No. 23-670

IN THE

Supreme Court of the United States

MARC S. KIRSCHNER, solely in his capacity as Trustee Of The Millennium Lender Claim Trust,

Petitioner,

v.

JP MORGAN CHASE BANK, N.A., JP MORGAN SECURITIES LLC, CITIBANK, N.A., BANK OF MONTREAL, BMO CAPITAL MARKETS CORP., SUNTRUST ROBINSON HUMPHREY, INC., SUNTRUST BANK, CITIGROUP GLOBAL MARKETS, INC.,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

AMICUS CURIAE BRIEF OF PROF. JOSEPH R. MASON IN SUPPORT OF PETITIONER

Kevin K. Russell
Counsel of Record
GOLDSTEIN, RUSSELL & WOOFTER LLC
1701 Pennsylvania Ave. NW
Suite 200
Washington, DC 20006
(202) 240-8433
kr@goldsteinrussell.com

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statutes

Other Authorities

INTEREST OF AMICUS CURIAE[1]

This brief is filed by Prof. Joseph Mason, Ph.D., an economist. Dr. Mason is currently a Fellow at the University of Pennsylvania's Wharton School of Business. Over the course of a lengthy academic career, he was a tenured Professor of Finance and the Hermann Moyse, Jr. / Louisiana Bankers Association Chair at Louisiana State University, an Assistant and tenured Associate Professor at Drexel University, and adjunct faculty at Georgetown University. Prof. Mason has specialized in the study of financial intermediation with a focus on innovation in financial markets and the effects of such innovations on economic growth and financial crises.

[1] No counsel for petitioner or respondents authored any part of this brief, and no person other than amicus curiae or its counsel made any monetary contribution to the preparation or submission of this brief. Counsel for the parties received timely notice of amicus's intent to file this brief.

INTRODUCTION AND SUMMARY OF ARGUMENT

This case presents the question whether syndicated loans qualify as "securities" within the meaning of federal securities law. That question warrants review because although they originated as bespoke arrangements to share risk between well-informed and sophisticated commercial banks, syndicated loans are now widely marketed to a far broader set of investors in a manner that is functionally indistinguishable from other common securities that all recognize are appropriately subject to federal securities law. The Second Circuit's failure to recognize that reality endangers both investors and the broader economy in exactly the ways federal securities laws are designed to prevent.

Economists recognize that labels like "syndicated loans" can be misleading, obscuring material changes in economic practices that often evolve over time. Indeed, it is common for niche financial arrangements to evolve into standardized financial instruments that trade as securities in public markets.

That is what happened with syndicated loans. They began as a means to spread the risk of corporate loans among highly regulated, sophisticated, and well-informed banks. But they have evolved into standardized contracts sold, and resold, to a mass audience of institutional and ordinary retail investors, materially indistinguishable from corporate bonds. Like bond investors, most purchasers of syndicated loans now lack the direct relationship with the borrower that would enable the due diligence necessary for an informed assessment of investment risk without the benefit of federal disclosures. At the same time, some of the features of early syndicated loans that diminished the need for federal regulation have fallen by the wayside.

Absent classification as a "security" under federal securities laws, then, investors in syndicated loans are deprived of the information and the protection against fraud Congress intended to provide them.

That the Second Circuit believed this result was compelled by this Court's decision in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), indicates that further clarification, or reconsideration, of that decision is in order.

ARGUMENT

Congress enacted the federal securities laws in the immediate aftermath of the Great Depression to protect investors and the broader financial system. In the run up to the stock market crash of 1929, "some 50 billions of new securities were floated in the United States." H.R. Rep. No. 73-85, at 2 (1933). "Fully half or $25,000,000,000 worth of securities floated during this period have been proved to be worthless," *ibid.*, amounting to more than half a trillion dollars today adjusted for inflation.[2] The eventual collapse of these investments destroyed investor confidence in the financial system generally.

When Congress responded by enacting the Securities Act of 1933 and the Securities Exchange Act of 1934, it identified investors' lack of the "facts essential to estimating the worth of any security" as a

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[2] *See* U.S. Inflation Calculator, https://www.usinflationcalculator.com (last visited January 21, 2024).

root cause of the crisis. *Ibid*. Accordingly, to "restore the confidence of the prospective investor in his ability to select sound securities," *id*. at 1, Congress enacted registration and other disclosure requirements, backed by private rights of action "designed to assure compliance" and provide injured investors an effective remedy against fraud. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82 (1983).

