ORAL ARGUMENT NOT YET SCHEDULED
No. 17-5004

UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

LOAN SYNDICATIONS AND TRADING ASSOCIATION,
Appellant,
v.

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

On Appeal from the United States District Court for the District of Columbia in Case No. 16 Civ. 652 (Hon. Reggie B. Walton)

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

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April 26, 2017

CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

The following information is provided pursuant to D.C. Circuit Rule 28(a)(1):

(A) Parties and Amici

Appellant

Loan Syndications and Trading Association

Amicus Curiae Supporting Appellant

Chamber of Commerce of the United States of America

Appellees

United States Securities and Exchange Commission

Board of Governors of the Federal Reserve System

Amicus Curiae Supporting Appellees

Better Markets, Inc.

(B) Ruling Under Review

This appeal challenges the memorandum and order granting summary judgment to Appellees and denying summary judgment to Appellant, entered by the Hon. Reggie B. Walton on December 22, 2016 and reported as *Loan Syndications and Trading Association v. SEC*, __ F. Supp. 3d __, 2016 WL 7408834. *See* JA2341-2388.

(C) Related Cases

In consolidated cases Nos. 14-1240 and 14-1304, Appellant petitioned for review of the final rules adopted by Appellees that are the subject of the instant appeal. After this Court held that it lacked jurisdiction to directly review the final rules, it transferred the petitions to the United States District Court for the District of Columbia. *See Loan Syndications and Trading Association v. SEC*, 818 F.3d 716 (D.C. Cir. 2016). Appellant now seeks review of the district court's order granting Appellees' motion for summary judgment and denying Appellant's. Counsel is aware of no related cases currently pending in this or any other court.

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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OTHER AUTHORITIES

GLOSSARY

Board	Board of Governors of the Federal Reserve System
CDO	Collateralized Debt Obligation
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 smaller, less-established companies and those with relatively high levels of debt that lack access to other sources of funds—and comprise a significant portion of the $1.2 trillion leveraged loan market. JA1433. Many of those businesses are members of the Chamber. Unlike other types of securitizations, such as collateralized debt obligations (CDOs), CLOs are stable and transparent long-term investments. For this reason, CLOs performed exceptionally well relative to CDOs and other securitizations during the financial crisis, and have continued to provide a critical and reliable source of funding for U.S. businesses.

The final rules challenged here threaten the CLO market by imposing 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 place "significant costs on financial markets," JA2277, and likely would cause "fewer CLO issuances and less competition in this market," JA2226. The agencies also acknowledged that their rules would increase costs to borrowers, "either in terms of increased borrowing costs or loss of access to credit." JA2277. 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 and deterring economic growth and job creation by businesses lacking alternative sources of credit. JA2120.

The agencies' justification for imposing these costs on the CLO market 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, historically riskier types of investors "*may* replace some of the supply of credit lost due to exit from the market of CLO managers." JA2297 (emphasis added). But the agencies identified no evidence supporting this conclusion, and failed to address the fact that such alternative sources of credit would not only be substantially more expensive than CLOs, but also undermine the very rationale the agencies 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 cite any evidence for this unsupported assumption.

The agencies also failed to establish a countervailing benefit, stating only 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. JA2226. But such speculation ignores 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 CLOs less vulnerable to the sort of moral hazards that create systemic risk. And the agencies failed to consider ways that a reduction in systemic risk could be achieved by less costly means. In short, 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 appeal is therefore of vital importance to the members of the Chamber, many of which rely on CLOs as a critical source of capital. Accordingly, the Chamber 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-finance market, which includes both high-yield bonds and commercial loans from syndicates of banks or individual financial institutions, known as "leveraged loans." *See* JA2103 (noting the total

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[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.

value of outstanding corporate credit in the leveraged finance market to be nearly $2.2 trillion).

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 well as highly leveraged borrowers, are generally unable to raise capital through bond issuances, or would have to do so at highly unfavorable terms. JA2103.

