Davis Polk

A Guide to the Laws, Regulations and Contracts of the Financial Crisis

September 2009

Financial Crisis Manual

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INTRODUCTION

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The Davis Polk *Financial Crisis Manual* has been written for anyone who wants to understand the flurry of new legislation, old law used in new ways, contracts with Treasury, press releases, frequently asked questions, guidelines and other rulemaking that has occurred at a dizzying speed over the last year and a half as a result of the financial crisis. This *Manual* attempts to describe these US financial crisis laws as they relate to financial institutions and is also meant to be, through the hyperlinks in each Chapter, a reference work gathering in one place the scattered primary sources of financial crisis laws.

As practicing lawyers, we leave to others the tasks of analyzing the causes of the crisis and assessing the government's responses to it.[1] That said, the political and social context in which financial crisis rulemaking occurred resulted in regulations with characteristics that affect the way lawyers interpret the law and provide advice to clients. According to one commentary, this system "married transactional practice to administrative law."[2]

Ad Hoc Emergency Process. In contrast to the traditional legislative process, financial crisis rulemaking was done on a rapid, ad hoc, emergency basis to address immediate concerns about the stability and continued existence of the global financial system. Programs were proposed, adopted and in cases quickly abandoned in response to changing market conditions and other concerns. The speed of market developments, aided by twenty-first century communication channels, upended the traditional pattern and timeline of legislative and regulatory change. Regulations were issued on an interim basis without prior notice and comment. Guidelines, interim rules, FAQs and even press releases heralded new regulation. Since an FAQ or a guideline is often changed without notice or public announcement, it became necessary for lawyers to track changes in real-time. And unlike a proposed regulation, interim regulations and guidelines are applicable immediately without industry or consumer comment. All of this took place within the

The publication date of this Introduction is September 21, 2009. All terms and acronyms used in this Introduction are defined in the Glossary beginning on page 7 of this Manual.

[1] The financial crisis has led many to call for a fundamental reform of the financial regulatory structure. While this Manual does not cover regulatory reform, a series of Davis Polk memoranda focusing on regulatory reform can be found at http://www.davispolk.com/publications/list.aspx?ServiceGroup=620a5607-c6ea-47e8-be6e-99235c64cee3&related=true.

[2] Steven M. Davidoff and David T. Zaring, *Big Deal: The Government's Response to the Financial Crisis* (Nov. 24, 2008), http://ssrn.com/abstract=1306342.

framework of *Chevron* deference – a legal doctrine that requires judges to defer to a regulatory agency's interpretation of the meaning of a statute's language unless the interpretation is unreasonable. Treasury's determination that auto companies were "financial institutions" qualified to receive TARP funds is an illustration of the sort of interpretation entitled to this type of deference. For a further discussion, see Chapter 2: *Emergency Economic Stabilization Act: The Original Vision*.

Treasury as Contractual Counterparty. Another characteristic of financial crisis law is Treasury as contractual counterparty and investor. During the crisis, the government, as the single available capital lifeline, announced programs via term sheets that, with only minor changes, became the largely non-negotiable standard contracts for all program participants. All CPP contracts contain an unusual provision permitting Treasury to amend them unilaterally and retroactively in case of a statutory change. For a further discussion, see Chapter 3: *The Capital Twist*. Since being signed, these contracts have, in fact, been amended twice by statute. In addition, the government used lessons garnered from its role as contractual counterparty to a few TARP recipients receiving exceptional assistance as the basis of future rulemaking that was more widely applicable. As a result, in many respects, TARP recipients find themselves subject to a complex web of contractual obligations, legislative and regulatory actions. Lawyers working in this area cannot, therefore, rely only on the contracts posted online, since they often do not reflect the statutory amendments. Nor can they interpret the regulations without understanding the contracts that may be applicable. For a further discussion, see Chapter 3: *The Capital Twist* and Chapter 4: *Warrants: Upside for the Taxpayer*. Any examination of compensation restrictions is especially caught in this interplay. For a further discussion, see Chapter 9: *Executive and Employee Compensation*.

Transparency, Accountability, Investigations and Enforcement. This new style of rapid rulemaking took place within a highly charged political, social and economic context, which has led, over time, to increasing calls for transparency and accountability, investigations and enforcement. While Congress gave Treasury wide latitude under EESA to define the scope and mechanics of program implementation, it also created three new Congressionally-mandated oversight bodies. Of these, the COP and the SIGTARP have been the most active and their reports have influenced both later law and regulatory action. For a further discussion, see Chapter 2: *Emergency Economic Stabilization Act: The Original Vision* and Chapter 8: *Investigations and Enforcement*. The Federal Reserve's exercise of its emergency powers has led to calls for more auditing and transparency of the Federal Reserve. Treasury, as contractual counterparty, has committed itself to transparency by posting all of its contracts online. First by contract and then by law, SIGTARP has the ability to review the books and records of TARP recipients. Media efforts to obtain information by FOIA reflect their view that this information is desired by their readers. Congress has also created the FCIC to investigate the causes of the crisis, and various DOJ, SEC and FDIC investigations, enforcement actions and lawsuits, as well as

SIGTARP investigations, are just beginning to show their public face. For a further discussion, see Chapter 8: *Investigations and Enforcement.*

Termination of Financial Crisis Program Dates:

- CPFF: February 1, 2010 unless the Board extends the program.
- EESA: December 31, 2009 or if extended by the Treasury Secretary, up to October 3, 2010.
- Money Market Funding Facility: October 30, 2009.
- TALF:
  - Newly issued ABS and legacy CMBS: March 31, 2010;
  - Newly issued CMBS: June 30, 2010.
- TLGP:
  - Debt Guarantee Program:
    - Issue guaranteed debt: October 31, 2009;
    - Guarantee Expires: December 31, 2012;
  - Transaction Account Guarantee Program: June 30, 2010.

Gradual Winding Down. We have now entered into a phase of the gradual winding down of the many temporary programs, some of which are noted in the sidebar, but the impact of financial crisis laws may not be as temporary as one might initially think. As the Treasury has recently observed in its report *The Next Phase of Government Financial Stabilization and Rehabilitation Policies* (September 14, 2009), the recovery remains "partial and fragile" and "the process of terminating crisis-related programs must be done in a measured way that does not derail the nascent economic recovery."[3] Indeed, while many of the laws, regulations and programs discussed in this manual were intended to be temporary, lasting only so long as emergency conditions persisted, their impact will continue long after the programs expire. The end of the programs may mean the end of new investments or loans, but the program's expiration does not end the government's investment or the applicability of financial crisis law to private actors. Even when Treasury's authority to make investments expires, financial institutions carrying Treasury investments will have to comply with executive compensation, employment and lobbying restrictions. Moreover, it remains to be seen whether the new style of lawmaking created during the financial crisis as well as the political risk of retroactive changes, see Chapter 2: *Emergency Economic Stabilization Act: The Original Vision - Political Risk*, influences how financial regulation is made and interpreted in the future. As a result, many of these regulations will have an impact beyond what may have been initially intended.

Global Regulatory Response. The financial crisis was global in nature and there was, at a high level, a broad similarity in the financial crisis regulatory solutions sought by regulators in most developed countries. There was also an increased call for regulatory cooperation across borders both in the response to the crisis and the calls for reform. While a full discussion of the cross border response is outside the scope of the Manual which focuses solely on US financial crisis laws, within some of the Chapters we have pointed out some international comparisons. The impact of international cooperation on regulatory reform and the gradual winding down of programs remains to be seen.

Resource and Timelines. We hope this manual will be a resource to anyone who wants to understand and give advice on financial crisis law. A timeline is set forth at the end of this Introduction, which links the major financial crisis events and the legislative and regulatory responses to them. In addition to the timeline mentioned above, we have also provided a glossary which explains the many new acronyms created – the alphabet

[3] U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES 14, 6 (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

soup of the financial crisis – and sets forth the defined terms of this manual which can be found immediately after this Introduction. Finally, the publication date of each Chapter is noted at the beginning of such Chapter.

Acknowledgements. Many elements of this *Financial Crisis Manual* have been based, in part, on a series of Davis Polk memoranda published during the financial crisis, beginning with the client memorandum *Emergency Economic Stabilization Act of 2008*, which won a Burton Award for Best Legal Memo 2009, as well as an internal wiki that we have used in our own practice. We are very grateful to the many readers of our memos who have passed on encouragement and comments, posted our memoranda on blogs and passed them on to others.

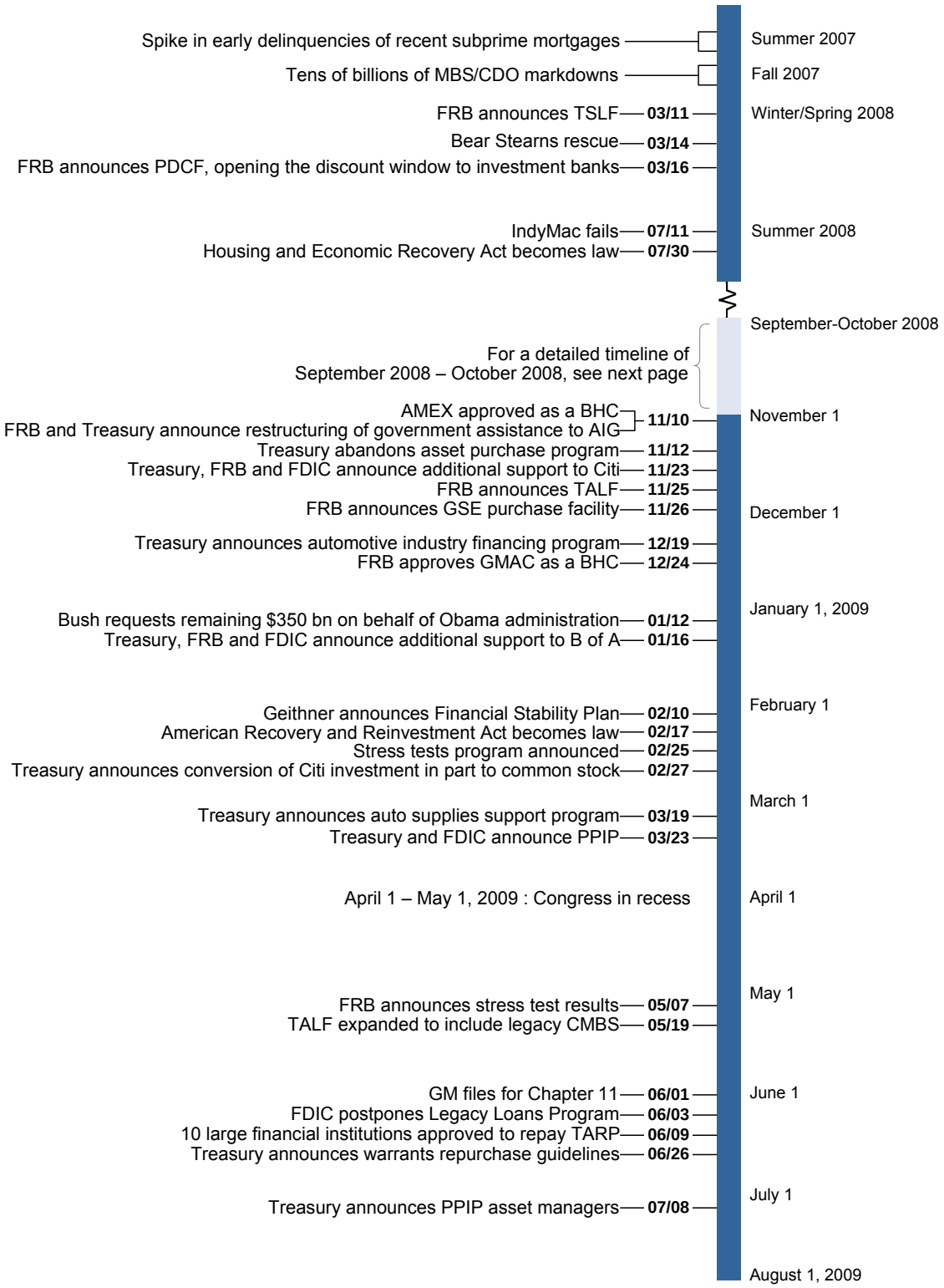
A work of this nature over the last few months would not have been possible without the intense teamwork that is the hallmark of the Davis Polk culture. Many partners and associates have written portions of this manual or contributed time to research or comments. Those partners and counsel who are the authors of the chapters are noted in the table of contents and on the first page of each Chapter and include: John M. Brandow, Beverly Chase, Luigi L. De Ghenghi, John L. Douglas, William J. Fenrich, Edmond T. FitzGerald, James A, Florack, Randall D. Guynn, Michael Kaplan, Yukako Kawata, Leor Landa, Kyoko Takahashi Lin, Jean M. McLoughlin, Annette L. Nazareth, Jennifer G. Newstead, Barbara Nims, Reena Agrawal Sahni, Margaret E. Tahyar, Linda Chatman Thomsen, Danforth Townley and Raul F. Yanes. In addition, partners Samuel Dimon, Ethan T. James and Arthur S. Long and counsel Robert L.D. Colby, Ning Chiu and George R. Ince, Jr. contributed comments and other help.