These protections, however, apply only to investment instruments deemed a "security" as that phrase is used in the statutes. *See Reves v. Ernst & Young*, 494 U.S. 56, 60 (1990). Although Congress broadly defined "security" to include "any note," *see* 15 U.S.C. §§ 77b(a)(1), 78c(a)(10), this Court in *Reves* concluded that definition should not be interpreted "literally," but rather functionally, "understood against the backdrop of what Congress was attempting to accomplish." 494 U.S. at 63.

Given this functional inquiry into "the economic realities of the transaction under investigation," *id*. at 62, something not originally deemed a "security" may evolve over time into one that should be so classified. That is precisely what has happened in the case of syndicated loans.

I. Financial Products Often Evolve From Bespoke Arrangements Between Informed, Sophisticated Parties Into Standardized Securities Sold To The Broader Public.

1. Efficient financial intermediation—facilitating transactions between lenders and borrowers—is crucial for a well-functioning economy. It provides a way to pool resources to fund large-scale economic enterprises, transfer resources through time and

across geographic regions and industries, control and manage uncertainty and risk, and provide price information that helps coordinate decentralized decision-making in our private economic system. *Id*. at 24.

To succeed, however, financial arrangements must overcome significant obstacles that can detract from these economic benefits or make otherwise productive investments less likely to occur. This includes asymmetric information and incentive problems that arise when one party to a financial transaction has information that the other does not—*e.g.*, when a company seeking financing knows far more about its own finances and prospects for success than any potential investor. Efficient investment arrangements must also provide investors assurance that they can trust their counterparties to fulfill their end of the bargain.[3]

These obstacles can often be overcome when financial "products have standardized terms, can serve a large number of customers, and are well-enough 'understood' for transactors to be comfortable in assessing their prices."[4] On the other hand, sometimes financial products are introduced to markets with problems of asymmetric information and reliability unresolved or temporarily papered over. When the unresolved problems eventually emerge, they can "significantly reduce the ex ante efficiency of

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[3] *See* Robert C. Merton, *A Functional Perspective of Financial Intermediation*, 24 Finan. Mgmt. 23, 24 (1995) (hereinafter "Merton").

[4] *Id*. at 26.

those contracts and thereby substantially reduce the effectiveness of the main economic function" of financial products. *Ibid*. Even more, as former Federal Reserve Chair and Nobel Laureate Ben Bernanke has emphasized, the failure to properly manage these problems can "lead to devastating financial crisis."[5]

Federal securities laws are designed to overcome these problems through mandatory disclosure rules and enforcement mechanisms that give investors confidence that they can accurately evaluate investment risks and will have a reliable remedy when the disclosures they rely upon are fraudulent. In this way, those laws pave the way for more efficient forms of investment that would otherwise fail to take hold due to their inability to surmount these problems of asymmetric information and trust. They also protect against the broader economic harm that can arise when investor confidence in a particular form of investment collapses.

2. One consequence of *Reves*' functional approach to deciding what counts as a "security" subject to this regime is that courts must be attentive to the reality that the salient features of financial instruments and practices often evolve over time.

For example, one common theme in the evolution of American financial markets is that financial instruments originating between a small number of sophisticated parties eventually become standardized,

[5] The Committee for the Prize in Economic Sciences in Memory of Alfred Nobel, *Financial Intermediation and the Economy* 3 (October 10, 2022) (emphasis added), *available at* https://www.nobelprize.org/uploads/2022/10/advanced-economicsciencesprize2022-2.pdf.

more common, and eventually sold to less informed and less sophisticated investors in public financial markets.[6] That transformation can produce important economic benefits, including by increasing liquidity and, therefore, making more capital available for productive investment. However, it can also increase problems of asymmetric information and investor uncertainty about default risk, as the ultimate investor becomes more detached from the firm in which they have invested. Unresolved asymmetric information gaps can impede financial development, harm investors, and increase financial risk for the broader economy.

A particularly clear example is the development of mortgage-backed securities. Initially, mortgages were made and held by banks and other regulated institutions that had substantial information about the investment and its risks (having originated the mortgages or had significant insight into the mortgage before purchasing it from an originator). The development of mortgage-backed securities massively expanded the pool of potential investors, improved liquidity, and thereby increased the pool of capital available to finance home purchases. But, as subsequent events illustrated, the development also created significant problems of asymmetric information, as those purchasing the securities in secondary markets had substantially less insight into the nature of the borrowers and the degree of investment risk. The failure to recognize and address

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[6] *See, e.g.*, Merton at 26-27.

these problems as they evolved led to a catastrophic failure of the financial system.

