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Suing your Regulators:
A Case Study from a General Counsel's Perspective

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I. Introduction.

On February 9, 2018, the United States Court of Appeals for the District of Columbia Circuit (the Circuit Court) reversed a decision by the District Court and **ruled in favor of** my organization, the Loan Syndications and Trading Association ("LSTA), a financial trade association, in its lawsuit against the Securities and Exchange Commission ("SEC") and Federal Reserve Board (the "Fed"; and collectively, the "agencies"). The decision voided the agencies' aggressive interpretation of the "risk retention rule" that they had imposed on many of the LSTA's members in 2014 and brought to an end an eight year saga on an issue of critical importance. As the LSTA's general counsel, I was charged with navigating the association through this difficult, but ultimately successful, chapter.

Litigating against one's primary regulators is not a tactic to be taken lightly or used frequently but sometimes it is the best, or only, option. For a general counsel, the decision to litigate, and the implementation and conduct of the litigation, is fraught with risks and challenges. This article will examine some of the difficult issues I faced as general counsel in (i) deciding to sue the very regulatory agencies that supervise our members, (ii) convincing our board to support the litigation, (iii) hiring the right counsel, (iv) managing the litigation, (v) dealing with interim setbacks, (vi) maintaining good relations with the regulators while litigating, and (vii) winning with grace. I hope that my experience can serve as a road map for those faced with similar situations.

II. Background on the LSTA.

The LSTA was formed in 1995 by a small number of banks to standardize documentation and trade practices in the small but growing US syndicated loan market. Since that time, the LSTA's mandate and reach has grown commensurate with the growth of the market which now exceeds $1 trillion. The LSTA's 440+ members represent the banks, institutional investors, lawyers and vendors that participate in the loan market and its mission is to promote a fair, orderly, efficient and growing market and provide leadership in advancing and balancing the interests of all market participants. It carries out that mission by, among other things, advocating for the interests of all loan market participants through political advocacy, amicus litigation, and, in rare circumstances, direct litigation.

III. The Path to Litigation

What was this litigation about and how did the LSTA get to the point of suing the Fed and the SEC?

A. The Financial Crisis, Dodd-Frank and an Unsuccessful Rulemaking Process.

In July 2010, in the wake of the great financial crisis, Congress passed the Dodd-Frank Act, which encompassed sweeping financial regulatory reform. Included in Dodd-Frank was Section 941 which required any "securitizer" of a securitization to retain and hold 5% of the credit risk associated with any such securitization. Section 941 delegated to the SEC and the federal banking agencies the joint responsibility of issuing rules implementing risk retention. In April 2011 the federal agencies issued an initial Notice of Proposed Rulemaking implementing Section 941 and, in August 2013, a second Notice of Proposed Rulemaking. In October 2014 the agencies issued their final rule concluding that CLO managers were indeed "securitizers" in respect of CLOs and requiring each manager to purchase and retain 5% of the fair value of the securitization it originates in either a horizontal first-loss equity strip or a vertical strip of all liabilities. Thus, for a $500 million CLO, a manager would be required to retain $25 million. The retained piece could not be sold or hedged but could be held by a "majority-owned affiliate" and financed with recourse. Throughout the rulemaking process the LSTA and others attempted to persuade the agencies that (a) the plain language of the statute did not authorize the agencies to require CLO managers to retain risk, and (b) as a policy matter, the agencies should not require managers to retain so much risk because (i) CLOs performed very well through the financial crisis and (ii) the structure of CLOs already builds in the types of "skin-in-the-game" features that the risk retention rules were meant to enforce.

Many CLO managers viewed the imposition of risk retention as an existential threat. With few exceptions, CLO managers, in contrast to banks, are thinly capitalized and their model, much like mutual fund managers, is to invest money on behalf of investors, not to co-invest. Without readily available sources of capital, many feared that they would be unable to issue additional CLOs once the rule went into effect.