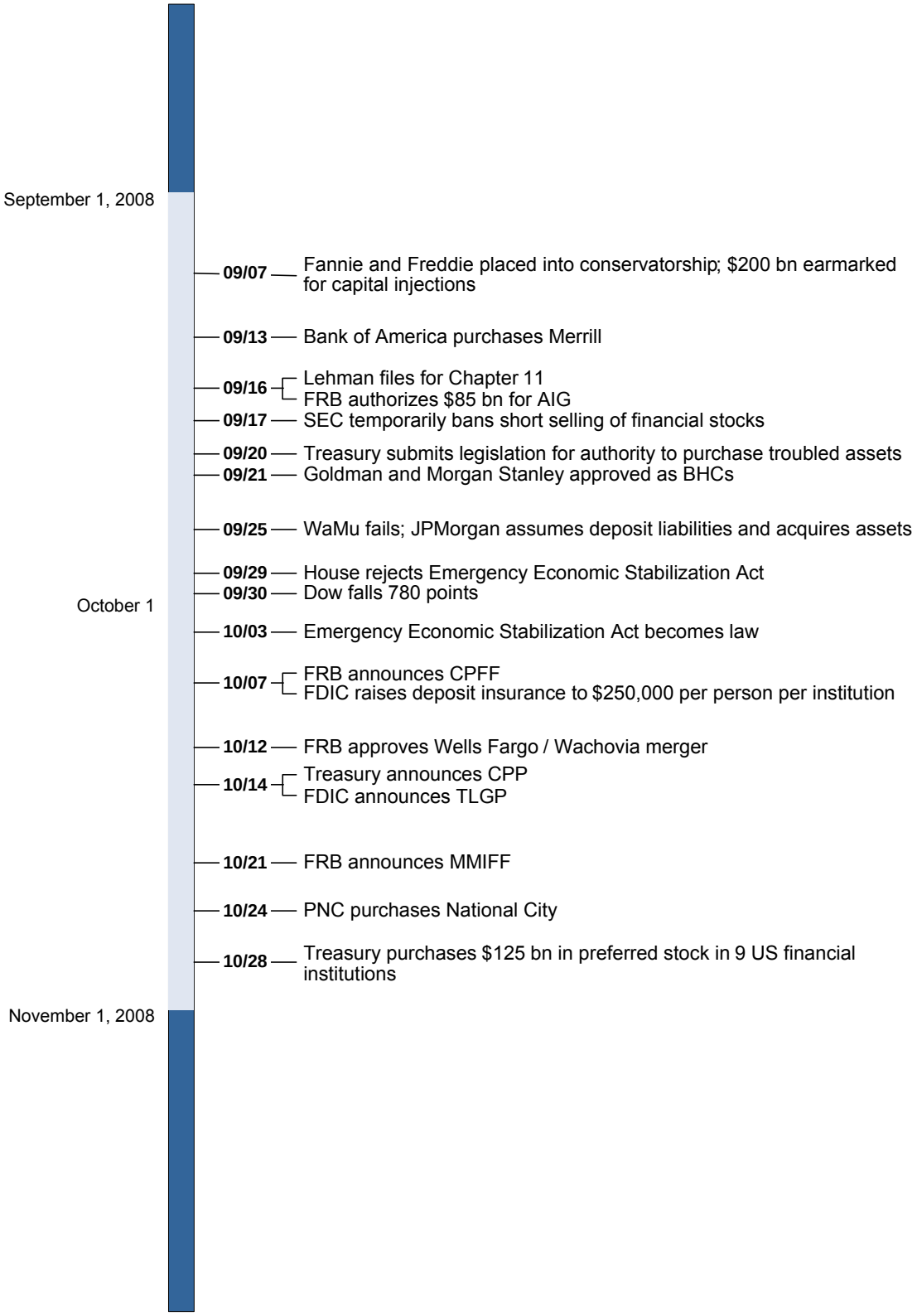
We also wish to acknowledge the significant effort of many associates, summer associates and legal assistants who worked on the memoranda over the last year, often during weekends and on tight time schedules and who also helped to make this manual a reality, in particular, Ron M. Aizen, Sparkle Alexander, Sarah Ashfaq, Edith Beerdsen, Priya Bindra, Harold Birnbaum, Anjali Bonner, Austin D. Brown, Robert G. Canning, Eleanor G. Carr, Caroline Chan, Daysun S. Chang, Jennifer Grant Cooper, Vesna Cuk, Cristina Fong, Michelle Galdos, Lauren Gillespie, Christine Graham, Grant Harm, Alison M. Hashmall, Sophia Hudson, Daniel S. Kahn, Alex Kardon, Ashleigh S. Kyle, Hsien-Jay Lee, Jessy Li, Darren Mahone, Shakhi Majumdar, Serge Martyn, Wataru Matsumoto, Fiona McCarthy, Adam Mehes, Stefan Neata, Jessica Neidhart, Aaron Page, Heidi E. Reiner, Joerg Riegel, Rebecca Rotem, Chaoyuan Charles Shi, Jonathan Stroble, Kacper A. Walicki, Scott Wilcox, Brian Wolfe, Alex Young-Anglim and Rachel S. Zeehandelaar. The work and research of those associates is acknowledged on the first page of each Chapter where they were involved.

Finally, this manual could not have been done without the organizational skill of Peter E. Devlin and Gabriel Rosenberg, who kept us all on track, and the enormous efforts of Kathryn Cragg, paralegal extraordinaire.

– Margaret E. Tahyar, Editor
September 21, 2009

FINANCIAL CRISIS LEGAL TIMELINE




September 1, 2008
09/07 Fannie and Freddie placed into conservatorship; $200 bn earmarked for capital injections
09/13 Bank of America purchases Merrill
09/16 Lehman files for Chapter 11
FRB authorizes $85 bn for AIG
09/17 SEC temporarily bans short selling of financial stocks
09/20 Treasury submits legislation for authority to purchase troubled assets
09/21 Goldman and Morgan Stanley approved as BHCs
09/25 WaMu fails; JPMorgan assumes deposit liabilities and acquires assets
09/29 House rejects Emergency Economic Stabilization Act
09/30 Dow falls 780 points
October 1
10/03 Emergency Economic Stabilization Act becomes law
10/07 FRB announces CPFF
FDIC raises deposit insurance to $250,000 per person per institution
10/12 FRB approves Wells Fargo / Wachovia merger
10/14 Treasury announces CPP
FDIC announces TLGP
10/21 FRB announces MMIFF
10/24 PNC purchases National City
10/28 Treasury purchases $125 bn in preferred stock in 9 US financial institutions
November 1, 2008

GLOSSARY

Term	Definition
ABS	Asset-backed securities. Securities whose value is derived from, and, in the case of cash (*i.e.*, non-synthetic) ABS, collateralized or backed by, a specific pool of underlying assets.
accredited investor	An "accredited investor" as defined in Regulation D under the Securities Act of 1933. It includes entities such as banks, insurance companies, registered investment companies; those charitable organizations, corporations, or partnerships that have assets exceeding $5 million; certain employee benefits plans; and natural persons who are directors, executive officers, or general partners of the company selling the securities or who meet certain income or net worth requirements.
AMLF	Asset-Backed Commercial Paper Money Market Fund Liquidity Facility. The AMLF was created by the Federal Reserve to provide funding to US depository institutions and bank holding companies and their US broker-dealer subsidiaries to finance purchases of asset-backed commercial paper from money market mutual funds.
APA	Administrative Procedure Act. The APA, among other things, governs how agencies of the Federal government make regulations and conduct hearings and sets forth the standard for judicial review.
ARRA	The American Recovery and Reinvestment Act of 2009, also known as the fiscal stimulus. ARRA contains provisions that amend parts of EESA.
Asset Guarantee Program	The Asset Guarantee Program, first used by Treasury in November, 2008, provides certain loss protections on a select pool of mortgage-related or similar assets held by financial institutions whose portfolios could pose a risk to market stability.
Bank Holding Company Act of 1956	Seminal legislation that regulated the interstate expansion of bank holding companies and the types of nonbanking activities in which bank holding companies could engage.
CAP	Capital Assistance Program. The Capital Assistance Program was established by Treasury in February, 2009 pursuant to EESA to inject capital in qualifying financial institutions through the purchase of mandatorily convertible preferred stock and warrants.
capital assessment	Another way to say "stress tests" which are a method of determining the financial health of an institution by calculating the institution's ability to absorb losses.
CD&A	Compensation Discussion and Analysis. CD&A is a required section about executive compensation in SEC filings of public companies.

Term	Definition
CDO	Collateralized Debt Obligation. A debt security collateralized by a variety of debt obligations including bonds and loans of different maturities and credit quality.
Central Bank of Denver v. First Interstate Bank of Denver	A 1994 Supreme Court case holding that Section 10(b) of the Securities Exchange Act of 1934, imposing civil liability on those who commit manipulative or deceptive acts in connection with securities sales, does not provide a cause of action against a person who aids and abets a manipulative or deceptive act.
CFPA	Consumer Financial Protection Agency. The Obama Administration has proposed legislation to create the Consumer Financial Protection Agency, a new agency that would regulate consumer financial products and services including home loans, credit card fees and payday loans. The draft Consumer Financial Protection Agency Act of 2009 was sent to Congress on June 30, 2009, and was later introduced in the House of Representatives.
Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.	Seminal 1984 Supreme Court case holding that a court must defer to a federal administrative agency's interpretation of a legislative statute in its area of expertise if the court determines that the statute is silent or ambiguous and that the agency's interpretation of the statute is reasonable.
clawback	The recovery, after payment, of that payment for specified reasons. Used here in connection with executive compensation payments that do not meet specified requirements or in connection with bonus clawbacks under the Sarbanes-Oxley Act.
CMBS	Commercial mortgage-backed securities. A category of ABS that is backed by pools of mortgage loans secured by commercial real estate. Under TALF, CMBS are further categorized as legacy CMBS or newly issued CMBS.
collateral haircut	A percentage subtracted from the par value of the collateral that reflects the perceived risk associated with holding such collateral.
collateral monitor	A term used under TALF to describe each entity that advises the Federal Reserve Bank of New York on assessing the risk of the pledged collateral. Currently, Trepp, LLC monitors all CMBS collateral while PIMCO monitors both non-mortgage-backed ABS and CMBS.
COP	Congressional Oversight Panel. The Congressional Oversight Panel was established by EESA and is charged with reviewing the current state of the financial markets and the regulatory system. The COP submits monthly reports to Congress regarding, among other things, the Secretary of the Treasury's use of authority under EESA, the impact of purchases made under EESA, and the effectiveness of TARP.
CPFF	Commercial Paper Funding Facility. Under the CPFF, the Federal Reserve Bank of New York purchases highly-rated unsecured and asset-backed commercial paper from eligible issuers via eligible primary dealers in order to provide a liquidity backstop to US issuers of commercial paper.
CPP	Capital Purchase Program. The Capital Purchase Program was established by Treasury in October, 2008 pursuant to EESA to inject capital into certain qualifying

Term	Definition
	financial institutions through the purchase of newly issued preferred stock and warrants.
credit-default swap	A credit default swap is a credit derivative contract between two counterparties. The buyer makes periodic payments to the seller, and in return receives a payoff if an underlying financial instrument defaults, typically a bond or loan.
CUSIP number	Committee on Uniform Security Identification Procedures number. A CUSIP number is a unique identification number that is assigned to stock and bond certificates.
customer agreement	An agreement between a TALF borrower and a TALF Agent that authorizes the TALF Agent to act on behalf of the borrower in connection with TALF borrowings.
debt guarantee limit	The maximum amount of FDIC-insured debt that a participating entity may issue under the Debt Guarantee Program.
Debt Guarantee Program	A program adopted by the FDIC as part of TLGP under which participating entities may issue certain senior unsecured debt guaranteed by the FDIC.
Deposit Insurance Fund	A fund maintained by the FDIC to ensure that, in the event of the insolvency of an FDIC-insured bank, depositors receive their deposits up to the deposit insurance coverage limit. The fund is funded mainly by assessments on insured depository institutions.
deposit insurance limit	The maximum deposit balance per customer insured by the FDIC. Federal deposit insurance funds currently guarantee all deposits at federally insured institutions up to $250,000 per depositor.
depository institutions	Banks and thrifts that are licensed to accept deposits from customers. Virtually all US depository institutions are insured by the FDIC.
discount window	Federal Reserve facility that lends short-term money directly to eligible institutions.
EAWA	Employ American Workers Act. EAWA was signed into law on February 17, 2009 as part of ARRA. It heightens the barriers on hiring foreign employees for TARP recipients.
EESA	Emergency Economic Stabilization Act of 2008. The Emergency Economic Stabilization Act of 2008 was signed into law on October 3, 2008. The Act authorized the Treasury to spend up to $700 billion to purchase troubled assets and make capital injections.
eligible borrower	As used under TALF, any US company that owns TALF-eligible collateral, maintains an account with a TALF Agent and satisfies certain TALF eligibility criteria, including limited liability companies, partnerships, banks, corporations, business or other non-personal trusts and different types of investment funds, for example hedge funds, private equity funds and mutual funds.
eligible entity	As used under TLGP, any insured depository institution, holding company or affiliate eligible to participate in any part of TLGP.

Term	Definition
emergency guarantee facility	A facility proposed by the FDIC by Notice of Proposed Rulemaking dated September 9, 2009, that would permit a participating entity in TLGP to issue FDIC-guaranteed debt after the Debt Guarantee Program's issuance window closes on October 31, 2009 if such entity satisfies certain onerous conditions for admission into the emergency guarantee facility.
ERISA	Employee Retirement Income Security Act. ERISA was designed to curb abuses by pension fund managers and sets standards for pension funds, including standards on: eligibility, performance, investment selection, funding, and vesting.
False Claims Act	The False Claims Act provides a cause of action against entities that defraud the US government through false claims or statements. In addition to the DOJ, a private "relator" with direct knowledge about the fraud may bring a qui tam suit against government contractors or subcontractors and receive a portion of any recovered damages, usually between 15-25 percent. The Fraud Enforcement and Recovery Act of 2009 amends the False Claims Act to broaden third-party civil liability and to include fraud in connection with the government stimulus package or recovery plan.
FAS	Financial accounting standard. An FAS is a financial accounting standard as stated and codified by the FASB.
FASB	Financial Accounting Standards Board. FASB is the independent accounting organization that determines the standards for financial accounting and reporting.
Fannie Mae	GSE that buys and sells home mortgages, either as whole mortgages or mortgage-backed securities. Originally part of a federal program, Fannie Mae converted into a privately-owned corporation in 1968. In September 2008, Treasury placed Fannie Mae and its "brother" corporation, Freddie Mac, into conservatorship that continues through the date of publication.
FCIC	Financial Crisis Inquiry Commission. The Financial Crisis Inquiry Commission is a 10-member legislative commission created to examine the causes of the current financial and economic crisis in the United States, including the collapse of each major financial institution. The FCIC has the authority to hold hearings, take testimony and subpoena witnesses and documents. It must report its findings to the President and Congress on December 15, 2010. Many have suggested that is inspired by the Pecora Commission of the 1930s.
FDIC	Federal Deposit Insurance Corporation. Under existing law, all federally-chartered and most state-chartered depository institutions must have federal deposit insurance from the FDIC.
FDICIA	Federal Deposit Insurance Corporation Improvement Act. FDICIA was enacted in 1991 and expanded the FDIC's authority over conservatorship and receivership processes for banks.
Federal Reserve Bank of New York	One of 12 regional Reserve Banks which, together with the Federal Reserve Board, the member banks and certain councils and the Federal Open Market Committee,

Term	Definition
	compose the Federal Reserve System.
Federal Reserve	Board of seven members that oversee the Federal Reserve System's financial and monetary policies.
Federal Reserve System	The central bank of the United States. Sets and maintains the financial and monetary policies of the United States.
FERA	Fraud Enforcement and Recovery Act of 2009. The Fraud Enforcement and Recovery Act of 2009, signed into law on May 20, 2009, is a law enacted to improve enforcement of mortgage fraud, securities and commodities fraud, financial institution fraud, and other frauds related to Federal assistance and relief programs.
FINRA	The Financial Industry Regulatory Authority. FINRA is a private corporation that acts as a self-regulatory organization for securities firms doing business in the United States.
FOIA	Freedom of Information Act. FOIA is a federal law that provides, in general, that any person has the right to inspect and request copies of federal agency records or policies subject to certain exceptions.
Foreign Corrupt Practices Act	Federal law that, among other things, prohibits US companies from making bribes to foreign officials. Sometimes referred to as the FCPA.
Freddie Mac	GSE that buys and sells home mortgages, either as whole mortgages or mortgage-backed securities. Freddie Mac was organized as a privately-owned corporation in 1970, primarily as a means to provide competition to the newly private Fannie Mae. In September 2008, Treasury placed Freddie Mac and Fannie Mae into conservatorship that continues through the date of publication.
FSP	Financial Accounting Standards Board Staff Position. FSPs are a form of guidance issued by the Financial Accounting Standards Board.
GAO	Government Accountability Office. The Government Accountability Office is the investigative arm of Congress and is required by EESA to conduct detailed ongoing audits of almost every aspect of TARP.
good bank/bad bank	Structuring technique designed to segregate troubled assets of a bank into a separate pool or liquidating vehicle, whether or not the separate pool or liquidating vehicle is technically a bank. It is often combined with an arrangement whereby a government entity assumes the risk of loss on all or some portion of the bad assets. Free of all or some of the risk of its bad assets, the transferring bank becomes the "good bank" that can now attract capital and carry out its business as a normal going concern.
GSE	Government-sponsored enterprises. GSEs are a group of financial services corporations created by the United States Congress, whose function is to enhance the flow of credit to targeted sectors of the economy. Fannie Mae and Freddie Mac are GSEs.