As discussed next, syndicated loans have followed a similar path, evolving into mass-market securities that are not materially distinguishable from other kinds of investments everyone agrees are subject to the protections of federal securities laws.

II. Syndicated Loans Have Followed The Traditional Pattern, Evolving From Specialized Lending Relationships Among Banks To Broadly Traded, Standardized Securities.

1. For many decades, banks had few options for selling corporate loans or spreading the risk of their corporate lending. Although the originating bank had invested the resources, and possessed the skills, to assess the risk and value of the loan when it was originated, it was difficult and costly for potential purchasers of those loans to make their own judgments on those questions.[7] There was, however, one group of potential purchasers who could overcome these problems of asymmetric information—other banks, "which specialized in credit analysis, had the ability and incentives to monitor their borrowers

[7] *See* Elisabeth de Fontenay, *Do the Securities Laws Matter? The Rise of the Leveraged Loan Market*, 39 J. Corp. L. 725, 736-37 (2014) (hereinafter "de Fontenay"). Assessing the creditworthiness of a business – particularly a mid-size firm – is considerably more difficult than assessing the risk on a residential mortgage secured by the borrower's house.

closely, and were themselves tightly regulated entities."[8]

Accordingly, syndicated loans originally were generally sold to other banks.[9] The loans were initially underwritten by a commercial bank (often called the "lead arranger") that then sold shares to other banks.[10] Lead arrangers would form and maintain the direct relationship with the borrower, conduct the initial due diligence on behalf of the syndicate, and monitor the loan after it was made.[11] Lead arrangers also retained a significant stake in the loans, keeping portions of the syndicated loans on their balance sheets in order to communicate confidence in the loans to others.[12]

2. Over time, however, syndicated loans began to be sold increasingly to non-bank investors, including ultimately to institutional and retail investors on a

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[8] *See* de Fontenay at 727; Jim Armstrong, *The Syndicated Loan Market: Developments in the North American Context* 2 (2003) (hereinafter "Armstrong"), https://www.bankofcanada.ca/wp-content/uploads/2012/02/fsr-0603-armstrong.pdf

[9] *See ibid*.

[10] *See* Amir Sufi, *Information Asymmetry and Financing Arrangements: Evidence from Syndicated Loans*, 62 J. Finance 629, 632-33 (2007) (hereinafter "Sufi"), *available at* https://onlinelibrary.wiley.com/doi/epdf/10.1111/j.1540-6261.2007.01219.x; Iñaki Aldasoro, *et al.*, "Non-bank lenders in the syndicated loan market," Bank for International Settlements Quarterly Review 15, 17 (March 2022) (hereinafter "Aldasoro"), *available at* https://www.bis.org/publ/qtrpdf/r_qt2203c.pdf.

[11] *See* Aldasoro at 17.

[12] *See* Sufi at 633; Aldasoro at 17.

massive scale. This development was driven by changes in supply, demand, and process.

Beginning in the early 1990s, federal banking regulations led banks to economize on capital, increasing the incentive to sell both commercial and consumer loans.[13] Growing leveraged-buyout activity also increased the supply of commercial loans to be syndicated while the higher interest rates on such loans attracted demand, including from an increasingly diverse set of investors.[14]

The expansion of the investor pool was made possible in part by the increasing standardization of settlement procedures.[15] This facilitated the trading, bundling, and reselling of syndicated loans in much the same way as mortgages previously became traded, bundled, and turned into publicly traded securities. Today, institutional investors participate in the syndications not only through direct investments, but also by re-intermediating the loans, repackaging and reselling them as parts of mutual funds, collateralized loan obligations, and other investment vehicles

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[13] *See* Linda Allen and Aron A. Gottesman, *The Informational Efficiency of the Equity Market as Compared to the Syndicated Bank Loan Market* 11 (Pace University Finance Research Paper No. 2004/05, 2004) (hereinafter "Allen"), *available at* https://ssrn.com/abstract=580963.

[14] *See* Bridget Marsh and Tess Virmani, *Loan Syndications and Trading: An Overview of the Syndicated Loan Market*, Lending & Secured Finance 2023, at 1-2 (11th ed. 2023) (hereinafter "Marsh"), *available at* https://www.lsta.org/content/loan-syndications-and-trading-an-overview-of-the-syndicated-loan-market/#.