B. Preparing to Litigate.

The LSTA had anticipated this outcome. In the summer of 2013, after engaging with the federal regulatory agencies on the rulemaking process for more than two years and filing multiple comment letters, the LSTA concluded that the agencies were very unlikely to grant any risk retention relief to managers of CLOs. Indeed, the agencies signalled this in their reproposal of the rule. Moreover, efforts to obtain a legislative solution did not seem promising. Because many of our members and the members of our board viewed the imposition of risk retention as a potentially existential risk, the LSTA board authorized the staff to begin its pivot to a "pre-litigation" mode.

C. The Nature of the Litigation.

A case brought by the LSTA would arise under the U.S. federal Administrative Procedure Act (APA) and would be more similar to appellate litigation rather than trial litigation. In order to grant relief, the court would have to conclude that the agencies' rulemaking was "arbitrary and capricious, an abuse of discretion, or otherwise not in accordance with the law". In APA litigation, no testimony is offered and there is no discovery. Instead, as in classic appellate litigation, the case is a battle of briefs based on the record. Whereas in typical appellate litigation "the record" on appeal is the trial record, in APA litigation, the record is limited to that which is submitted to the agencies during the rule-making process and nothing more.

For the remainder of the rulemaking process, building the best record possible would become as important a focus for the LSTA as trying to persuade the agencies to grant relief. Thus, the LSTA's comment letters in response to the reproposal would serve as the main vehicle for building the APA record.

D. Selecting Counsel and a Reality Check.

The pivot to possible litigation also required selecting new outside counsel. We needed a firm that understood the subject matter, (i.e., securitization and CLOs), had extensive regulatory experience including drafting comment letters, and, most importantly, was a skilled APA litigation firm. We were also very mindful that we could be victims of "confirmation bias", i.e., an unwarranted belief in the merits of our legal case. We interviewed a handful of firms that fell within our three-part Venn diagram and among the first questions we asked was whether our view of our chances for success was realistic. While each of the firms thought we could prevail, none would offer better than 50-50 odds given the so-called "Chevron deference" that federal courts give to the government in APA cases. We decided to engage the team from Sidley in Washington, D.C. and began the process of building the record.

E. Setting up the Litigation.

While continuing our uphill battle to persuade the agencies to grant CLO managers relief from the risk retention rules, our remaining comment letters included numerous compromise proposals as well as data and information that supported the LSTA's positions. For example, we proposed a "qualified" CLO that would require a significantly lower level of risk retention and engaged a professor from Harvard Business School to undertake an analysis that demonstrated that the agencies were requiring managers to retain almost *ten times* the amount of credit risk as is required by statute.

IV. The LSTA files suit.

As predicted, the agencies' final rule offered no relief and imposed risk retention on CLO managers in an amount equal to five percent of the fair value of a CLO. The rule was published in the Federal Register on December 24, 2014 and would go into effect exactly two years later.

A. The Board Authorizes Litigation.

Once the final rule was published the LSTA board convened to consider its options. While the board had previously approved the pivot to preparation for litigation, there is a big difference between a decision to *authorize* litigation from one to *actually* sue the very government agencies that regulate your business. The decision to sue was made even more difficult given the nature of our members, the firms represented by the members of our board and the immense political fallout from the great financial crisis. Unlike many financial trade associations, the LSTA represents both the so-called "sell-side" of the market, i.e., the banks and broker dealers that originate, underwrite and syndicate loans, as well as the "buy-side", i.e., the institutional investors such as CLOs, mutual funds, insurance companies and hedge funds that purchase loans. Our buy-side members, which had the most to lose from risk retention and were not the focus of much regulatory attention, were strong supporters. On the other hand, banks and broker dealers, while potentially harmed by risk retention, had much less a stake. More importantly, the banks and broker dealers had been under intense scrutiny and pressure from the agencies since the financial crisis and were loath to rock the boat; a vote to sue the government, even indirectly, would be a bold step.

As general counsel, it was my role to persuade the sell-side board members to support the litigation. At a board meeting, our counsel at Sidley explained the pros and cons of the litigation and made a persuasive case for going forward. In reality, there was virtually no dissent that the case was just and that it was our best option to prevail. Instead, the issue boiled down to political will. Ultimately, most of the sell-side board members supported the litigation (with small a number abstaining) taking comfort from the fact that it is not uncommon for trade associations across many industries to serve as a buffer between members and regulatory agencies and to litigate under the APA.