Term	Definition
Guarantee Program	The Guarantee Program was established by EESA and is implemented by Treasury. The program provides guarantees for assets held by systemically significant financial institutions that face a high risk of losing market confidence.
Helping Families Save Their Homes Act of 2009	The Helping Families Save Their Homes Act of 2009 was signed into law on May 20, 2009. Among other provisions that were mostly related to mortgage loan modifications, the Act extended FDIC and NCUA deposit insurance coverage to $250,000 per depositor through December 31, 2013. Its main purpose was to prevent mortgage foreclosures.
HERA	The Housing Economic Recovery Act of 2008 was signed into law July 30, 2008. The Act allows the Federal Housing Administration to guarantee up to $300 billion in new 30 year fixed rate mortgages for subprime borrowers and injects capital into mortgage institutions Freddie Mac and Fannie Mae.
IOLTA	Interest on Lawyers Trust Accounts. A lawyer may place client funds in an IOLTA if such funds could not otherwise earn net interest. Revenues from the IOLTA program are generally used to provide civil legal aid. The Transaction Account Guarantee Program covers IOLTAs paying an interest rate at or below 0.5%.
insured depository institution	A depository institution benefitting from federal deposit insurance. Under existing law, all federally-chartered and most state-chartered depository institutions must have federal deposit insurance. Federal deposit insurance funds currently guarantee all deposits at federally insured institutions up to $250,000 per depositor.
Investor Protection Act of 2009	The proposed Investor Protection Act of 2009, sent to Congress by the Treasury Department on July 10, 2009, would provide the SEC with the authority to seek remedies for aiding and abetting violations under the Securities Act of 1933 and the Investment Company Act of 1940; would extend the SEC's aiding and abetting enforcement authority across all of the securities laws to include reckless conduct; would expand the SEC's authority to compensate whistleblowers; and would permit the SEC to impose on violators a broader range of collateral bars under the Exchange Act and the Advisers Act.
legacy CMBS	Legacy commercial mortgage-backed securities. As used under TALF, a subcategory of CMBS, referring to CMBS issued before January 1, 2009.
Legacy Loans Fund	A PPIF formed under the Legacy Loans Program.
Legacy Loans Program	One half of PPIP (the other is the Legacy Securities Program). The Legacy Loans Program is now indefinitely suspended, but if it were to proceed as announced, it would be run by the FDIC and involve the creation of PPIFs to purchase troubled whole loans from FDIC-insured US depository institutions.
Legacy Securities Funds	A PPIF formed under the Legacy Securities Program.
Legacy Securities Program	The other half of PPIP (along with the Legacy Loans Program). The Legacy Securities Program is run by Treasury and involves the creation of PPIFs to purchase troubled mortgage-backed securities from "financial institutions" under EESA.

Term	Definition
LIBOR	The London Interbank Offered Rate. LIBOR is a daily reference rate based on the interest rates at which banks borrow unsecured funds from other banks in the London wholesale money market (or interbank market).
long-term non-guaranteed debt option	Before the Debt Guarantee Program was amended to extend the issuance window from June 30, 2009 to October 31, 2009, participating entities could elect to pay a non-refundable fee to the FDIC in order to issue long-term non guaranteed debt.
Maiden Lane	A vehicle formed to acquire troubled assets of Bear Stearns pursuant to the agreement between the Federal Reserve Bank of New York and JP Morgan. On June 26, 2008, the Federal Reserve Bank of New York extended credit to Maiden Lane, now called Maiden Lane I, under the authority of Section 13(3).
Maiden Lane II and III	Delaware limited liability companies that received extensions of credit from the Federal Reserve Bank of New York authorized under Section 13(3). They were created to facilitate assistance to AIG.
mandatory convertible debt	Certain debt instruments that, when issued by an entity participating in the Debt Guarantee Program during the prescribed issuance window, will be guaranteed by the FDIC. To be eligible for the government guarantee, the mandatory convertible debt must provide in the debt instrument for the mandatory conversion of the debt into common shares of the issuer on a fixed date and satisfy certain other conditions.
Master Agreement	A contract entered into between the FDIC and a participating entity in the Debt Guarantee Program that sets out the terms and conditions of taking part in the program.
Master Loan and Security Agreement	An agreement containing the terms and conditions for borrowing and collateral arrangements under TALF between the Federal Reserve Bank of New York, the Bank of New York Mellon as custodian bank and the TALF Agents on their own behalf and on behalf of their respective borrowers.
MBS	Mortgage-backed security. MBS is an asset-backed security or debt obligation that represents a claim on the cash flows from pools of mortgage loans, most commonly on residential property.
member banks	State-chartered banks that are members of the Federal Reserve System.
Money Market Investor Funding Facility	The Money Market Investor Funding Facility is a Section 13(3) Federal Reserve liquidity facility which provides senior secured funding to a series of special purpose vehicles to finance the purchase of eligible assets from eligible investors with the purpose to provide liquidity to US money market investors.
newly issued CMBS	Newly issued commercial mortgage-backed securities. As used under TALF, a subcategory of CMBS, referring to CMBS issued on or after January 1, 2009.
non-interest bearing transaction accounts	Certain accounts at FDIC-insured institutions participating in the Transaction Account Guarantee Program (part of TLGP) that are fully guaranteed by the FDIC through either December 31, 2009 or June 30, 2010.

Term	Definition
non-mortgage-backed ABS	Non-mortgage-backed asset-backed securities. As used under TALF, a category of ABS that currently includes securities backed by auto loans, student loans, credit card receivables, equipment loans, floorplan loans, insurance premium finance loans, small business loans fully guaranteed as to principal and interest by the SBA, and receivables related to residential mortgage servicing advances.
NOW account	Negotiable Order of Withdrawal Account. A NOW account is an interest-earning bank account with which the customer is permitted to write drafts against money held on deposit. The Transaction Account Guarantee Program covers NOW accounts paying an interest rate at or below 0.5%.
NRSRO	Nationally Recognized Statistical Rating Organization. A SEC-registered credit rating agency that issues credit ratings used by other financial firms for certain regulatory purposes. Currently, there are ten firms registered as NRSROs.
OCC	Office of the Comptroller of the Currency. Charters and regulates all national banks.
OTS	Office of Thrift Supervision. Regulates federal and state-chartered savings associations and savings banks.
participating entity	As used under TLGP, any insured depository institution, holding company or affiliate that has not opted out of the applicable part of TLGP.
PDCF	Primary Dealer Credit Facility. The Primary Dealer Credit Facility is a Federal Reserve secured liquidity facility created under Section 13(3). The facility provides primary dealers with daily access to funding in an amount determined by the borrowing institutions' needs and available collateral.
PPIF	Public-Private Investment Fund. An investment fund established to purchase troubled mortgage-backed securities or whole loans under PPIP. Also known as a "Legacy Securities Fund" if formed under the Legacy Securities Program and a "Legacy Loans Fund" if formed under the Legacy Loans Program.
PPIP	Public-Private Investment Program. A TARP program involving the creation of public-private investment funds to purchase troubled mortgage-backed securities and whole loans. Each fund will be capitalized with equity from Treasury and private investors and leveraged with government debt financing. The program originally had two halves: the Legacy Securities Program and the Legacy Loans Program, but the latter has been suspended indefinitely.
primary dealer	Primary dealers are approximately 20 large financial institutions that are the counterparties with which the Federal Reserve undertakes open market operations. In order to be a primary dealer, an institution must, among other things, meet relevant Basel or SEC capital requirements and maintain a good trading relationship with the Federal Reserve.
primary federal banking agency	The federal agency that has the primary authority to examine and supervise a type of bank or savings associations. The primary federal banking agencies are as follows: the OCC (for national banks), the Federal Reserve (for bank holding companies and

Term	Definition
	financial holding companies as well as state-chartered banks that are members of the Federal Reserve System), the FDIC (state-chartered banks that are not members of the Federal Reserve System), and the OTS (savings and loan holding companies and federal savings associations).
Private Fund Investment Advisers Registration Act of 2009	The proposed Private Fund Investment Advisers Registration Act of 2009, sent to Congress by the Treasury Department on July 15, 2009, would amend the Investment Advisers Act of 1940 to require nearly all advisers to hedge funds and other private pools of capital to register with the SEC.
Recovery Accountability and Transparency Board	The Recovery Accountability and Transparency Board was established by ARRA, enacted on February 17, 2009. The Board's mission is to oversee the use of ARRA funds in order to "prevent fraud, waste, and abuse" and to provide the public with "accurate, user-friendly information" concerning Recovery Act spending. The Board is empowered to issue subpoenas and to conduct audits and reviews.
RMBS	Residential MBS. A form of MBS backed by a pool of mortgage loans on residential property.
say on pay	Legal requirement that companies permit their shareholders to provide a non-binding vote on executive compensation.
SBA	US Small Business Administration. SBA is an independent federal agency that seeks to aid, counsel, assist and protect the interests of small business concerns. TALF supports the issuance of asset-backed securities collateralized by loans guaranteed by the SBA.
SEC v. Nature's Sunshine Products	Case settled on July 31, 2009, where the SEC had alleged violations of the FCPA and securities laws by a company and the company's executives, respectively.
Section 13(3)	Section 13(3) of the Federal Reserve Act gives the Federal Reserve broad secured lending power in "unusual and exigent circumstances."
Securities Purchase Agreement	The standard agreement between Treasury and financial institutions participating in TARP governing the terms of the financial institution's issuance of preferred stock and warrants to the government.
senior unsecured debt	As used under the Debt Guarantee Program, certain types of debt securities that, when issued by an participating entity in the Debt Guarantee Program, are guaranteed by the FDIC. To be eligible for the FDIC guarantee, the debt must satisfy certain conditions.
SIFMA	The Securities Industry and Financial Markets Association. SIFMA is a non-profit association that represents the shared interests of participants in global financial markets. SIFMA members include international securities firms, US-registered broker-dealers and asset managers.
significant operations	In EESA, a financial institution must have significant operations in the US in order to be eligible to participate in TARP. Treasury has not provided guidance on the definition.

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Term	Definition
SIGTARP	Special Inspector General for TARP. The Office of the Special Inspector General for TARP was established by EESA and is charged with conducting, supervising and coordinating audits and investigations of the purchase, management and sale of assets under TARP.
SIGTARP Act	Signed into law April 24, 2009, the SIGTARP ACT expanded SIGTARP's oversight authority over TARP programs and participants.
SOX	The Sarbanes-Oxley Act of 2002. SOX is a United States federal law enacted on July 30, 2002 that set enhanced standards for all US public company boards, management and public accounting firms.
Special Master	Treasury has appointed a Special Master, Kenneth Feinberg, to oversee executive compensation arrangements of certain TARP recipients.
TALF	Term Asset-Backed Securities Loan Facility. TALF is a Federal Reserve credit facility authorized under section 13(3) of the Federal Reserve Act that can lend up to $200 billion (or, if expanded, up to $1 trillion) on a non-recourse basis to holders of eligible ABS with the goal of facilitating ABS issuance and improving the ABS market.
TALF Agent	A financial institution that is a party to the Master Loan and Security Agreement from time to time, individually and as agent for its borrower.
TALF LLC	A special purpose vehicle established under TALF by the Federal Reserve Bank of New York to purchase and manage assets surrendered to the Federal Reserve Bank of New York in connection with TALF loans.
TALF Task Force	A multi-agency task force established by the SIGTARP and the Federal Reserve to deter, detect and investigate instances of fraud under TALF.
TARP	Troubled Asset Relief Program. The Troubled Asset Relief Program, strictly speaking, refers only to Treasury's asset and capital purchase or guarantee programs. It has, however, been commonly used to refer to the entire series of relief programs that the government has established to promote financial market stability and homeowner relief.
TARP period	The period of time starting when a TARP recipient first receives financial assistance from the Treasury and ending on the last date upon which any obligation arising from financial assistance remains outstanding. For this purpose, TARP obligations do not include warrants to purchase common stock of the TARP recipient.
TLGP	Temporary Liquidity Guarantee Program. A program adopted by the FDIC to preserve confidence and encourage liquidity in the US banking system, and to ease lending to creditworthy businesses and consumers. TLGP consists of two parts: the Debt Guarantee Program and the Transaction Account Guarantee Program.
Transaction Account Guarantee Program	A program adopted by the FDIC as part of TLGP that provides unlimited deposit insurance above the current $250,000 per depositor coverage for certain non-interest bearing transaction accounts at participating insured depository institutions.

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Term	Definition
troubled asset	Troubled assets under EESA fall into two broad categories. The first category includes residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case were originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability. The second category gives Treasury the power to declare any other financial instrument to be a troubled asset if the purchase of the instrument is "necessary" to promote financial market stability.
TSLF	Term Securities Lending Facility. TSLF is a Federal Reserve secured liquidity facility created under Section 13(3). The facility lends primary dealers a pre-determined amount of funding, which is secured for a term of 28 days, at auctions on pre-announced dates.
TSLF Options Program	A component of the TSLF program that auctions shorter-term TSLF loans at future dates to primary dealers.
US GAAP	Generally accepted accounting principles used by US companies to prepare financial statements.
warrant	An option to purchase a specified amount of securities at a specified price within a specified period. Financial institutions participating in TARP were required to issued warrants to the government.

CHAPTER 1: FEDERAL RESERVE EMERGENCY INTERVENTION AUTHORITY: OLD TOOLS USED IN NEW WAYS

Randall D. Guynn, Annette L. Nazareth and Margaret E. Tahyar

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This Chapter describes the emergency powers of the Federal Reserve contained in Section 13(3) of the Federal Reserve Act, a statutory tool that had not been used since the Great Depression. Section 13(3) has been one of the government's most important tools during the financial crisis. It was used by the Federal Reserve to provide liquidity to Wall Street and US companies, rescue Bear Stearns and AIG, and conduct monetary policy. Indeed, it was the government's tool of choice until the Bush Administration asked for new congressional authority – first to inject capital directly into Fannie Mae and Freddie Mac, and then to purchase troubled assets from and inject capital directly into the financial system as a whole.

The government had not had such direct investment authority since the Reconstruction Finance Corporation was dissolved in 1957. The Reconstruction Finance Corporation had been established by the Hoover Administration during the Great Depression to invest in troubled financial institutions. It was dissolved by the Eisenhower Administration after World War II. Treasury needed express congressional investment authority because federal law prohibits any federal agency from acquiring any corporation without express Congressional approval.[1]

The Bush Administration's determination that it needed congressional authority to make direct investments set the stage for the enactment of HERA[2] and EESA, as well as the development of the FDIC's TLGP. For

The publication date of this Chapter is September 21, 2009. All terms and acronyms used in this Chapter are defined in the Glossary at the front of this Manual.