Such companies instead turn to leveraged loans, which offer companies the ability to take on debt that typically has more flexible terms and 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. JA1093-1094.

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 otherwise be unable or unwilling to shoulder the range of operational and administrative burdens required of lenders. JA1093-1096.

CLOs are a type of specialized investment vehicle designed to invest in leveraged loans. 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 who has agreed to act as an agent for the CLO—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] JA876, 1095. 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. JA1095.

The characteristics, credit risk, and performance of the underlying loans are highly transparent, and the typical CLO portfolio contains just 100-150 loans. JA1095, 1430. A CLO manager therefore can easily manage the CLO's portfolio, tracking individual loans and deciding to buy or sell loans based on 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. JA1095, 1430-1431.

The investment structure of a CLO typically involves the pooling of the income stream (payments of interest and repayments of principal) generated from

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[2] Amicus uses the term "CLO" to mean the "open market" CLOs at issue in LSTA's brief, as distinguished from so-called "balance sheet" CLOs. The distinction between the two is set forth in Appellant's Brief at 6.

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 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. JA1168.

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." Appellant's Br. 12-13. 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 10-11 (citing JA1133-1135, 770-772).

- As regulated investment advisers under the Investment Advisers Act of 1940, CLO managers have fiduciary duties to CLOs and CLO investors. *Id.* at 11 (citing JA1095-1096).

- 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 11 (citing JA1095-1096).

- CLO managers actively manage the portfolio of assets in a CLO, allowing them to adapt to changing market conditions. *Id.* at 9; *see also* JA1095.

- 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. Appellant's Br. 4-5; *see also* JA1093-1095.

- 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. Appellant's Br. 6-7, 9-10; *see also* JA0875, 1134.

- CLOs often have performance-based triggers that protect investors in the lowest-risk tranches. Appellant's Br. 7; *see also* JA1134-1135, 1145.

In fact, no managed CLO triggered an event of default during the crisis, and losses were limited. JA1096, 1130.

Of the more than $1.2 trillion in outstanding syndicated loans in the United States in 2012, CLOs provided nearly $290 billion. JA1433-1434. The companies that rely on this source of funding represent a broad swath of "companies from the health care, energy, retail, entertainment, and telecommunications sectors," JA1036, such as Aramark, Cablevision, Chrysler Group, Delta Airlines, Ford Motor Company, Rite Aid, and Toys R Us, JA943-953. It has been estimated that the companies that rely on CLOs for their funding employ more than five million people.[3]

II. The Agencies' Risk-Retention Rules

Section 941 of the Dodd-Frank Act directed several financial regulatory agencies—including 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, 1890-1892 (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." 15 U.S.C. § 78*o*-11(a)(3). The Act also expressly permits the agencies to provide "a total or partial exemption of any securitization" from the credit-retention obligation, *id.* § 78*o*-11(c)(1)(G), and "adopt or issue exemptions, exceptions, or adjustments" to their regulations, including "for classes of

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3 *Hearing on The Dodd-Frank Act's Impact on Asset-Backed 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* JA1037 ("The CLO market enables … companies to create and preserve millions of American jobs.").

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 such exemption, exception, or adjustment, one of which is "improv[ing] the access of consumers and businesses to credit on reasonable terms." *Id.* § 78*o*-11(e)(2)(B).

A. The Agencies' Rulemaking

The agencies' rulemaking is explained in detail in LSTA's brief. *See* Appellant's Br. 14-18. The Chamber describes it briefly here to provide context for its discussion of the agencies' failure properly to weigh the costs and benefits of the rules.

The final rules apply the statutory definition of "securitizers" to CLOs based on the agencies' interpretation that 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. JA2222-2223. In interpreting the statutory definition this way, the agencies declined to give effect to the remaining statutory terms that clearly establish that, because the CLO managers do not originate, own, or even possess a single loan, they cannot be the "issuer" of a security, or "sell[] or transfer[]" an interest in a loan. *See* 15 U.S.C. § 78*o*-11(a)(3).