[15] *See* Allen at 11; Marsh at 1-2.

composed exclusively, or nearly exclusively, of such interests.[16]

This new "non-bank appetite for syndicated leveraged loans would be the primary driver of demand that helped propel the loan market's growth."[17] By the mid-1990s, "investors began to look to the secondary market as a more effective platform from which to manage their risk exposure to loans, and eventually active portfolio management through secondary loan trading was born."[18] As a result, by "the latter part of the 1990s," there were "more than 30 active loan traders (e.g., JP Morgan Chase, Citigroup, Deutsche Bank, CFSB, and Goldman Sachs) becoming involved in the syndicated loan market and dealing in a wide range of syndicated loan credit quality."[19]

Explosive growth in syndicated loans followed. Between 1987 and 2004, the size of the primary market of syndicated loan originations grew from $37 million to $1.2 trillion.[20] At the end of 2022, the syndicated loan market was estimated to be composed

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[16] *See* Marsh at 2.

[17] *Ibid*.

[18] *Ibid*.

[19] Peter Nigro, *et al.*, *Some Evidence on the Secondary Market Trading of Syndicated Loans*, 8:5 J. Bus. & Econ. Res. 33, 37 (2010) (hereinafter "Nigro") (internal citations omitted), *available at* https://clutejournals.com/index.php/JBER/article/view/717/702.

[20] *See id*. at 33.

of $2.9 trillion outstanding (of almost $6 trillion committed).[21]

2. The result of these developments was a fundamental transformation of syndicated loans from a niche arrangement among banks to a standardized security sold to general investors. By 2010, 87% of syndicated loans were held by non-banks such as mutual funds, insurance companies, and hedge funds; only 13% remained in the hands of banks.[22]

As noted, many institutional buyers of syndicated loans now repackage them for sale to retail investors in the form of registered securities. There are now numerous mutual funds and exchange-traded funds ("ETFs") focused on syndicated loans, marketing tens of billions of dollars in these securities to retail investors.[23] Although those funds are themselves securities subject to the Acts' registration requirements and investor protections, their integrity as an investment is entirely dependent on the

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[21] Shared National Credit Program: 1st and 3rd Quarter 2022 Reviews, App. B (Feb. 24, 2023), *available at* https://www.occ.gov/publications-and-resources/publications/shared-national-credit-report/files/shared-national-credit-report-2022.html.

[22] Loan Syndication and Trading Association presentation to the Commodities Futures Trading Commission, Slide 6, *available* at https://www.cftc.gov/sites/default/files/idc/groups/public/@swaps/documents/dfsubmission/dfsubmission_021711_535_0.pdf.

[23] *See* Blackrock, *Non-Bank Lending: A Primer* 1-2 (Aug. 2019), *available at* https://www.blackrock.com/corporate/literature/whitepaper/policy-spotlight-non-bank-lending-a-primer.pdf.

integrity of the syndicated loans that make up their portfolios.

III. In Their Current Form, Syndicated Loans Give Rise To The Same Risks To Investors And The Financial System As Any Other Security Subject To Federal Securities Laws.

In the aftermath of all these changes, "when the smoke cleared, the business of commercial banking began to look much like the business of investment banking, and the loan market began to resemble its erstwhile opposite, the bond market."[24] As now sold and traded (both directly and in the form of mutual funds, collateralized loan obligations, ETFs, and other financial instruments), syndicated loans have taken on the central features of other federally regulated securities, giving rise to the same risks to investors and the economy that led Congress to subject those investments to federal regulation.

1. The originally defining feature of syndicated loans—which arguably distinguished them from other kinds of securities and diminished the need for subjecting them to federal securities protections—was that syndicated loans were owned predominantly by highly regulated banks that had the expertise and information to adequately evaluate the relevant risk on their own. As discussed, that is no longer the case. Those who purchase syndicated loans today—be they institutional investors participating directly in the syndication or retail investors buying shares of a corporate loan mutual fund or ETF—are in exactly the

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[24] de Fontenay at 738.

same position as any investor buying, for example, corporate bonds (which everyone agrees are "securities" subject to federal securities law).

At the same time, changes in who arranges and purchases loan syndications have eliminated guardrails that may have once diminished the need for federal securities regulation. When syndications involved only banks, both leading arrangers and participants had strong incentives to ensure the quality of the loans thus financed. Banks tend to be "particularly concerned with problematic loans because of the Shared National Credit review of the Federal Reserve."[25] That review "is important because 'examiners can downgrade a loan below a bank's own rating and force the lender to either boost reserves or even write the loan off.'"[26] Within the relatively small bank market for syndicated loans, therefore, banks that sold nonperforming loans could, in the past, easily be excluded from future syndicates.