Senior associate Cristina Fong has played a major role in the writing and research of this Chapter. Research assistance has been provided by Austin D. Brown, Caroline Chan, Wataru Matsumoto, Fiona McCarthy and Aaron Page.

[1] 31 U.S.C. § 9102. *See also Youngstown Sheet & Tube Co. v. Sawyer*, 343 U.S. 579 (1952) (striking down President Truman's executive order seizing control of certain steel manufacturing plants during the Korean War because the order was not backed by congressional approval or any grant of authority under the Constitution).

[2] An analysis of HERA, the situation with Fannie Mae and Freddie Mac, as well as the future of the GSEs is beyond the scope of this Manual. For a summary of the legislation, see The Housing & Economic Recovery Act of 2008, H.R. 3221, 110th Cong. (2008) (Detailed Summary), http://financialservices.house.gov/detailed_summary_of_hr_3221.pdf. *See also* Fed. Reserve Bank of Richmond, Policy Updates: Housing and Economic Recovery Act of 2008 and 2009, http://www.richmondfed.org/community_development/policy_updates/hera/index.cfm#tabview=tab0.

further discussion of EESA and the TLGP, see Chapter 2: *Emergency Economic Stabilization Act: The Original Vision* and Chapter 5: *The FDIC's Temporary Liquidity Guarantee Program*.

Despite the shift to HERA, EESA and the TLGP, and the much greater press and political attention paid to the latter two, the programs implemented under Section 13(3) represent the largest portion of federal intervention,[3] and account for the vast majority of the increase in the Federal Reserve's balance sheet. The balance sheet more than doubled from August 2007 to December 2008 and total assets at December 31, 2008, at the height of the crisis, were more than $2 trillion, more than twice the highest year-end total in its history.[4] The doubling of the Federal Reserve's balance sheet from year-end 2007 eclipses any other year-to-year increase; the next highest was a 60 percent increase from 1933 to 1934.[5] As of December 10, 2008, total Federal Reserve assets were approximately 15.8 percent of GDP, the highest total since the late 1940s.[6] While the Federal Reserve's recent balance sheet is somewhat smaller than at year-end 2008 — approximately $2.072 trillion at September 10, 2009 versus approximately $2.20 trillion at year-end 2008[7] — it still remains significantly higher than recent levels.

As illustrated in the Financial Crisis Legal Timeline set forth at the end of the Introduction, even after HERA and EESA were enacted, the Federal Reserve continued to add new programs, such as TALF in November 2008, reflecting the continued importance of the Federal Reserve's emergency powers under Section 13(3). For a further discussion of TALF, which Secretary Geithner has recently characterized as "[o]ne of the most important"[8] Federal Reserve Programs, see Chapter 6: *The Term Asset-Backed Securities Loan Facility*.

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[3] Representative Barney Frank (D-MA) noted that, "It is very clear that the Obama administration . . . is using the money in the TARP program in conjunction with the lending authority of the Federal Reserve. That is, the TARP money is going further than it otherwise might, because the Federal Reserve has its capacity to lend." *An Examination of the Extraordinary Efforts by the Federal Reserve Bank to Provide Liquidity in the Current Financial Crisis: Hearing Before the H. Comm. on Financial Servs.*, 111th Cong. 2 (2009) (opening statement of Rep. Barney Frank).

[4] Niel Willardson, *Actions to Restore Financial Stability*, FED. RES. BANK OF MINNEAPOLIS: THE REGION, Dec. 2008, at 16, http://www.minneapolisfed.org/pubs/region/08-12/willardson.pdf.

[5] Niel Willardson, *Actions to Restore Financial Stability*, FED. RES. BANK OF MINNEAPOLIS: THE REGION, Dec. 2008, at 16, http://www.minneapolisfed.org/pubs/region/08-12/willardson.pdf.

[6] *See* Niel Willardson, *Actions to Restore Financial Stability*, FED. RES. BANK OF MINNEAPOLIS: THE REGION, Dec. 2008, at 16, http://www.minneapolisfed.org/pubs/region/08-12/willardson.pdf.

[7] *See* Fed. Reserve, Statistical Release H.4.1 (Sept. 10, 2009), http://www.federalreserve.gov/releases/h41/.

[8] *See Troubled Asset Relief Program: Hearing Before the Cong. Oversight Panel* 26 (2009) (response by Timothy Geithner, Secretary, U.S. Dep't of the Treasury, to a question from Rep. Jeb Hensarling (R-TX)).

Federal Reserve Emergency Lending Powers

Section 13(3) of the Federal Reserve Act

The Federal Reserve's discount window for member banks and other depository institutions, which has existed since the Federal Reserve System was created in 1913, has long served the banking industry "as a safety valve in relieving pressures in reserve markets."[9] Its typical overnight extensions of credit to depository institutions can "relieve liquidity strains in a depository institution and in the banking system as a whole,"[10] as well as ensuring "the basic stability of the payment system more generally by supplying liquidity during times of systemic stress."[11] The Federal Reserve's traditional programs, set forth in its Regulation A,[12] are a basic part of the central bank's functions in a modern economy and are so non-controversial that many banking lawyers are not familiar with them. All of these commonly used features of the discount window share a genesis in the "real bills" doctrine[13] and require that lending be done as either a "discount" of notes held by the depository institution, *i.e.*, they must be collateralized, or an "advance" that is secured by collateral pledged by the depository institution "in the amounts and of types that are satisfactory to the lending Reserve Bank."[14] As a practical matter, almost all discount window credit has been extended as secured advances for many years.[15]

Section 13(3), however, permits secured extensions of credit to any "individual, partnership, or corporation."[16] It is not limited to depository institutions. But it can be invoked only under "unusual and exigent circumstances" upon the affirmative vote of at least five members of the

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[9] FED. RESERVE, THE FEDERAL RESERVE DISCOUNT WINDOW 1 (2008), http://www.frbdiscountwindow.org/discountwindow_pf.doc.

[10] FED. RESERVE, THE FEDERAL RESERVE DISCOUNT WINDOW 1 (2008), http://www.frbdiscountwindow.org/discountwindow_pf.doc.

[11] FED. RESERVE, THE FEDERAL RESERVE DISCOUNT WINDOW 1 (2008), http://www.frbdiscountwindow.org/discountwindow_pf.doc.

[12] 12 C.F.R. §201.

[13] Real bills are "notes, drafts, and bills of exchange arising out of actual commercial transactions," with remaining maturities of not more than 90 days, "issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes," as distinguished from "speculative," investment, or working-capital purposes. *See* Walker Todd, *FDICIA's Emergency Liquidity Provisions*, FED. RES. BANK OF CLEVELAND: ECON.REV., 1993 Q.3, at 18, http://www.clevelandfed.org/research/Review/1993/93-q3-todd.pdf (1993).

[14] Section 201.108 of the Federal Reserve's Regulation A lists the types of satisfactory collateral.

[15] *See* James Clouse, *Recent Developments in Discount Window Policy*, 80 FED. RES. BULL. 966 (Nov. 1994).

[16] It was added to the Federal Reserve Act by the Act of July 21, 1932, 47 Stat. 715.

Federal Reserve. Until 2008, it had not been used since the Great Depression.[17]

Until the savings and loan crisis of the late 1980s, Section 13(3) constrained the Federal Reserve's discretion to accept collateral other than "real bills" and certain US government securities of the kinds and maturities eligible to be pledged by depository institutions to the discount window under other provisions of the Federal Reserve Act.[18] It generally prohibited the Federal Reserve from accepting collateral in the form of investment securities or debt issued "for the purpose of carrying or trading in stocks, bonds or other investments securities" except for US Treasuries.[19]

During the savings and loan crisis, the constraints in Section 13(3) were seen by some as unwise.[20] In a little noticed change inserted in FDICIA, the

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[17] Five days after its enactment, on July 26, 1932, the Federal Reserve issued a circular granting permission to the Federal Reserve banks to make loans under the new authority for a period of six months, beginning August 1, 1932, and renewed such authorization from time to time until July 31, 1936. *See* Howard Hackley, LENDING FUNCTIONS OF THE FEDERAL RESERVE BANKS: A HISTORY 129-130 (1973). Before March 11, 2008, all secured loans under Section 13(3) had been made during the 1932-36 period, with most occurring in 1932 and 1933. Section 13(3) fell into disuse even during the Great Depression principally because of: (i) the addition of Section 13(b) to the Federal Reserve Act by the Industrial Advances Act of 1934, which authorized the Federal Reserve to make loans to commercial and industrial companies without the emergency condition and (ii) the ability of the Reconstruction Finance Corporation to make loans to nonbanking companies on more attractive terms than those offered by the Federal Reserve. The Reconstruction Finance Corporation was liquidated in 1957 pursuant to the Reconstruction Finance Corporation Liquidation Act of 1953 and Section 13(b) was repealed by the Small Business Investment Act of 1958. *See* David Fettig, *Lender of More than Last Resort: Recalling Section 13(b) and the years when the Federal Reserve opened its discount window to businesses*, THE REGION, Dec. 2002, at 18-19, 44-45 http://www.minneapolisfed.org/pubs/region/02-12/lender.pdf; Walker Todd, *History of and Rationales for the Reconstruction Finance Corporation*, FED. RES. BANK OF CLEVELAND: ECON. REV., 1992 Q.4, 24 http://www.clevelandfed.org/research/review/1992/92-q4-todd.pdf; Howard Hackley, LENDING FUNCTIONS OF THE FEDERAL RESERVE BANKS: A HISTORY 127-136, 144-145 (1973).

The Federal Reserve invoked Section 13(3) two other times, but no loans were actually made. The first was in 1966 when mutual savings banks and savings and loan associations came under liquidity pressures as a result of substantial withdrawals of deposits over the mid-year interest credit period. The authority to use Section 13(3) was effective for about eight months. The second was made in 1969 when it appeared that savings institutions might experience massive deposit losses as individual savers were attracted to higher-yielding investments available in the market. This time the authorization was effective for about seven months. Howard Hackley, LENDING FUNCTIONS OF THE FEDERAL RESERVE BANKS: A HISTORY 122, 130 (1973).

Further, while the Federal Reserve has not used its Section 13(3) authority since the 1930s, the Federal Reserve has been pressured to use its Section 13(3) authority several times in recent history. Each time, however, the Federal Reserve refused to lend (*e.g.*, New York budget crisis in 1975, FDIC Insurance Fund in 1991 and post-September 11th in 2001). *See* Anna J. Schwartz, Senior Research Fellow, Nat'l Bureau of Econ. Research, The Misuse of the Fed's Discount Window, Speech at the Sixth Annual Homer Jones Memorial Lecture at St. Louis University 62-63 (Apr. 9, 1992), http://research.stlouisfed.org/publications/review/92/09/Misuse_Sep_Oct1992.pdf; David Fettig, *Lender of More than Last Resort: Recalling Section 13(b) and the years when the Federal Reserve opened its discount window to businesses*, THE REGION, Dec. 2002 at 47, http://www.minneapolisfed.org/pubs/region/02-12/lender.pdf.

[18] *See* 12 U.S.C. §343 (1990).

[19] *See* 12 U.S.C. §343 (1990).

[20] After the stock market crash of 1987, the Federal Reserve leaned heavily on the big New York banks to meet Wall Street's soaring demand for credit, since the Federal Reserve was

constraining language was eliminated.[21] Senator Christopher Dodd (D-CT), then chairman of the securities subcommittee of the Senate Banking, Housing and Urban Affairs Committee, proposed the amendment and explained that it would give the Federal Reserve "greater flexibility to respond in instances in which the overall financial system threatens to collapse."[22]

Term Securities Lending Facility

The Federal Reserve's first use of its Section 13(3) authority during the most recent financial crisis was to establish the TSLF on March 11, 2008.

Context. In the weeks leading up to the program, the credit markets had become frozen for certain highly-leveraged market participants. As the value of their securities portfolios decreased, they were increasingly viewed by the credit markets as being higher credit risks. As rumors swirled that some large financial institutions might collapse, interest spreads widened dramatically and creditors refused to lend to certain borrowers. The problems reverberated throughout the global credit markets as market participants were unaware of which of their counterparties might have significant exposure to troubled financial institutions. In the face of this credit crunch, the Federal Reserve created the TSLF to attempt to restore the efficient functioning of credit markets.[23]

TSLF Mechanics. The TSLF was designed as a term lending facility for primary dealers.[24] It was created to provide liquidity for primary dealers, and specifically to add liquidity to the mortgage-backed securities market. Under the program's terms, securities loans are awarded based on competitive single-price auctions. The Federal Reserve Bank of New York was authorized to lend up to $200 billion of Treasury securities to primary

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concerned that it did not have the authority to lend directly to the investment banks on the basis of available collateral. E. Gerald Corrigan, the President of the New York Federal Reserve Bank at the time, personally called top bankers to convey this message. Mark Carlson, *A Brief History of the 1987 Stock Market Crash with a Discussion of the Federal Reserve Response* 19 (Fin. and Econ. Discussion Series, Fed. Reserve, Working Paper, 2006), http://www.federalreserve.gov/Pubs/feds/2007/200713/200713pap.pdf.

[21] *See* Walker Todd, *FDICIA's Emergency Liquidity Provisions*, FED. RES. BANK OF CLEVELAND: ECON. REV., 1993 Q.3, at 19-22, http://www.clevelandfed.org/research/Review/1993/93-q3-todd.pdf; David Fettig, *The History of a Powerful Paragraph: Section 13(3) enacted Fed business loans 76 years ago*, THE REGION, June 2008, at 34, http://www.minneapolisfed.org/pubs/region/08-06/section13.pdf.

[22] CONG. REC. S18691 (1991). *See also* Binyamin Appelbaum & Neil Irwin, *Congress's Afterthought, Wall Street's Trillion Dollars: Fed's Bailout Authority Sat Unused Since 1991*, WASH. POST, May 30, 2009, at A1.

[23] *See generally* DAVID WESSEL, IN FED WE TRUST 151-152 (2009).

[24] Primary dealers are the 18 large financial institutions that are the counterparties with which the Federal Reserve undertakes open market operations. Many of the 18 were also Wall Street's most prominent investment banks.

dealers secured for a term of 28 days by a pledge of eligible collateral.[25] In effect, the program allowed primary dealers to swap lower quality securities for higher quality securities that could be used more easily to obtain credit in the interbank or capital markets.

On July 30, 2008, the Federal Reserve extended the TSLF program by establishing the TSLF Options Program. Under the TSLF Options Program, options to draw shorter-term TSLF loans at future dates are auctioned to primary dealers. All loans under the facility are collateralized by eligible collateral, including investment-grade corporate, municipal, mortgage-backed and asset-backed securities.