The final rules also 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 rules also include the so-called "lead arranger" alternative, which excuses certain CLO managers from the risk-retention requirement if each financial institution that served as the "lead arranger" of a syndicated loan underlying the CLO retained at least 5% of the face amount of that loan. *See generally* JA2220.

In adopting these rules, the agencies refused to exercise their exemption authority to adjust the rules to permit CLO managers to meet the risk retention requirement through a series of "best practices." For example, 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. JA2125-2146. 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—without finding that the credit risk reflected in the proposed alternatives was insufficient or defending the high levels of credit that CLO managers would have to retain under the agencies' rules.

B. Economic Impact Of The Credit-Risk Retention Rules

Throughout the rulemaking process, commenters informed the agencies of the substantial cost that the 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%. JA2114. The analysis also 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 and that 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. JA2113. Many of even 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. *Id.* As a result, this analysis concluded that 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. JA2113-2114.

Similarly, 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 conducted by LSTA), 35 CLO managers—representing 509 individual CLOs—estimated that, faced with the agencies' rules, they would issue only 69 new CLOs, resulting in a decline in total CLOs in the market of approximately 86%. JA1192. In response to the same survey, 85% of the CLO managers estimated that the CLO market would contract by 50% or more. JA1193.

And, as the evidence before the agencies demonstrated, the substantial reduction in the CLO market would, in turn, dry up a significant source of funding for many U.S. businesses and increase costs for smaller-business and highly-leveraged borrowers. Indeed, with fewer CLOs to provide capital and market liquidity, borrowers would be forced to seek other sources of financing, and such replacement financing could cost corporate borrowers $2.5-3.8 billion per year in additional interest costs. JA2120. The added cost would directly impact the ability of these companies to develop, innovate, and create jobs. It would also require businesses to build up cash reserves, removing productive capital that provides the dynamism and efficiency necessary for a growing economy. And 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

These impacts were not lost on the agencies. The agencies acknowledged, for instance, that the rules could result in "fewer CLO issuances and less competition in this market." JA2226. Similarly, in a separate economic analysis in which a dissenting Commissioner noted the "glaring[]" absence of economic analysis from the other rulemaking agencies, the Commission recognized that fewer CLO issuances "may increase cost to leveraged loan[] borrowers, " JA2297, and that increased costs for CLO managers "would likely be passed on to borrowers, either in terms of increased borrowing costs or loss of access to credit," JA2277. *See also* JA2277 (recognizing that the rules "could impose significant costs on financial markets" and that borrowers "could face increased borrowing costs, or be priced out of the loan market, thus restricting their access to credit").

Yet, the agencies provided only limited and purely speculative analysis of these costs in the joint portion of the final rules. *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

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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. 15-16 (2014) (statement of U.S. Chamber of Commerce), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-113hhrg88521/pdf/CHRG-113hhrg88521.pdf.

market of CLO managers with higher cost of funds." JA2297 (emphasis added); *see also* JA2296 (Commission criticizing the economic analysis in the record as assuming that CLO managers have 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). Tellingly, the Commission 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." JA2298. Nonetheless, the Commission concluded—by merely splitting a list of 111 "known" CLO managers into two general categories—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. JA2298-2299.

Second, the Commission—following the agencies' bare prediction that more volatile investors might replace CLOs in the market, JA2226—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." JA2297 (emphasis added); *see also* JA2299 ("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)). 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. JA2299. Without supporting their assumption with any data or empirical evidence, the agencies also concluded that "the market will adjust to the rule and … lending to creditworthy commercial borrowers … will continue at a healthy rate." JA2226; *see also* JA2295-2296 (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.").

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." JA2227. 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." JA2226. 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." JA2227.

Based on these speculative conclusions, the agencies rejected various alternatives suggested by commenters, even though, as the Commission acknowledged, "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." JA2297. For support, the Commission simply 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 also 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").

