CLOs are a major source of funding for leveraged loan originators, there is significant economic incentive for arrangers to use the lead arranger option to ensure the continued participation of CLO managers." Doc.5.77727. But the agencies again cited absolutely no evidence for this assumption, providing "no basis beyond mere speculation." *Business Roundtable*, 647 F.3d at 1150.

The fact that no evidence supported this conclusion should not be surprising, because the final rules would make CLOs increasingly expensive for originators, thereby reducing the incentive for originators to participate. Doc.488.19 (explaining that "[h]olding a portion of the loan would increase the costs of arranging loans" and would require a lender "to dedicate additional capital," thereby "ensur[ing] that less borrowing will occur").[8] Originators will also be unlikely to hold 5% of the economic value given the rules' prohibition on hedging that retained risk—in fact, holding unhedged risk of that magnitude could very well run afoul of other regulatory requirements. *Id.* at 18 (explaining that "wide

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[8] That CLOs comprise a significant portion of the *current* leveraged loan market, of course, says nothing about whether lead arrangers will *continue* to make such loans after the agencies' regulations make doing so considerably more expensive.

range" of lead arrangers surveyed "indicated that they cannot envision a context in which their supervisory regulators and principles of prudent risk management would encourage them to arrange loans in a manner [meeting the lead arranger alternative's requirements]."); Doc.564.93-94 (lead arranger option "is inconsistent with current bank regulations"). And even if originators might make use of the agencies' lead arranger option, the Commission itself recognizes that the originator's participation in the lead arranger option would still result in higher costs to *borrowers*. Doc.496.101 (costs of lead arranger option "would be passed on to the borrowers, greatly restricting access to and cost of capital"). As the Commission put it, to accommodate the "costs of the ongoing credit exposure from the risk retention requirement, lead arrangers *may be willing to charge higher rates to borrowers* and, as a result, continue generating revenue from underwriting, warehousing, and selling leveraged loans." Doc.5.77729 (emphasis added).

The Commission also stated that "there *may* be economically feasible means for CLO managers to meet the risk retention requirements," Doc.5.77728 (emphasis added). But the Commission again identified no evidentiary support in the record for its conclusion, and its belief in some hypothetical "economically feasible" means to meet the risk retention requirements is no answer to a wealth of evidence demonstrating just the opposite. Indeed, over 85% of market participants predicted that the risk retention requirements would result in a 75% decline in the

CLO market. Doc.6.5. The Commission's speculation that this evidence "may" be wrong, without identifying any evidence to the contrary, is not enough to meet its obligations. *Cf. Business Roundtable*, 647 F.3d at 1151 (holding that Commission had "not sufficiently supported its conclusion" when it "discounted" studies provided by commenters and relied instead on two "relatively unpersuasive studies" that supported its decision).

III. THE BENEFIT IDENTIFIED BY THE AGENCIES DOES NOT JUSTIFY THE COSTS

Perhaps these costs could have been justified if the agencies had established a countervailing benefit. Here again, however, the agencies' rulemaking proved inadequate. The only benefit identified by the agencies was their speculative concern that the continued use of CLOs could result in "lower quality commercial loans." Doc.5.77657; *see also id.* at 77650-77651. The solution they adopted—to deliberately decrease the number of CLOs in order to reduce the market for commercial loans—is divorced from the realities of the market, leaving no "rational connection between the facts found and the choices made." *State Farm*, 463 U.S. at 43.

In determining that CLOs *might* create systemic risk, the agencies arbitrarily dismissed the variety of ways in which the structure of the CLO market—such as transparency to investors, CLO managers' performance-based fee structure, and the active management of CLO assets by CLO managers—makes it less vulnerable

to the sort of moral hazards that create systemic risk and allowed CLOs to prove so stable during the financial crisis. Petitioner's Br. 59-60. The agencies offered no rational basis for discounting these features. Their contention that such features are shared by other types of securitizations, such as collateralized debt obligations (CDOs), *see* Doc.5.77651, 77657 n.182, is countered by the wealth of analysis in the record distinguishing the two types of securitizations. *See, e.g.*, Doc.229.90-95 (distinguishing CLOs and CDOs). CLOs and CDOs are readily distinguished by the relative transparency of loan assets and the nature of the underlying assets, with CLOs being the far more transparent and stable of the two. And CDOs, of course, performed terribly during the financial crisis. Petitioner's Br. 11 (chart comparing performance of securitized products during financial crisis).

In addition, as explained above, the largely unregulated hedge-fund-types of entities that the agencies predict would replace CLOs would introduce more systemic risk than the current regime. *See supra* p. 25. The Commission's failure to consider the effect of this increased risk on the purported benefit of its rules creates a critical flaw in its reasoning. *See Business Roundtable*, 647 F.3d at 1155 (Commission acted arbitrarily when it did not "adequately address the probability the rule will be of no net benefit" when applied).

Nor did the agencies address the other, less costly ways in which they could ensure prudent underwriting practices at significantly less cost to the larger

economy. Petitioner's Br. 58 (explaining that agencies have ample powers to address underwriting practices of banks and other loan originators without resorting to "the regulatory bankshot of curtailing CLO issuance"). Such alternatives include issuing improved underwriting guidelines for loan originators, Doc.5.77651 (mentioning that the Board has "updated leveraged lending supervisory guidance" that includes "expectations that banks and thrifts exercise prudent underwriting standards when originating leveraged loans"), or adjusting interest rate policies to reduce the purported "search for yield in the low interest rate environment." *Id*. at 77657. The failure to consider whether other, less costly protections were already available is a hallmark of arbitrary agency action. *See American Equity Life Inv. Ins. Co.*, 613 F.3d at 166 (holding Commission's decision arbitrary and capricious when it "fail[ed] to determine whether, under the existing regime, sufficient protections existed").

CONCLUSION

For the foregoing reasons, the petition should be granted.

Respectfully submitted.

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CERTIFICATE OF COMPLIANCE

Pursuant to Rule 32(a)(7)(C) of the Federal Rules of Appellate Procedure, I certify that this brief complies with the limitations of Fed. R. App. P. 32(a)(7)(B) and 29(d) because it is 6,989 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii). This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type-style requirements of Fed. R. App. P. 32(a)(6) because it has been prepared in a proportionally spaced typeface using Microsoft Word 2010 in Times New Roman 14-point font.

/s/ Stephen V. Carey
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CERTIFICATE OF SERVICE

I hereby certify that on this 31st day of March, 2015, a true and correct copy of the foregoing Brief for the Chamber of Commerce of the United States of America as Amicus Curiae Supporting Petitioner was filed with the Clerk of the United States Court of Appeals for the D.C. Circuit via the Court's CM/ECF system. Counsel for all parties are registered CM/ECF users and will be served by the appellate CM/ECF system.

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