As of August 12, 2009, the aggregate par value of Treasury securities lent under the TSLF, including the TSLF Options Program, was $2.7 billion and the market value of the collateral pledged was $3.4 billion.[26]

The Federal Reserve has approved the extension of the TSLF program through February 1, 2010.[27]

Unwinding TSLF. Owing to improved market conditions, the Federal Reserve has started to reduce the scope of the TSLF program.[28] For instance, the total amount offered under the TSLF will be reduced to $75 billion from $200 billion.[29]

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[25] For "Schedule 1" auctions, the eligible collateral included Treasury securities, agency securities, and agency mortgage-backed securities issued or fully guaranteed by the federal agencies. For "Schedule 2" auctions, the eligible collateral includes Schedule 1 collateral plus highly rated private securities. Highly rated securities refers to investment grade corporate securities, investment grade municipal securities, investment grade mortgage-backed securities, and investment grade asset-backed securities. "Schedule 1" auctions have since been discontinued, while "Schedule 2" auctions continue to take place. *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 2-4 (Aug. 25, 2009).

[26] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 3 (Aug. 25, 2009). This is a marked improvement compared to June 2009 when the aggregate par value of Treasury securities lent under the TSLF (including the TSLF Options Program) was $15.8 billion and the market value of the collateral pledged was $18.9 billion. *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 4 (June 26, 2009).

[27] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 3 (Aug. 25, 2009).

[28] Treasury has stated that "[b]orrowing at the [TSLF] has stopped as a result of further improvement . . . in the money markets." U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES 2 (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

[29] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 3 (Aug. 25, 2009).

TSLF Implications. As described above, the TSLF effectively allows primary dealers to use relatively illiquid securities as collateral to secure a borrowing of highly liquid Treasury securities. This allows the borrower to use the higher quality Treasury securities as collateral to obtain credit in the interbank or capital markets. The Federal Reserve presumed that the credit markets would lend to any borrower that could pledge Treasury securities as collateral, thus restoring stability to the credit markets and the financial markets generally. The potential benefits of the program, however, were limited by the fact that the program was short-term by design and primary dealers retained the downside of the collateral that they pledged to the Federal Reserve.[30]

The program was most notable because it was a means for the Federal Reserve to lend Treasury securities directly to nonbank primary dealers and indirectly to other nonbank institutions through primary dealers, an action not within the Federal Reserve's ordinary course statutory powers or authorities. In fact, according to one commentator, a senior lawyer at the Federal Reserve advised that the TSLF required an "unusual and exigent" determination by the Federal Reserve, which was then made but not publicly announced until later.[31]

Bear Stearns

First Loan to Bear Stearns

Context. Despite the implementation of the TSLF, Bear Stearns suffered a classic "run on the bank." Its cash reserves fell from over $20 billion to $2 billion in approximately one week. By Friday, March 14, Bear Stearns was prepared to file for bankruptcy in the absence of a significant capital infusion. Since no significant private investment was forthcoming, the Federal Reserve was left as the only player that could quickly rescue Bear Stearns from bankruptcy.[32]

Mechanics. On March 14, 2008, the Federal Reserve, by the unanimous vote of all available members, authorized an extension of credit to the Bear Stearns Companies, through JPMorgan Chase Bank under Section 13(3).[33] The Federal Reserve Bank of New York made an overnight loan of $12.9

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[30] *See* DAVID WESSEL, IN FED WE TRUST 151-152 (2009).

[31] *See* DAVID WESSEL, IN FED WE TRUST 161-162 (2009).

[32] *See* DAVID WESSEL, IN FED WE TRUST 157-159 (2009).

[33] Section 13(3) generally requires an affirmative vote of at least five members of the Board to approve an extension of credit under that provision. On March 14, 2008, one member of the Board was unavailable at the time of the Board vote because he was en route to the Board from Finland and two other board seats were vacant. *See* DAVID WESSEL, IN FED WE TRUST 162 (2009). As permitted under Section 11(r)(2) of the Federal Reserve Act, however, the Board's action approving the extension of credit was adopted by unanimous vote of all available members. *See* DAVID WESSEL, IN FED WE TRUST 162 (2009).

billion to JPMorgan Chase Bank through its normal discount window facilities. The loan was nonrecourse and was fully secured by $13.8 billion of Bear Stearns assets. The loan was a simultaneous back-to-back transaction, whereby JPMorgan Chase Bank provided secured financing to Bear Stearns and took as collateral the same assets that JPMorgan Chase Bank used to secure its loan from the Federal Reserve. This loan was repaid to the Federal Reserve on March 17, 2008, including $4 million in interest.[34]

Section 13(3) Authorization. The requisite finding of "unusual and exigent circumstances" was based on the view that "the large presence of Bear Stearns in several important financial markets, including in particular the markets for repo-style transactions, over-the-counter derivative and foreign exchange transactions, mortgage-backed securities, and securities clearing services, and the potential for contagion to similarly situated firms raised significant concern that financial markets would be seriously disrupted if Bear Stearns were suddenly unable to meet its obligations to counterparties."[35]

Federal Reserve Assistance for the Acquisition of Bear Stearns by JPMorgan

Context. After the Federal Reserve's emergency loan, the focus turned to finding an acquirer for Bear Stearns—before the open of business in Asia on Monday morning, March 17th, which was Sunday evening, March 16th in the United States.[36] JPMorgan was the likeliest candidate but after conducting due diligence on Bear Stearns, JPMorgan concluded that the deal might be too risky. Since Bear Stearns would likely need to file for bankruptcy if it were not acquired, potentially wreaking havoc on the markets, the Federal Reserve decided to lend support to JPMorgan's bid to acquire Bear Stearns.[37]

Mechanics and Authorization. JPMorgan initially offered to acquire Bear Stearns for $2 per share, or approximately $236 million in total, but later raised its price to $10 per share, or approximately $1.1 billion in total, in

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[34] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: BRIDGE LOAN TO THE BEAR STEARNS COMPANIES INC. THROUGH JPMORGAN CHASE BANK, N.A. 3 (2008).

[35] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: BRIDGE LOAN TO BEAR STEARNS COMPANIES INC. THROUGH JPMORGAN CHASE BANK, N.A. 2 (2008).

[36] During the worst weeks of the financial crisis in the fall of 2008, weekend rescues generally operated under a Sunday evening deadline, reflecting the importance of Asian markets. According to one commentator, Goldman Sachs' economists sent one of their weekly e-mails with the subject line "Sunday is the New Monday." *See* DAVID WESSEL, IN FED WE TRUST 1-2 (2009).

[37] *See* DAVID WESSEL, IN FED WE TRUST 165-168 (2009).

order to obtain shareholder approval.[38] Since JPMorgan did not want to acquire certain illiquid Bear Stearns assets, the Federal Reserve would need to absorb the risks associated with such assets. The Federal Reserve only had the authority to lend and did not have the authority to purchase assets, so any structure would have to be based upon the Federal Reserve making a loan.

Section 13(3) and the Special Purpose Vehicle. As a result, the Federal Reserve authorized the Federal Reserve Bank of New York to make a secured loan of up to $30 billion to a special purpose vehicle, Maiden Lane, in order to purchase "less liquid"[39] assets of Bear Stearns and facilitate the acquisition of Bear Stearns by JPMorgan. The loan was authorized pursuant to Section 13(3). JPMorgan would be required to lend Maiden Lane $1 billion. The Federal Reserve's loan was to be secured by the assets held by Maiden Lane.[40]

The Federal Reserve Bank of New York's general counsel has referred to Section 13(3) lending to a special purpose vehicle as a "powerful tool available to the Central Bank to inject liquidity and tailor the injection to a particular purpose."[41] In contrast, some commentators have referred to this structure as "legal semantics" considering that the economic reality of the transaction was that the Federal Reserve had purchased assets from Bear Stearns and held the downside risk of any decrease in the value of the portfolio.[42] At the time of the loan, the Federal Reserve stated that it was fully collateralized, as lending by the Federal Reserve is required to be. As of August 12, 2009, however, the principal amount on the Federal Reserve's

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[38] Some commentators have noted that JPMorgan's bargaining position was weakened by the fact that it had agreed to guarantee all of Bear Stearns' obligations for one year from the signing of the acquisition agreement, and the guarantee did not include a provision that would allow the guarantee to terminate if the Bear Stearns shareholders failed to approve the transaction. *See* Steven M. Davidoff, *Bear's Big Guarantee*, N.Y. TIMES, Mar. 24, 2008, http://dealbook.blogs.nytimes.com/2008/03/24/bears-big-guarantee/; Ashby Jones, *Did Deal Overexpose JP Morgan?*, WALL ST. J., Mar. 25, 2008, at C3, http://online.wsj.com/article/SB120640936857461199.html?mod=hps_us_whats_news.

[39] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 9 (Aug. 25, 2009).

[40] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 9-10 (Aug. 25, 2009).

[41] Thomas C. Baxter, The Legal Position of the Central Bank: The Case of the Federal Reserve Bank of New York, Presentation at the Regulatory Response to the Financial Crisis Conference at the London School of Economics 12 (Jan. 19, 2009), http://fmg.lse.ac.uk/upload_file/1160_Baxter.pdf.

[42] *See* DAVID WESSEL, IN FED WE TRUST 165-168 (2009).

loan to Maiden Lane was $28.8 billion, while the fair value of the assets held by Maiden Lane as of the same date was only $26.0 billion.[43]

Primary Dealer Credit Facility

Although Bear Stearns had been rescued, there was a fear that other investment banks with similar funding models could also face liquidity squeezes and ultimately the risk of failure. In order to provide these institutions with more liquidity and prevent this outcome, the Federal Reserve announced the creation of the PDCF on March 16, 2008, under Section 13(3). The Board determined that "unusual and exigent circumstances" existed in the financial markets, including a severe lack of liquidity that threatened to impair the functioning of a broad range of markets.[44]

The PDCF is a temporary overnight liquidity facility that provides secured loans to primary dealers. The PDCF allows primary dealers to borrow funds from the Federal Reserve secured by a broader range of collateral than is permissible to secure borrowings under the discount window. Since the primary dealers included the largest investment banks in the US, the PDCF provided the largest US broker-dealers with temporary access to a Federal Reserve liquidity facility that is very similar to the discount window.

On September 21, 2008, the Federal Reserve authorized temporary extensions of secured credit to a set of other securities dealers on very similar terms to the PDCF. Notably these other securities dealers were London-based broker-dealers that were subsidiaries of Merrill Lynch, Goldman Sachs and Morgan Stanley. Further, on November 23, 2008, Citigroup's London-based broker-dealer was also authorized to borrow under the PDCF.[45]

PDCF credit is fully secured by collateral with appropriate haircuts – that is, percentage discounts in the market value of eligible collateral so that the

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[43] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 10 (Aug. 25, 2009). In a report required pursuant to EESA, the Federal Reserve explains, "Despite the decline in the current fair value of the collateral, the Board does not anticipate that the loan to Maiden Lane will result in any net loss to the Federal Reserve . . . [The] loan was extended with the expectation that the value of its portfolio would be realized either by holding the assets to maturity or by selling the assets over an extended period of time during which the full value of the assets could be realized." *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 12 (June 26, 2009).

[44] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: PRIMARY DEALER CREDIT FACILITY AND OTHER CREDIT FOR BROKER-DEALERS 1-2 (2008).

[45] *See* Tobias Adrian, Christopher R. Burke, James J. McAndrews, *The Federal Reserve's Primary Dealer Credit Facility*, FED. RES. BANK OF N.Y., 15 CURRENT ISSUES IN ECONOMICS AND FINANCE 4, 3-5 (Aug. 2009), http://www.newyorkfed.org/research/current_issues/ci15-4.pdf.

"collateral value" assigned to any particular collateral exceeds the amount of the related secured loan by the amount of the "haircut." Initially, eligible collateral was restricted to all collateral eligible for pledge in open market operations and to investment-grade corporate securities, municipal securities, mortgage-backed securities, as well as asset-backed securities that were priced by the clearing banks. On September 14, 2008, the eligible set of collateral was broadened to match the types of instruments that can be pledged in the tri-party repurchase agreement programs of the two major clearing banks.[46]

Despite the fact that as of August 12, 2009 there were no loans outstanding under the PDCF, the Federal Reserve has nonetheless extended the program through February 1, 2010.[47] It remains to be seen whether the Federal Reserve will take the view that "unusual and exigent circumstances" continue to exist after that date.

Loans and Equity Investments in AIG

Context. In the third quarter of 2008, AIG experienced an increasingly serious liquidity crunch, due in large part to two business lines:

- The securities lending business and
- AIG Financial Products's credit default swap portfolio.

Under AIG's securities lending program, AIG lent securities on behalf of its insurance company subsidiaries against cash collateral that was received from borrowers and invested the cash collateral in securities, ranging from fixed maturity securities to RMBS, to earn a spread. In light of more favorable terms offered by other lenders of securities, AIG accepted cash collateral advanced by borrowers of less than the 102 percent historically required by insurance regulators. Under an agreement with its insurance company subsidiaries participating in the securities lending program, AIG deposited collateral in an amount sufficient to address the deficit. AIG was also required to deposit amounts into the collateral pool to offset any losses realized by the pool in connection with sales of impaired securities.[48]

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[46] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 4-5 (Aug. 25, 2009).

[47] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 5 (Aug. 25, 2009). *See also* U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES 2 (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

[48] Am. Int'l Group, Inc., Annual Report (Form 10-K), at 3-5 (Mar. 2, 2009).

In the third quarter of 2008, trading markets for a number of structured finance products, including RMBS, slowed significantly, and trading values declined. Accordingly, aggregate deposits by AIG to or for the benefit of the securities lending collateral pool through August 31, 2008 totaled $3.3 billion.[49]

Also in the third quarter through August 31, 2008, the continuing decline in value of the collateralized debt obligation securities protected by AIG Financial Products' credit default swap portfolio, together with ratings downgrades of such collateralized debt obligation securities, resulted in AIG Financial Products posting additional collateral in an aggregate net amount of $5.9 billion.[50]

By the beginning of September 2008, these collateral postings and securities lending requirements were placing increasing stress on AIG's liquidity. In the face of this liquidity crunch, several factors simultaneously contributed to AIG's inability to continue as a going concern without significant private and/or government intervention.

- *Credit rating agency actions*. On September 12, 2008, Standard & Poor's placed AIG on credit watch with negative implications and on September 15, 2008, Standard & Poor's downgraded AIG's long-term debt rating by three notches, Moody's by two notches and Fitch by two notches. As a consequence of these ratings actions, AIG Financial Products estimated that it would need in excess of $20 billion in order to fund additional collateral demands on its credit default swap obligations.[51]

- *Inability to Refinance Commercial Paper Commitments*. After Standard & Poor's placed AIG on credit watch, AIG's primary commercial paper programs were unable to access the commercial paper market and AIG advanced loans to these subsidiaries in order to meet funding obligations. On September 15, 2008, payments under the programs totaled $2.2 billion and AIG lent International Lease Finance Corporation and American General Finance, Inc., both AIG subsidiaries, $2.2 billion in order for them to meet their funding obligations.[52]

- *Sharp Declines in the Value of AIG's Common Stock*. AIG's common stock price plummeted from $22.76, on September 8, 2008 to $4.76 by September 15, 2008, hindering AIG's attempts to raise more capital.[53]

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[49] Am. Int'l Group, Inc., Annual Report (Form 10-K), at 3-5 (Mar. 2, 2009).