B. Picking the Jurisdiction.

With the lawsuit authorized, the question of where to file was joined. Because Section 941 of Dodd-Frank required a multi-agency rulemaking, the APA itself was unclear whether original jurisdiction lay in the District of Columbia District Court or the Court of Appeals for the DC Circuit. Importantly, the consequences of choosing incorrectly could be catastrophic. If one chose to sue in the District Court and turned out to be wrong, the ability to then sue at the Circuit Court would have lapsed. On the other hand, if the Court of Appeals decided it did not have original jurisdiction, one could then revert to the District

Court. Our strong preference, the safer bet, and what we ultimately decided, was to file at the Court of Appeals. First, the Court of Appeals has much more experience on APA cases than any District Judge. Moreover, any decision at the District Court would surely be appealed to the Circuit Court so if the Circuit Court were to agree that it had original jurisdiction, the entire process would be much faster. So, in November 2014, almost immediately after the agencies approved the final risk retention rules for CLOs, the LSTA filed a Notice of Appeal against the SEC and the Federal Reserve Board with Court of Appeals. Interestingly, the agencies did not dispute our decision on jurisdiction.

C. The Lawsuit

The LSTA asserted that the agencies lacked statutory authority to impose risk retention on CLO managers *at all* and that, even if they had such authority, requiring a manager to hold a horizontal first-loss position in an amount equal to 5% of the *fair value* of a CLO (rather than 5% of the *credit risk* as required by the statute) was a misapplication of the statute. On the issue of statutory authority, the LSTA argued that the Dodd-Frank Act does not apply to CLO managers because they do not initiate CLOs by *selling* assets to it as required by the statute, which targets “originate-to-distribute securitizations." Instead, like other fund managers, CLO managers act on behalf of the CLOs by facilitating the *purchase* of the loans, and never actually originate or own any loans that they could sell or transfer. On the issue of the appropriate measure of risk retention, the LSTA contended that the rule is “arbitrary and capricious” and violates the APA because the agencies disregarded the statutorily mandated “credit risk” standard and, instead, based risk retention on “fair value,” a standard that has no connection to credit risk. The difference is profound. Where 5% of the credit risk held as a horizontal first loss position would be equal to just over $2.5 million for a $500 million CLO (since most of the credit risk of a CLO is in the equity), the final rule required CLO managers to purchase and retain *almost 10 times* that amount, a challenging task for many thinly capitalized asset managers. The LSTA’s final challenge was that the agencies also acted in an arbitrary manner by failing to respond to comments and rejecting better alternatives.

D. The First Setback: Back to the District Court.

The LSTA and the agencies filed briefs with the Court of Appeals and oral argument was scheduled for February 2016. Two weeks before oral argument, our concern about jurisdiction proved to be well-founded when the Court of Appeals, on its own motion, asked the LSTA and the agencies to explain why we thought original jurisdiction belonged with them. The LSTA filed a brief one week later and much of the oral argument focused on jurisdiction rather than the merits of the LSTA’s case. In March 2016, the Court ruled that they did *not* have original jurisdiction and the case was transferred to the US District Court for the DC District. Although this possibility had been anticipated, it was a significant setback because it meant that there was little likelihood that the case would be resolved before December 24, 2016, the effective date of the risk retention rule. The parties quickly agreed to expedite the case as much as possible by using the same briefs at the District Court that were filed with Court of Appeals.

E. The Second Setback: A Loss at the District Court.

On December 22, 2016, two days before the effective date of the rule, the District Court ruled in favor of the agencies. The opinion was perfunctory, with the judge failing to undertake a deep analysis and relying instead on the so-called Chevron Doctrine which gives the benefit of the doubt to agencies in cases in which the interpretation of their own rules is at issue. This was a much bigger setback for the LSTA and the market because the risk retention rule went into effect only two days later requiring all CLO managers to comply. Notwithstanding the two setbacks, and because of the importance of the issue and their continued confidence in the case, LSTA board stood firm and authorized the staff to appeal the decision to the Court of Appeals.