III. JUDICIAL PROCEEDINGS

In 2014, LSTA petitioned this Court for review of the agencies' credit-risk retention rules. The Court transferred LSTA's petition to the district court for lack of jurisdiction. *See Loan Syndications & Trading Ass'n v. SEC*, 818 F.3d 716, 724 (D.C. Cir. 2016). On December 22, 2016, the district court granted the agencies' summary judgment motion, ruling that the agencies' construction of "securitizer" under 15 U.S.C. § 78*o*-11(a)(3) to include CLO managers was reasonable, and that the agency did not act arbitrarily or capriciously in adopting "fair value" as a measure of credit risk or in refusing to adjust the rules based on the alternatives proposed by commenters. JA2354-2388. LSTA timely appealed. JA2390.

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 focuses on 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 "examine[] the relevant data and articulate[] 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). As the district court recognized, moreover, *see* JA2385, the Commission is under the "unique obligation," *id.*, 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).

As a result, the Commission's—and, here, the agencies'[5]—action must be set aside if the Commission "inconsistently and opportunistically frame[s] the costs and benefits of [a] rule," "fail[s] adequately to quantify … certain costs or to

[5] 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* JA2148 (noting failure of Board and other agencies to conduct cost-benefit analysis under the Riegle Act).

explain why those costs [can]not be quantified," "neglect[s] to support its predictive judgments," "contradict[s] itself," or "fail[s] to respond to substantial problems raised by commenters." *Business Roundtable*, 647 F.3d at 1148-1149. The agencies failed to satisfy these requirements in the rulemaking challenged here.

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

The agencies were presented with clear and substantial 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 agencies' rules; that a reduction of CLOs would decrease credit availability and increase borrowing costs to many smaller businesses and highly-leveraged companies; and that, as a result, borrowers would be forced to "cut back their operations or forgo expansion," leading to "reduced employment, business efficiency, capital formation, domestic and international competition, innovation, and product development." JA1163. Indeed, in extreme situations, companies that rely on CLOs for refinancing could face liquidity crises and even bankruptcy because of the agencies' rules. JA1184.

The agencies essentially acknowledged these negative consequences, but ignored them 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." JA2226. But the agencies provided *no* reasoned basis to support that prediction, and the district court failed to notice this absence. *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.'"); *see also* JA2385-2388. Indeed, irrefutable evidence in the record demonstrated that a sizable part of financing from the CLO market is irreplaceable.

In any event, even if the agencies' prediction happened to be correct, the alternative sources of capital they identified—hedge funds and loan-mutual funds—would be substantially more expensive than the CLOs they would replace. JA2101. Even under conservative assumptions, credit from these sources would cost 100 basis points or more than CLO-supplied credit. JA2117. 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.[6] The 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 other sources of capital might replace CLOs undermines the only benefit articulated by the agencies for their rules. 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

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[6] The Commission faulted the study for equating elasticity of supply with elasticity of demand, resulting in a "significantly inflated" estimate. JA2297. 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." JA2116-2117. 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. JA2117.

agencies' rules purport to promote. In fact, CLOs have historically been safer and posed lower risk than other securitizations and investments. *See, e.g.*, JA1703.

For these reasons, the agencies' reliance on these alternative investors was wholly arbitrary and capricious, and nothing in the district court's opinion—which did not address this issue at all, *see* JA2350-2388—suggests otherwise. *See Business Roundtable*, 647 F.3d at 1153-1154 (rejecting as arbitrary "internally inconsistent" cost analysis).

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

The agencies also purported to conclude that the rules would not contract the CLO market. For instance, the agencies stated that, "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." JA2296. But the agencies again cited absolutely no evidence for this assumption "beyond mere speculation." *Business Roundtable*, 647 F.3d at 1150. The district court similarly failed to address this issue, stating only that the agencies determined based on "various applicable factors" that the rules would result in "an approximately 14.8 percent reduction in supply of capital" and that they rejected "contrary findings" based on their "qualms with more costly estimates."[7] JA2386.