[50] Am. Int'l Group, Inc., Annual Report (Form 10-K), at 3-5 (Mar. 2, 2009).

[51] Am. Int'l Group, Inc., Annual Report (Form 10-K), at 3-5 (Mar. 2, 2009).

[52] Am. Int'l Group, Inc., Annual Report (Form 10-K), at 3-5 (Mar. 2, 2009).

[53] Am. Int'l Group, Inc., Annual Report (Form 10-K), at 3-5 (Mar. 2, 2009).

- *Crisis of Confidence in the Markets*. By September 15, 2008, counterparties started to withhold payments from AIG and refused to transact with AIG even on a secured short-term basis.[54]

- *Inability to Borrow from Insurance Subsidiaries*. On September 16, 2008, AIG was notified by its insurance regulators that it would no longer be permitted to borrow funds from its insurance company subsidiaries under a revolving credit facility that AIG maintained with them. This effectively closed the door on one of the last sources of liquidity that AIG had left.[55]

In light of AIG's deteriorating financial condition, the Federal Reserve encouraged AIG to obtain additional liquidity or capital from the private sector. On the weekend of September 13-14, 2008, AIG discussed potential capital injections and other liquidity measures with private equity firms, sovereign wealth funds and other potential investors. AIG also consulted with Goldman Sachs and JPMorgan on creating a syndicated secured lending facility of up to $75 billion. Despite these efforts, AIG was unable to obtain additional liquidity or capital from the private sector.[56]

Federal Reserve Loan and Treasury Equity Investment in AIG.

On September 16, 2008, pursuant to its Section 13(3) authority, the Federal Reserve authorized the Federal Reserve Bank of New York to lend AIG up to $85 billion under a secured revolving credit facility.[57]

The Federal Reserve justified its Section 13(3) determination by stating that "in light of the prevailing market conditions and the size and composition of AIG's obligations, a disorderly failure of AIG would have severely threatened global financial stability and, consequently, the performance of the US economy."[58] In a subsequent report, the Federal Reserve added that, "[a]t best, the consequences of AIG's failure would have been a significant intensification of an already severe financial crisis . . . Conceivably, its

[54] Am. Int'l Group, Inc., Annual Report (Form 10-K), at 3-5 (Mar. 2, 2009).

[55] Am. Int'l Group, Inc., Annual Report (Form 10-K), at 3-5 (Mar. 2, 2009).

[56] Am. Int'l Group, Inc., Annual Report (Form 10-K), at 3-5 (Mar. 2, 2009).

[57] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 12 (Aug. 25, 2009).

[58] *See Turmoil in US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 10 (2008) (statement of Ben S. Bernanke, Chairman, Board of Governors, Federal Reserve System).

failure could have resulted in a 1930s-style global financial and economic meltdown, with catastrophic implications for production, income, and jobs."[59]

As a condition of the loan under the credit facility, AIG also agreed to issue to the AIG Credit Facility Trust (the Trust), a trust established for the sole benefit of the United States Treasury, a series of preferred stock (AIG Series C Preferred Stock), which was ultimately issued to the Trust on March 4, 2009. The AIG Series C Preferred Stock is entitled to a percentage of voting power and dividend rights, on an as converted basis, which when aggregated with the percentage of voting power and dividend rights of the shares of AIG common stock underlying the warrants issued to Treasury, represents 79.9% of each such voting power and total dividends payable.[60] In addition, the purchase agreement for the AIG Series C Preferred Stock, among other things, requires AIG and its Board of Directors to work in good faith with the Trust to ensure satisfactory corporate governance arrangements and prohibits AIG from issuing capital stock without the approval of the Trust, subject to certain exceptions, so long as the Trust has a certain equity ownership in AIG.

Restructuring of Federal Reserve Loan and Treasury Investment in AIG.

The Federal Reserve's initial loan to AIG was agreed to in principle within hours and later documented under intense time pressure. In response to evolving market conditions and the need to refine the terms of the Federal Reserve's initial extension of credit to AIG, in November 2008, the Federal Reserve authorized the Federal Reserve Bank of New York, pursuant to its Section 13(3) authority, to restructure the revolving credit facility and to extend loans to two new special purpose vehicles—Maiden Lane II and Maiden Lane III.[61]

- *Maiden Lane II*. The Federal Reserve would lend approximately $19.5 billion to Maiden Lane II so that it could purchase RMBS from AIG.[62]
- *Maiden Lane III*. The Federal Reserve would lend approximately $19.6 billion to Maiden Lane III so that it could purchase from AIG Financial Products' counterparties approximately $62 billion of collateralized debt

[59] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 12 (Aug. 25, 2009).

[60] Because of the degree to which the deemed conversion of the AIG Series C Preferred Stock is dilutive to AIG's common stockholders, the shares underlying Treasury's warrants, which are not adjusted for the conversion, represent only a tiny fraction of the total voting power of AIG's equity. As a result, the AIG Series C Preferred Stock currently represents approximately 79.8% of the total voting power.

[61] In addition to the Federal Reserve's actions, Treasury also later acquired $40 billion in senior preferred stock of AIG. For a further discussion of this investment see Chapter 3: *The Capital Twist*; Am. Int'l Group, Inc., Quarterly Report (Form 10-Q), at 3-5 (Aug. 7, 2009).

[62] Am. Int'l Group, Inc., Current Report (Form 8-K) (Dec. 12, 2008).

obligations that were protected by AIG Financial Products's credit default swaps.[63]

This intervention is notable because it illustrates how the secured lending power provided by Section 13(3), combined with non-recourse terms and special purpose vehicles, allowed the Federal Reserve to exercise powers substantially equivalent to Treasury's express power under TARP to purchase troubled assets.

Evolution of Federal Reserve Loan and Treasury Investment in AIG.

The Federal Reserve and Treasury's investment in AIG evolved in response to market conditions, and it was restructured in March 2009.[64] For a further discussion relating to Treasury's investment in AIG, see Chapter 3: *The Capital Twist* – Additional TARP Capital Injections.

Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility and Commercial Paper Funding Facility

Context. By the fall of 2008, another nonbanking financial sector, money market mutual funds, was facing severe liquidity pressure. After the failure of a large money market mutual fund, Reserve Primary Fund, investors began a run on money market mutual funds that lasted for weeks. Redemptions totaled over $100 billion. In the face of redemptions, money market mutual funds had to start selling assets, including asset-backed commercial paper, and stop investing customer funds in markets such as the commercial paper market. Once commercial paper issuers faced liquidity crunches as a result of the money market funds' actions, many began drawing on backup lines of credit from banks, putting further pressure on the banking industry. Most banks had not anticipated that so many of these back-up facilities would be drawn on at once. In order to address the fire sales of asset-backed commercial paper as a result of redemption pressures and the lack of liquidity in the commercial paper market, the Federal Reserve created the AMLF and the CPFF.[65]

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[63] Am. Int'l Group, Inc., Current Report (Form 8-K) (Nov. 25, 2008).

[64] For a further discussion of the status of the Federal Reserve loan and Treasury investment in AIG see Chapter 3: *The Capital Twist*; Am. Int'l Group, Inc., Quarterly Report (Form 10-Q), at 3-5 (Aug. 7, 2009); FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 11-17 (Aug. 25, 2009).

[65] *See* Brian F. Madigan, Director, Div. of Monetary Affairs, Fed. Reserve, Bagehot's Dictum in Practice: Formulating and Implementing Policies to Combat the Financial Crisis, Speech at the Federal Reserve Bank of Kansas City's Annual Economic Symposium (Aug. 21, 2009), http://www.federalreserve.gov/newsevents/speech/madigan20090821a.htm.

Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility

Mechanics. The AMLF was authorized by the Federal Reserve on September 19, 2008 to provide funding to US depository institutions and bank holding companies and their US broker-dealer subsidiaries to finance purchases of high-quality asset-backed commercial paper from money market mutual funds. The Federal Reserve Bank of Boston administers and directly provides the lending for the AMLF program. No special purpose vehicle is used. The collateral for the loans is the pledged asset-backed commercial paper, which is equal to the amount of the advances. In addition, there is a redemption threshold whereby a money market mutual fund must experience material outflows before it can sell asset-backed commercial paper that would be eligible collateral for AMLF loans.[66]

As of August 12, 2009, the aggregate amount of outstanding advances under the AMLF was $113 million.[67] The Federal Reserve has extended the program's scheduled termination date from October 30, 2009 to February 1, 2010.[68]

Commercial Paper Funding Facility

Mechanics. The CPFF was authorized by the Federal Reserve on October 14, 2008, pursuant to its Section 13(3) authority. The Federal Reserve established a special purpose vehicle that purchases three-month unsecured and asset-backed commercial paper directly from eligible issuers. Eligible issuers include any US commercial paper issuers, including US issuers with foreign parent companies. The Federal Reserve makes three-month loans to the special purpose vehicle that match the term of the commercial paper acquired.

This Federal Reserve program is important because for the first time the Federal Reserve offered direct emergency assistance to non-financial institutions.

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[66] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 9 (Aug. 25, 2009).

[67] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 9 (Aug. 25, 2009). This is a marked improvement compared to June when the aggregate amount of outstanding advances under the AMLF was $18.6 billion. *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 11 (June 26, 2009).

[68] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 9 (Aug. 25, 2009).

As of August 12, 2009, the aggregate amount of outstanding advances under the CPFF was $53.5 billion with collateral pledged of $58.1 billion.[69] The Federal Reserve has noted that use of the CPFF is declining steadily, because the interest rates under the CPFF are increasingly less attractive than market rates.[70] The Federal Reserve has extended the program's scheduled termination date from October 30, 2009 to February 1, 2010.[71]

The Term Asset-Backed Securities Loan Facility

For a full discussion of this important Section 13(3) program, please see Chapter 6: *The Term Asset-Backed Securities Loan Facility*.

Authorized Programs That Have Not Been Implemented

The following programs have been authorized by the Federal Reserve pursuant to Section 13(3) but have not resulted in any loans being made:

- the Money Market Investor Funding Facility;[72]
- contingent nonrecourse financing arrangements for certain borrowers;[73] and

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[69] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 6 (Aug. 25, 2009). This is a marked improvement compared to June when the aggregate amount of outstanding advances under the CPFF was $127.9 billion with collateral pledged of $132 billion. *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 7 (June 26, 2009).

[70] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 7 (June 26, 2009). Treasury has also noted that the amount of commercial paper held in the CPFF has fallen from a peak of $351 billion to $48 billion, as improvements in market conditions have allowed some borrowers to obtain financing from private investors in the commercial paper market or from other sources. *See* U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES 2 (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

[71] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 5 (Aug. 25, 2009).

[72] Some commentators note that representatives from the money fund industry told the Federal Reserve that money market mutual funds would not borrow directly from the Federal Reserve out of fear that such borrowing would instigate further runs on funds. *See* Brian F. Madigan, Director, Div. of Monetary Affairs, Fed. Reserve Bagehot's Dictum in Practice: Formulating and Implementing Policies to Combat the Financial Crisis, Speech at the Federal Reserve Bank of Kansas City's Annual Economic Symposium (Aug. 21, 2009), http://www.federalreserve.gov/newsevents/speech/madigan20090821a.htm.

[73] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 1 (Aug. 25, 2009).

- up to $8.5 billion in financing to special purpose vehicles that may be established by the domestic life insurance subsidiaries of AIG to facilitate the securitization of designated blocks of existing life insurance policies held by such life insurance companies.[74]

Lehman — Limits on the Use of Section 13(3)

The Federal Reserve has stated that Section 13(3) did not provide it with sufficient legal authority to rescue Lehman Brothers because Lehman Brothers did not have enough eligible collateral available to secure a loan under Section 13(3) that would have been large enough to rescue it.[75] At the time Lehman Brothers failed, however, Treasury and the Federal Reserve had publicly emphasized the desire to prevent moral hazard — that is, the lack of market discipline created by insulating investors against some or all of the losses on their investments, while they keep all the gains — and the fact that the market had had ample notice that Lehman could fail.[76] If the government wanted to provide assistance to systemically important institutions like Lehman Brothers, the authority to do so would have to come from an alternative source. The conclusion that the traditional toolkit was not sufficient set the stage for the enactment of EESA and the development of the FDIC programs. For a further discussion, see Chapter 2: *Emergency Economic Stabilization Act: The Original Vision* and Chapter 5: *The FDIC's Temporary Liquidity Guarantee Program*.

Proposals for Reform

While many commentators have lauded the Federal Reserve's role in steering the nation through the financial crisis, there has been increasing unease, especially in Congress, about the lack of Congressional oversight

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[74] *See* FED. RESERVE, PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 1 (Aug. 25, 2009).

[75] *See* Ben S. Bernanke, Chairman, Board of Governors, Federal Reserve System, Federal Reserve Policies in the Financial Crisis, Speech at the Greater Austin Chamber of Commerce (Dec. 1, 2008), http://www.federalreserve.gov/newsevents/speech/bernanke20081201a.htm.

[76] The *New York Times* reported that "Mr. Paulson and Mr. Geithner made it clear ". . . that the government has no plans to put taxpayer money on the line. The government [was] deeply worried that its actions have created a moral hazard and the Federal Reserve does not want to reach deeper into its coffers." *See* Eric Dash, *U.S. Gives Banks Urgent Warning to Solve Crisis*, N.Y. TIMES, at A1 (Sept. 13, 2008), http://www.nytimes.com/2008/09/13/business/13rescue.html. In testimony before the Senate, Chairman Bernanke said, "In the case of Lehman Brothers . . . the Federal Reserve and the Treasury declined to commit public funds to support the institution. The failure of Lehman posed risks. But the troubles at Lehman had been well known for some time . . . Thus, we judged that investors and counterparties had had time to take precautionary measures." *Turmoil in US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. 11 (2008) (statement of Ben S. Bernanke, Chairman, Board of Governors, Federal Reserve System).

over the Federal Reserve's exercise of its emergency powers during the financial crisis. A number of legislative reforms have been proposed.

Transparency, Disclosure, Accountability and Independence

In the first instance, Congress called for increased disclosure by the Federal Reserve regarding its use of the Section 13(3) authority. At a House hearing Representative Spencer Bachus (R-AL) observed, "In many of these transactions . . . we've been told we could not be given the specifics . . . because it was proprietary information of the companies involved. We have been left to guess as to the terms, conditions, the size in many cases, the results expected, the consequences, the criteria for eligibility, or even the identity of all the parties."[77] More pointedly, Senator Bernie Sanders (I-VT) said, "It is very hard for any public official to go home and explain that $2.2 trillion of your money was lent out and we don't know where it went."[78] In light of such Congressional and public concerns, Congress has taken several formal steps to encourage additional disclosure from the Federal Reserve.