Almost three years from the day it initially filed its lawsuit, the LSTA finally got its “day in court.” On Oct. 10, 2017, a three-judge panel of the DC Circuit Court heard oral arguments on the merits of the case. The oral argument seemed to go well for the LSTA with the three judge panel (including, notably, Judge Brett Kavanagh!) appearing skeptical of the agencies’ arguments. (But, as any experienced appellate lawyer will warn, it is not wise to draw conclusions from oral arguments).

F. The Court Rules.

On February 9, 2018, the Circuit Court published a unanimous 17-page decision reversing the District Court’s decision and instructing the court to enter judgment for the LSTA and vacate the risk retention rule as it is applies to CLO managers. Because it ruled that risk retention does not apply to CLO managers, the Circuit Court did not consider the issue of the proper measure of credit risk.

The Circuit Court closely analyzed the statutory language and concluded that to be a securitizer for purposes of Section 941 “a party must actually be a transferor, relinquishing ownership or control of assets to an issuer” of the securitization notes. The Circuit Court did not accept the agencies’ argument that a manager is a securitizer because it causes *other* parties to transfer assets to the securitization. It also observed that the statute requires securitizers to “retain” (not *obtain*) credit risk and pointed out that one cannot retain that which it has never owned or controlled. After dismissing the agencies’ statutory arguments the Circuit Court pivoted to the agencies’ policy arguments and was not persuaded. Moreover, the Circuit Court noted that no matter the policy arguments, they “cannot compel us to redraft the statutory boundaries set by Congress. Our commentary on those concerns only reinforces the reasoning that the ordinary meaning of § 941 does not extend to CLO managers.”

G. The Other Shoe Doesn’t Drop.

The Circuit Court’s decision became effective on April 5, 2018 when the DC District Court issued an order vacating the risk retention rule as applied to open market CLO managers. The agencies had 45 days from the day of the decision to request *en banc* review (i.e., review by the entire DC Circuit Court) and 90 days to request review by the U.S. Supreme Court but let each of those deadlines pass, thus putting to an end the three and a half year judicial process.

V. Litigating with Grace.

We decided early on in the process that even if our efforts to reach a workable solution with the agencies ultimately failed and we had to resort to litigation we would keep our dealings with the agencies as cordial and transparent as possible. We did this for two reasons. First, it was the right thing to do, and second, we knew that whatever the outcome of the litigation, we would continue to have very important dealings with the agencies for many years to come and burning bridges, no matter how important the immediate issue, is unsound. So, for example, as a courtesy, I called the general counsel of the Fed and the Chief of Staff of the SEC within minutes of our filing the initial notice of appeal so that they would not find out second hand (or worse, by getting a call from a reporter or reading about it in a newspaper). We cooperated all along with agency counsel, agreeing on the details of briefing schedules and to all requests to extend deadlines. The agencies reciprocated and our relationship remained cordial. As it turned out, the LSTA had to approach the SEC staff for no-action relief on an issue arising in the context of risk retention during the litigation process. While many of our members were surprised when the staff granted that relief while we were suing them on a related issue, it only validated the wisdom of our approach.

VI. Winning with Grace.

Similarly, when the appellate court decision came out, we did not "spike the ball". We tried to keep a relatively low profile when speaking to reporters and analysts, expressing our delight with the result, explaining the fine points of the decision, but never denigrating the agencies or predicting how they might react to the decision or whether they would likely appeal.

VI. Conclusion.

Litigating against one's primary regulators is not an action to be taken lightly but there are times when it is the best, or only, option. In those situations it is important to confirm with independent experts that your belief in the merits of your position are warranted. It is important also to understand the nature of the litigation and to prepare for it well in advance by developing a strong record. It is also critical to select counsel that is at home in all the areas of expertise that the case demands. Obtaining and maintaining the support of your leadership, through the ups and potential downs of a litigation, is also obligatory. Finally, it is important to recognize that whatever the stakes of the particular case, it is absolutely essential to maintain a cordial relationship with the regulators and to litigate accordingly.

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The LSTA (www.lsta.org) is the trade association for the US corporate loan market. With over 435 members, the LSTA promotes a fair, orderly, efficient, and growing corporate loan market and provides leadership in advancing and balancing the interests of all market participants. The LSTA meets its objectives through education, advocacy, and promotion of the asset class.