Today, however, many purchasers of syndicated loans are non-banks, such as hedge funds.[27] Non-banks do not face the same regulatory scrutiny imposed by the Shared National Credit review and, therefore, lack that key historical constraint on loan quality. Perhaps unsurprisingly, then, non-bank lenders have been found to fund loans to riskier firms

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[25] Sufi at 634.

[26] *Ibid*. (quoting Todd Davenport, *As SNC exam wraps up, no news is good news*, The American Banker (July 14, 2003)).

[27] Aldasoro at 17.

in order to obtain higher returns.[28] Even the Loan Syndication and Trading Association, a trade group promoting broader trading of syndicated loans, admits that "structural changes" in the industry have "contributed to a more aggressive risk-return profile, which was necessary in order to still attract more liquidity to the asset class."[29]

Other non-regulatory incentives that may have once protected investors have also faded away. Originally, banks that arranged syndicated loans retained a meaningful portion of the loan on their own books.[30] They accordingly had a direct incentive to ensure the quality of the loans they helped syndicate to others. But that is no longer true today, as arranging banks rarely hold onto significant portions of the underlying loan after syndication.[31]

Instead, an increasingly large share of arrangers' compensation comes from the fees arrangers charge borrowers for creating the syndicated loan.[32] These circumstances, in which arrangers have a greater incentive to increase sales than to maintain quality, create a financial environment like that preceding the Global Financial Crisis, wherein market participants

[28] Sergey Chernenko, *et al.*, *Why Do Firms Borrow Directly from Nonbanks?,* at 6 (NB4ER Working Paper No. w26458, Nov. 2019), *available at* https://ssrn.com/abstract=3488958.

[29] Marsh at 2.

[30] Sufi at 633.

[31] *See* Nuveen, *Not Created Equal* 3 (2018).

[32] *See* Armstrong at 2.

earning fees from mortgage-backed securities were able to lay off credit risk to unwitting investors.

2. The market for syndicated loans is thus potentially ripe for the kind of manipulation, fraud, and systemic financial harm the securities laws are designed to address. There is a fundamental asymmetry of information between buyers and sellers regarding the quality of underlying assets because the banks originating the loans know so much more about the borrowers than do the ultimate holders of the securities. The bundling and re-intermediation of individual loans into securities to be marketed to a broader audience only serves to increase the opacity of the offering. Those who invest in these products, like securities investors generally, thus typically lack the "facts essential to estimating the worth" of what they are being sold. H.R. Rep. No. 73-85, at 2.

As with other securities, these informational problems give rise not only to a risk of fraud against investors, but of broader harm to the financial system if and when investors lose confidence in the now multi-trillion-dollar market for these investments that has become a vital source of liquidity for banks and capital of businesses. As in the context of mortgage-backed securities, it may be tempting to disregard that risk when it appears that the market is presently performing well. But that is a false comfort—in good economic times, high-risk loans sold on unreliable information may still pay out. That should not, however, obscure the potentially grave consequences of lax regulation when the next downturn in the business cycle comes along, as those high-risk and under-scrutinized loans go bad. Economists have found that the higher asymmetric information among non-bank syndicated loan investors leads to sensitivity to business cycle fluctuations of around *three times* that of bank investors, meaning that such investors will flee the market in the event of a major (or even minor) disruption more readily than banks.[33] Accordingly, the increasing non-bank participation in the market for syndicated loans increases both the availability *and the volatility* of this essential form of credit.

Federal securities laws were enacted to deal with exactly these kinds of risks. The laws require those who would market investments to the public make available the essential information Congress and the SEC have deemed necessary to evaluate the risk and value of the offering. They impose a legal obligation—backed by prospect of civil, and even criminal, liability—to ensure the accuracy of that information and to avoid misleading investors.

The Second Circuit's conclusion that these protections do not apply to syndicated loans under this Court's decision in *Reves* suggests either that the lower courts require further guidance on the proper application of *Reves* or that the non-textual approach of *Reves* itself should be revisited. Either way, the Court should grant certiorari in this case.

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[33] Quirin Fleckenstein, *et al.*, *Nonbank Lending and Credit Cyclicality* 17, 21 (December 2023), *available at* http://dx.doi.org/10.2139/ssrn.3629232.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

Kevin K. Russell
Counsel of Record
GOLDSTEIN, RUSSELL &
WOOFTER LLC
1701 Pennsylvania Ave. NW
Suite 200
Washington, DC 20006
(202) 240-8433
kr@goldsteinrussell.com

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