- *New GAO Authority*. Congress granted the GAO new authority to conduct audits of the credit facilities extended by the Federal Reserve to "single and specific" companies under its Section 13(3) authority, including the facilities for AIG and Bear Stearns.[79]
- *Senate Resolutions*. The Senate passed two resolutions, one calling for the Federal Reserve to reveal the names of the institutions it extends credit to and the other calling for enhanced oversight of the Federal Reserve's role in providing "emergency economic assistance."[80]
- *Proposed Legislation*. The Federal Reserve Transparency Act of 2009 was proposed by Representative Ron Paul (R-TX), has been supported by House Financial Services Committee Chairman Representative Barney Frank (D-MA),[81] and has approximately 250 co-sponsors in the

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[77] *An Examination of the Extraordinary Efforts By the Federal Reserve Bank to Provide Liquidity in the Current Financial Crisis: Hearing Before the H. Comm. on Financial Servs.*, 111th Cong. 3 (2009) (part of question by Rep. Spencer Bachus).

[78] *See* Jon Hilsenrath & Corey Boles, *Senate Seeks Names of Finance Firms Receiving Fed Aid,* WALL ST. J. (Apr. 2, 2009).

[79] Traditionally, while the Federal Reserve has been subject to GAO audits, certain areas of Federal Reserve activity such as monetary policy deliberations and operations, including open market and discount window operations, transactions with or for foreign central banks, foreign governments and public international financing organizations have been excluded from the scope of GAO audits. Statement by Donald L. Kohn, Vice Chairman, Board of Governors, Federal Reserve System, before *the Subcomm. on Domestic Monetary Policy and Technology of the H. Comm. on Financial Servs.,* 111th Cong. 9-11 (July 9, 2009).

[80] *See* Jon Hilsenrath & Corey Boles, *Senate Seeks Names of Finance Firms Receiving Fed Aid*, WALL ST. J. (Apr. 2, 2009).

[81] Of the Federal Reserve Transparency Act of 2009, Rep. Frank said, "This will probably pass in October." *See* Amanda Carpenter, *Barney Frank Says Ron Paul Bill Will Pass*, WASH. TIMES, at A18 (Aug. 31, 2009).

House. The bill would repeal a provision of law that prohibits GAO from auditing monetary policy decisions.[82]

In response, the Federal Reserve has greatly increased its disclosure of information regarding its Section 13(3) programs. The Federal Reserve now publishes a publicly-available monthly report in which it discloses aggregate data regarding its Section 13(3) programs, including the number of borrowers, ratings of the securities pledged as collateral for loans, concentration of borrowers and weekly balance sheets.[83] This is an addition to bi-monthly reports that it provides Congress regarding these programs. Many commentators have interpreted this increased disclosure as the Federal Reserve's attempt to address Congress's concerns before it implements any further legislation mandating either increased disclosure or oversight.

The Federal Reserve has thus far refused to identify, however, the names of borrowers under certain programs, stating that disclosure might set off a run by depositors and unsettle shareholders, increasing volatility in the marketplace.[84] The Federal Reserve has also resisted efforts to allow GAO audits of monetary policy such as open market and discount window operations, stating that "removing the statutory limits on GAO audits of monetary policy matters would be contrary to the public interest by tending to undermine the independence and efficacy of monetary policy."[85] Prominent economists have also supported the Federal Reserve's position and submitted a petition to Congress arguing that "the independence of US monetary policy [is] . . . at risk."[86]

Major media organizations are also taking the Federal Reserve to task and are seeking increased disclosure pursuant to FOIA, including in the courts.[87] It remains to be seen whether these efforts will be successful in forcing

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[82] *See* Krishna Guha, *Congress Seeks To Open Fed Actions To More Scrutiny*, FIN. TIMES, at 3 (June 5, 2009).

[83] These reports are located on the Federal Reserve's website: http://www.federalreserve.gov/monetarypolicy/bst.htm. *See also* Scott Lanman, *Fed Unveils Lending Details After Lawmaker Pressure*, BLOOMBERG (June 10, 2009).

[84] *See* Scott Lanman, *Fed Unveils Lending Details After Lawmaker Pressure*, BLOOMBERG (June 10, 2009).

[85] Statement by Donald L. Kohn, Vice Chairman, Board of Governors, Fed. Reserve System before *the Subcomm. on Domestic Monetary Policy and Technology of the H. Comm. on Financial Servs.,* 111th Cong. 10-11 (July 9, 2009).

[86] *See* David Wessel, *Experts Tell Congress to Lay Off The Fed*, WALL ST. J., at A3 (July 16, 2009).

[87] *See e.g.*, Bloomberg L.P. v. Bd. of Governors of the Fed. Reserve Sys., No. 08 Civ. 9595 (S.D.N.Y. Aug. 24, 2009) (ruling that the Federal Reserve improperly withheld information regarding emergency lending programs, including the identities of borrowers, requested by Bloomberg News via a FOIA request and requiring the Federal Reserve to produce such records). The Federal Reserve has appealed this ruling and has yet to produce such records, arguing that such disclosure might impact its ability to effectively manage the current, and any future, financial crisis.

additional Federal Reserve disclosure of Section 13(3) program information.[88]

Balance-of-Power and Regulatory Reform

The Federal Reserve's Section 13(3) authority was recently described by Representative Ron Paul (R-TX) as, "an ominous power; it is the most powerful tool for central economic planning around."[89] Representative Barney Frank (D-MA) has stated, "Going forward . . . it does not seem . . . healthy in our democracy for the amount of power that is now lodged in the Federal Reserve, with very few restrictions, to continue."[90]

These statements reflect Congress's concern that a quasi-governmental agency that is not accountable to voters, such as the Federal Reserve, should have more constraints placed on how it is permitted to exercise the Section 13(3) authority. Congress and commentators have been debating whether a federal resolution authority for systemically important financial institutions – which would give a federal agency the power to conduct an orderly winding up of such institutions – would address some of the concerns over the Federal Reserve's potential use of Section 13(3) to carry out some unwritten "too big or interconnected to fail" policy.[91]

The Federal Reserve has taken the position that while Section 13(3) authority should remain, "it would be better if we had a more formal mechanism that created some hurdles from decision-making that set a high bar in terms of when these kinds of powers would be invoked and provided more than a lending tool, which was not well-suited in some cases to address systemically important failures."[92] In recent Congressional testimony, Daniel Tarullo, a member of the Board of Governors, noted that, "[w]e believe that Treasury is the appropriate source of funding for the resolution of systemically important financial institutions, given the unpredictable and inherently fiscal nature of this function. The availability of such funding from Treasury would eliminate the need for the Federal

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[88] *See* Mark Pittman, *Federal Reserve Says Disclosing Loans Will Hurt Banks*, BLOOMBERG (Aug. 27, 2009).

[89] *An Examination of the Extraordinary Efforts By the Federal Reserve Bank to Provide Liquidity in the Current Financial Crisis: Hearing Before the H. Comm. on Financial Servs.*, 111th Cong. 16 (2009) (part of question of Rep. Ron Paul).

[90] *An Examination of the Extraordinary Efforts By the Federal Reserve Bank to Provide Liquidity in the Current Financial Crisis: Hearing Before the H. Comm. on Financial Servs.*, 111th Cong. 2 (2009) (opening statement of Rep. Barney Frank).

[91] *See* Davis Polk memorandum, *The Regulatory Reform Marathon*, http://www.davispolk.com/files/Publication/963cb101-2593-4ba0-9133-02f73afd2bd9/Presentation/PublicationAttachment/bfcca243-1cf2-47b6-81fb-0a23756a927c/072809_Marathon.pdf.

[92] *Systemic Risk And The Financial Markets: Hearing Before the H. Comm. on Financial Servs.*, 111th Cong. 43 (2009) (response by Ben S. Bernanke Chairman, Board of Governors, Federal Reserve System to question posed by Rep. Al Green).

Reserve to use its emergency lending authority under Section 13(3) of the Federal Reserve Act to prevent the failure of specific institutions."[93]

In addition to proposals for a resolution authority, in its white paper, *A New Foundation: Rebuilding Financial Supervision and Regulation*, the Obama Administration proposed limiting the Federal Reserve's Section 13(3) authority by requiring that the Federal Reserve receive prior written approval from the Secretary of the Treasury for emergency lending under Section 13(3).[94] This proposal has been met with mixed reaction varying from those who believe that such a restriction is too weak, to those who argue that such a restriction would politicize the Federal Reserve's decision-making process.

As of the publication date, the direction of financial regulatory reform in the United States remains to be seen and it is unclear how, if at all, the Federal Reserve's Section 13(3) authority will be impacted by such reform.

[93] Statement by Daniel K. Tarullo, Member, Board of Governors, Fed. Reserve System before *the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 13-14 (July 23, 2009).

[94] U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 16 (June 17, 2009), http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

References

For historical information regarding Section 13(3), please see the footnotes in this Chapter.

Links to the terms and conditions of the Federal Reserve's Section 13(3) lending programs can be found below.

Term Securities Lending Facility (Effective June 25, 2009)
http://www.newyorkfed.org/markets/tslf_terms.html

Primary Dealer Credit Facility (Effective June 25, 2009)
http://www.newyorkfed.org/markets/pdcf_terms.html

Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (Effective June 25, 2009)
http://www.frbdiscountwindow.org/mmmftc.cfm?hdrID=14&dtlID

Commercial Paper Funding Facility (Effective June 25, 2009)
http://www.newyorkfed.org/markets/cpff_terms.html

Term Asset-Backed Securities Loan Facility (Effective September 1, 2009)
http://www.newyorkfed.org/markets/talf_terms.html

For a further discussion of this important Section 13(3) program,
see Chapter 6: *The Term Asset-Backed Securities Loan Facility*

CHAPTER 2: EMERGENCY ECONOMIC STABILIZATION ACT: THE ORIGINAL VISION

Randall D. Guynn, Annette L. Nazareth and Margaret E. Tahyar

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The original vision of EESA was that Treasury would purchase up to $700 billion of "troubled assets" from "financial institutions" through TARP. The TARP facility was expected to be used to purchase mortgages and other real-estate related assets in order to stabilize, enhance or at least establish reliable market values for illiquid assets.

That original vision, however, was never implemented. Instead, Treasury and the Federal Reserve quickly abandoned that plan and used the TARP funds to make direct investments in the US financial system through CPP. For a further discussion, see Chapter 3: *The Capital Twist*. The government had not had such direct investment authority since the Reconstruction Finance Corporation was dissolved in 1957.[1] The Reconstruction Finance Corporation had been established by the Hoover Administration during the Great Depression to invest in troubled financial institutions and was dissolved by the Eisenhower Administration after World War II. Treasury needed express congressional investment authority because federal law prohibits any federal agency from acquiring any corporation without express Congressional approval.[2]

Although the original vision of EESA was abandoned, major elements of the statutory framework remain relevant to the implementation and interpretation of later programs, contracts, regulations and guidelines. This Chapter addresses those aspects of the original vision that remain relevant.

As discussed below, unless the authority to purchase under EESA is extended to October 3, 2010, that authority expires on December 31, 2009.

The publication date of this Chapter is September 21, 2009. All terms and acronyms used in this Chapter are defined in the Glossary at the front of this Manual.

Research assistance has been provided by Austin D. Brown, Kathryn Cragg, Shakhi Majumdar and Fiona McCarthy.

[1] The Reconstruction Finance Corporation was created by the Reconstruction Finance Corporation Act of 1932, 47 Stat. 5. It was dissolved pursuant to the Reconstruction Finance Corporation Liquidation Act of 1953, 67 Stat. 230. *See* Walker Todd, *History of and Rationales for the Reconstruction Finance Corporation*, FED. RES. BANK OF CLEVELAND: ECON. REV., 1992 Q.4, at 22 http://www.clevelandfed.org/research/review/1992/92-q4-todd.pdf.

[2] 31 U.S.C. § 9102. *See also* Youngstown Sheet & Tube Co. v. Sawyer, 343 U.S. 579 (1952) (striking down President Truman's executive order seizing control of certain steel manufacturing plants during the Korean War because the order was not backed by congressional approval or any grant of authority under the Constitution).

The termination of Treasury's authority to make new TARP expenditures, however, does not affect Treasury's ability to continue to hold TARP investments made during the investment period.

The Original Treasury Proposal and the Bill's Passage

On Saturday, September 20, 2008, Treasury sent Congress a draft of proposed legislation, which would have permitted Treasury to establish a program to purchase troubled assets from financial institutions. The initial proposal was two and a half pages long.[3] The proposal granted exceedingly broad power to Treasury to purchase "troubled assets" from any "financial institution" up to an aggregate amount outstanding at "any one time," not to exceed $700 billion. The only limit on Treasury's powers was the requirement that it begin reporting to Congressional committees within three months after its first purchase of troubled assets and semi-annually thereafter. Decisions by the Treasury Secretary were exempt from review by any court or any other administrative agency.

The initial proposal was not accepted by Congress. It prompted a series of counterproposals over the next two weeks, resulting in a bill of more than 100 pages. The political storm around EESA's passage featured a revolt in the House of Representatives that led to the initial rejection of EESA on September 29, 2008 and, shortly thereafter, the largest ever one-day drop in the Dow Jones Industrial Average.

While Americans watched their retirement savings drop precipitously and Europeans rescued one bank after another in quick succession, the Senate took up and voted on a revised version of the legislation on October 1, 2008. The House reconsidered and ultimately passed H.R. 1424, Division A — the Emergency Economic Stabilization Act of 2008 — on October 3, 2008. President Bush signed the bill into law that same day.

The text of EESA is largely a general framework with very limited legislative history – evidence not only of the lightning speed but also the very stressful conditions under which it was passed. The ability of Treasury to shift the focus of EESA from purchasing troubled assets to recapitalizing the financial sector within 11 days of the law's passage illustrates the enormous discretion that Congress gave Treasury in the text of the statute. Treasury exercised that discretion not only to shift the main purpose of the statute but also to implement the statute through guidelines, FAQs, term sheets, contracts and other innovations outside of the normal "notice and comment" rulemaking process under the APA. Treasury took full advantage of the

[3] *See* U.S. Dep't of the Treasury Press Release, Proposed Treasury Authority to Purchase Troubled Assets (Sept. 20, 2008), http://www.ustreas.gov/press/releases/hp1150.htm.

discretion traditionally afforded regulatory agencies by *Chevron* and its progeny.[4] Almost no one objected at the time out of fear that the financial crisis might otherwise lead to another Great Depression.

We will leave to historians and political scientists to analyze why the Bush Administration did not immediately propose direct investments in the banking system, as the Hoover and Roosevelt Administrations did during the Great Depression and the UK and various continental European governments did this time, but instead initially proposed a program to purchase troubled assets. Treasury Secretary Henry Paulson's explanation for the initial shift in focus was that in the period between when the TARP legislation was first conceived and eventually passed, "the markets continued to freeze" and there were a "whole series of bank failures overseas." As a result, he said that Treasury made a determination that it "needed to do something quickly" and the best path was to inject capital into the banking system.[5]

One consideration that almost certainly influenced Treasury's change in plans was the difficulty of finding a market clearing price for illiquid assets that would have been high enough to induce voluntary sales but low enough to insulate Treasury from accusations that it paid too much. This difficulty applied both to assets that were subject to mark-to-market accounting – like collateralized debt obligations – that had already been marked down far below their initial book values, and to assets that were subject to historical cost accounting – like loans – that were still being carried at initial book value, subject to reserves. In the former case, many financial institutions believed that the true value of the assets exceeded the marked values because the assets had been heavily marked down based on a financial model as the best approximation of market value; there was no true market for the assets. Financial institutions were reluctant to sell the assets at marked values. In the latter case, many financial institutions were reluctant to sell the assets at their market prices – which were almost certainly well below their book values – because of the steep mark downs that would have been required upon sale. While Treasury's capital infusions provided an additional cushion that enabled financial institutions to write down troubled assets and increase loss reserves against future write downs and losses, billions of dollars of troubled assets continue to be retained on the balance sheets of American financial institutions. For a further discussion, see Chapter 7: *The Public-Private Investment Program.*

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[4] Federal government agencies have extensive authority under *Chevron U.S.A. v. Natural Res. Def. Council*, 467 U.S. 837 (1984), which governs whether to grant deference to a government agency's interpretation of its own statutory mandate.