To the contrary, however, overwhelming evidence in the record indicated that the final rules would make CLOs increasingly expensive for originators, thereby reducing the incentive for originators to participate. *See* JA1913 (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. *See* JA1912 (explaining that

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[7] The district court also determined that the agencies' "decision to promulgate the final rules without an adjustment or exemption for open market CLO managers, despite th[e] potentially negative effect on the CLO market, is entitled to deference" because, "[d]espite the lack of data, the [SEC and the other agencies] had to promulgate a [] rule." JA2386 (internal quotation marks omitted). There *are* data on the rules' effect on the CLO market, however, and an agency's rules that "ignore[] evidence contradicting its position" are not entitled to deference. *Butte Cty., Cal. v. Hogen*, 613 F.3d 190, 194 (D.C. Cir. 2010); *see also National Ass'n of Clean Water Agencies v. EPA*, 734 F.3d 1115, 1136-1138 (D.C. Cir. 2013) (rejecting agency rule where the agency was presented with evidence contrary to the agency's findings, and the agency offered a "mere assertion" that the rule took such evidence into consideration).

[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.

"wide 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]."); JA1441 (lead arranger option "is inconsistent with current bank regulations"). And even if originators might make use of the agencies' lead arranger option, as the agencies speculated, the Commission itself recognized that the originator's participation in the lead arranger option would still result in higher costs to *borrowers*. 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." JA2298 (emphasis added); *see also* JA1713 (costs of lead arranger option "would be passed on to the borrowers, greatly restricting access to and cost of capital").

The Commission also stated that "there *may* be economically feasible means for CLO managers to meet the risk retention requirements," JA2296 (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. For example, over 85% of market participants predicted that the risk-retention requirements would result in a 50% or more decline in the CLO market. JA1193. The Commission's speculation that this evidence "may" be wrong, without identifying any evidence to the contrary, is not sufficient 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, however, the only benefit identified by the agencies was their claimed belief that the continued use of CLOs could result in "lower quality commercial loans." JA2226. 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.'" *Motor Vehicle Mfrs. Ass'n*, 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. *See, e.g.*, Appellant's Br. 54-56. The agencies offered no rational basis for discounting these features. Their contention—adopted by the district court, *see* JA2383-2384—that such features are shared by other types of securitizations, such as CDOs, *see* JA2225, is countered by clear evidence distinguishing the two types of securitizations. CLOs and CDOs are fundamentally different in terms of their transparency of loan assets and the nature of the underlying assets, with CLOs being the far more transparent and stable of the two. *See* JA874-875, 526-527 (distinguishing CLOs and CDOs). That is why CLOs performed exceptionally well during the financial crisis, even as CDOs performed so poorly. *See* JA526-527, 1096, 1152-1153; Appellant's Br. 10-12.

As noted above, moreover, the agencies' claimed benefit is undermined by the differences between CLOs and the historically more volatile investors that the agencies predict would replace them. *See supra* pp. 22-23.

Finally, the agencies ignored the fact that the claimed benefits could be achieved in other ways that would ensure prudent underwriting practices at significantly less cost to the larger economy. Such alternatives include issuing improved underwriting guidelines for loan originators, JA2220 (stating 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," JA2226. The failure to consider whether other, less costly protections were already available is a hallmark of arbitrary agency action. *See Business Roundtable*, 647 F.3d at 1148-1149; *American Equity Life Inv. Ins. Co.*, 613 F.3d at 179 (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 Court should reverse the judgment below and vacate the rules as they apply to CLO managers.

Respectfully submitted.

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CERTIFICATE OF COMPLIANCE

I certify that this brief complies with the limitations of Fed. R. App. P. 32(a)(7)(B) and 29(a)(5) because it is 6,424 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(f). 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 2016 in Times New Roman 14-point font.

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CERTIFICATE OF SERVICE

I hereby certify that on this 26th day of April, 2017, a true and correct copy of the foregoing Brief for the Chamber of Commerce of the United States of America as Amicus Curiae Supporting Appellant 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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