[5] *See Bank of America and Merrill Lynch: How Did a Private Deal Turn Into a Federal Bailout? Part III, Hearing Before the Subcomm. on Domestic Policy of the H. Comm. on Oversight and Gov't Reform*, 111th Cong. (2009) (testimony of Hank Paulson, Former Secretary, U.S. Dep't of Treasury), http://www.gpo.gov/fdsys/pkg/CPRT-110JPRT51601/pdf/CPRT-110JPRT51601.pdf.

This same conundrum bedeviled the oft-discussed good bank / bad bank restructurings,[6] as well as the implementation of the PPIP program. For a further discussion, see Chapter 7: *The Public-Private Investment Program*. Later changes in mark-to-market accounting rules, the discussion of which was vivid in the fall of 2008, also made the "sale" of troubled assets less attractive to financial institutions. For a further discussion, see Annex A – Mark-to-Market Accounting Changes to this Chapter.

What is a "Financial Institution"?

"Financial Institution"

A key provision of EESA is the definition of "financial institution", which crystallizes Congress's determination of which entities should be able to sell troubled assets to the government. A financial institution is broadly defined as "any institution, including but not limited" to an enumerated list of financial institutions that are "established and regulated" under the laws of the United States and have "significant operations in the United States."[7]

Included, so long as significant operations in the US and not owned by a foreign government

- Any US bank;
- Any US branch or agency of a foreign bank;
- Any US savings bank or credit union;
- Any US broker-dealer;
- Any US insurance company;
- Any public US mutual fund or other US registered investment company;
- Any tax-qualified US employee retirement plan; and
- Any bank holding company and some or all of its unregulated affiliates.

Included and Excluded Institutions

Congress left Treasury the discretion to refine the scope of the new term. The categories of financial actors set forth in the sidebar are, in our view, clearly considered "financial institutions" so long as they have significant operations in the US. For a further discussion, see Chapter 3: *The Capital Twist* – What is a "Qualifying Financial Institution".

Clearly excluded from the definition are foreign central banks and any institution "owned" by a foreign government. EESA did not define the term "owned." As a result, the scope of the exclusion from TARP of foreign financial institutions "owned" by a foreign government remains unclear. We believe that this was intended to exclude financial institutions that are wholly-owned or majority-owned, and likely meant to exclude foreign financial institutions controlled by a foreign government. Several of Treasury's programs, such as the CPP and CAP, have been more narrowly crafted to exclude domestic banks that are controlled by foreign banks or other institutions from participating.

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[6] A "good bank / bad bank" structuring technique refers to any technique designed to segregate troubled assets into a separate pool or liquidating vehicle, whether or not the separate pool or liquidating vehicle is technically a bank. It is often combined with an arrangement whereby a government entity assumes the risk of loss on all or some portion of the bad assets. Free of all or some of the risk of its bad assets, the transferring bank becomes the "good bank" that can now attract capital and carry out its business as a normal going concern.

[7] Emergency Economic Stabilization Act of 2008 § 3(5), codified at 12 U.S.C.A. § 5205(5) (2008).

Based on a common understanding of the term "financial institution," one might have expected Treasury to have interpreted the term to include private equity funds, hedge funds and other types of unregistered mortgage-backed and asset-backed vehicles, structured investment vehicles and other unregistered special purpose vehicles. But at least some members of Congress meant to exclude private funds from the definition of "financial institution" on the basis that they are not "regulated," even though, in some but not all cases, their investment advisers may be subject to regulatory supervision.[8]

Conversely, initially one would not have expected Treasury's discretion to be so broad that it could interpret the term to include automotive companies for purposes of TARP.[9] But Treasury, with the full knowledge and approval of the President and at least the leadership of Congress, stretched the statutory meaning to include automotive companies, and their financial arms.

Thus, on December 19, 2008, Treasury exercised its authority under TARP to make loans to General Motors and to Chrysler's financing arm, Chrysler Financial.[10] The decision to provide assistance to Chrysler was challenged in *Indiana State Police Pension Trust v. Chrysler LLC*. The Indiana State Police Pension Trust argued that the government's use of TARP funds for an automotive company read the word "financial" out of the term "financial institution." In response, the Solicitor General, using a creative interpretation of the classic *Chevron* analysis, argued that "[w]here Congress expressly defines a term, courts do not parse the individual words that make up the term; they look to the statutory definition. And, to the extent that the statutory definition is ambiguous, the interpretation of that

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[8] For example, Senator Carl Levin (D-MI) emphasized at the time the importance of focusing efforts on US institutions subject to US regulation. *See* 154 CONG. REC. 10,220, 10,258 (2009). Also, many hedge funds and at least some private equity funds are organized in jurisdictions outside of the US.

[9] An analysis of the programs established to bring relief to the U.S. auto industry is beyond the scope of this Manual. For an overview of the U.S. government's involvement in the automotive industry, see U.S. GOV'T ACCOUNTABILITY OFFICE, REPORT TO CONGRESSIONAL COMMITTEES, AUTO INDUSTRY: SUMMARY OF GOVERNMENT EFFORTS AND AUTOMAKERS' RESTRUCTURING TO DATE (Apr. 2009), http://www.gao.gov/new.items/d09553.pdf. For details on the Treasury Department's Automotive Industry Financing Program, see U.S. Dep't of the Treasury Website, Automotive Industry Financing Program, http://www.financialstability.gov/roadtostability/autoprogram.html (providing overview and links to individual programs); see also U.S. Dep't of the Treasury Website, Automotive Industry Financing Program: Additional Transactions, http://www.financialstability.gov/impact/DataTables/additionaltransactions.html (providing information regarding specific transactions involving the automotive industry).

[10] On May 21, 2009, the FDIC approved GMAC's participation in TLGP, enabling GMAC to issue up to $7.4 billion in FDIC-guaranteed debt on or before October 31, 2009. *See* GMAC Inc., Quarterly Report (Form 10-Q), at 94 (Aug. 7, 2009). For a discussion of GMAC's participation in TLGP, see Chapter 5: *The FDIC's Temporary Liquidity Guarantee Program – Terms of the Debt Guarantee – Eligible Entities*.

provision adopted by the Treasury Department . . . is entitled to judicial deference."[11]

Of course, the counterargument is that the plain meaning of the word "financial institution" cannot be stretched to include automotive companies. As a technical legal matter, the issue was not settled because on June 9, 2009, the Supreme Court handed down a *per curiam* denial of the applications for a stay of the sale, with no opinions. The Court explicitly noted, however, that the denial was not a decision on the merits of the underlying legal issues.

As a practical matter, the limited time left for Treasury to make new investments means that the set of "financial institutions" into which investments have been made is likely to be the final set.[12]

"Significant Operations"

Under EESA, a financial institution must have significant operations in the US in order to be eligible to participate. Treasury has not provided guidance on the definition of "significant operations." This limit was likely originally intended to prevent US taxpayer funds from going to foreign banks with only tangential US operations. Both large and small US banks and bank holding companies have participated in CPP. Thus the "significant operations" limit has had no real meaning or effect on domestic entities. For a further discussion, see Chapter 3: *The Capital Twist* – What is a "Qualifying Financial Institution".

What is a "Troubled Asset"?

Definition of Troubled Asset

Not surprisingly, the definition of "troubled assets" is broad and leaves discretion to Treasury.[13] Troubled assets fall into two broad categories. The first category includes "residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008,[14] the purchase of which the Secretary determines promotes financial market stability." This category includes synthetic

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[11] *See* Memorandum for the United States in Opposition at 17-18, Indiana State Police Pension Trust v. Chysler LLC, 556 U.S. ___ (2009) (per curiam).

[12] *See* Indiana State Police Pension Trust v. Chrysler LLC, 556 U. S. ____ (2009) (per curiam), http://www.supremecourtus.gov/opinions/08pdf/08A1096.pdf.

[13] Emergency Economic Stabilization Act of 2008 § 3(9), codified at 12 U.S.C.A. § 5202(9) (2008).

[14] The date of the Bear Stearns rescue.

instruments written, directly or indirectly, on mortgages. Since EESA directs Treasury to consider the utility of purchasing "other real estate owned," the bank regulatory term for foreclosed properties, such property is also eligible for purchase under TARP.

The second category gives Treasury the power to declare any other financial instrument to be a troubled asset if the purchase of the instrument is "necessary" to promote financial market stability. The breadth and ambiguity of this section's wording set the legal stage for the twist into capital investments. Indeed, that ambiguity was, at least in the minds of some legislators, deliberate and in a floor debate preceding the final vote in the House of Representatives, equity investments were expressly contemplated.[15]

In order to add a new non-mortgage related asset to the troubled asset category, Treasury must make its determination in writing to the Congressional financial oversight committees. There is no timing requirement attached to the notice requirement, so Treasury can give the notice concurrently with a purchase. This is, in fact, what Treasury did with the creation of CPP, on October 14, 2008. For a further discussion, see Chapter 3: *The Capital Twist* – The Twist Into Investments – The Capital Purchase Program.

Preventing Unjust Enrichment

EESA requires Treasury to take such steps as may be necessary to prevent unjust enrichment of financial institutions participating in TARP, including preventing the sale of a troubled asset to Treasury at a higher price than what the seller paid to purchase the asset. For a further discussion, see Chapter 8: *Investigations and Enforcement* – Inspectors General and Investigative Bodies. The prohibition does not apply to troubled assets acquired in a merger or acquisition or in a purchase from a financial institution in a conservatorship, receivership or certain bankruptcy proceedings. This exception was intended to allow the acquirers in emergency takeovers, as well as the purchasers of assets in insolvency/receivership proceedings, to sell certain troubled assets acquired in the process at a gain. The legislative intent, presumably, was that these exemptions create an opportunity for profit and would thereby encourage the participation of multiple private sector participants in troubled situations.

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[15] Representative Barney Frank (D-MA) asserted that "[w]here the legislation speaks of 'assets', that term is intended to include capital instruments of an institution such as common and preferred stock, subordinated and senior debt, and equity rights. . . . [O]ne of the things that this House and the Senate added to the bill [is] the authority to buy equity. It is not simply buying up the assets, it is to buy equity, and to buy equity in a way that the Federal Government will able to benefit if there is an appreciation." *See* 154 CONG. REC. 10,763 (daily ed. Oct. 3, 2008) (statement of Rep. Barney Frank), http://frwebgate.access.gpo.gov/cgi-bin/getpage.cgi?dbname=2008_record&page=H10763&position=all.

Warrant Requirement

Under EESA, each financial institution that sells assets to Treasury under TARP or takes a capital injection must also grant Treasury equity warrants or, in the case of non-listed companies, equity or senior debt securities. For a further discussion, see Chapter 4: *Warrants: Upside for the Taxpayer – Statutory Requirements for the Creation of the Warrants*.

Executive Compensation

Under EESA, each financial institution that sells assets to Treasury under TARP or takes a capital injection must abide by certain executive compensation restrictions. For a further discussion of these restrictions, see Chapter 9: *Executive and Employee Compensation*.

Pricing, Market Mechanisms and Reverse Auctions

EESA requires Treasury, wherever possible, to use market mechanisms to purchase troubled assets, but leaves the design and implementation of those mechanisms to the discretion of Treasury. EESA also adopts a general framework directing Treasury to purchase assets "at the lowest price that the Secretary determines to be consistent with the purposes of [the] Act" and to "maximize the efficiency of the use of taxpayer resources by using market mechanisms, including auctions or reverse auctions, where appropriate."[16] Although none of these market mechanisms have been directly implemented, both the CPP pricing and warrant repayment terms have incorporated market pricing mechanisms. See Chapter 3: *The Capital Twist* and Chapter 4: *Warrants: Upside for the Taxpayer*. The strong US policy impulse to use market mechanisms for pricing has remained, however, and has also been included in PPIP and, to a certain extent, TALF programs. For a further discussion, see Chapter 6: *The Term Asset-Backed Securities Loan Facility* and Chapter 7: *The Public-Private Investment Program*.

Spending Limits and Funding

EESA limits the amount of troubled assets Treasury has the power to purchase under TARP, taking into account guarantees extended for troubled assets under the Optional Guarantee Program discussed later in this Chapter.

[16] Emergency Economic Stabilization Act of 2008 § 113(b), codified at 12 U.S.C.A. § 5223(b) (2008).

Initial Spending Authorization

EESA authorizes Treasury to purchase up to $700 billion of troubled assets with the funding made available in graduated increments. To fund TARP, Treasury is authorized to issue US Treasury bills and certain other US public debt instruments.

Initially, upon enactment, Treasury's authority to purchase troubled assets was limited to $250 billion. Under a subsequent Presidential certification of need, the Treasury Secretary was authorized to make an additional $100 billion in purchases.

Additional Spending Authorization

On January 12, 2009, at the request of President-elect Obama, President Bush submitted to Congress notification of intent to exercise his authority under EESA to purchase an additional $350 billion in troubled assets. The request triggered a provision in EESA that gave Congress fifteen days to pass a joint resolution of disapproval and stop the release of the second tranche of funds.

On January 12, top economic adviser to President-elect Obama Lawrence Summers sent a three-page letter to Congressional leaders.[17] The letter vowed to better track how TARP money was spent and bolster oversight.

At the same time, Representative Barney Frank (D-MA) pressed for more specific constraints on TARP spending. He proposed a bill that would amend TARP to limit executive salaries at all firms that had taken TARP funds, including retroactively those that had already received funds. It also proposed a requirement that the Obama Administration spend at least $40 billion to help distressed homeowners.[18] Though President Obama and his team stated that they agreed with those goals, Representative Barney Frank (D-MA) nonetheless sought legislation "that sets forth the conditions we believe are necessary to assure that the public gets the full benefit of these funds."[19]

Lawmakers from both parties took the view that Lawrence Summers' initial letter offered insufficient detail about President Obama's plans and several said they would oppose release of the funds unless President Obama

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[17] Letter from Lawrence H. Summers, Director-Designate, Nat'l Econ. Council to congressional leaders (January 12, 2009), http://otrans.3cdn.net/9c7731e5022478bd49_vom6bh41q.pdf.

[18] TARP Reform and Accountability Act of 2009, H.R. 384, 111th Cong. (2009), http://www.house.gov/apps/list/press/financialsvcs_dem/hr384.pdf.

[19] *See* Lori Montgomery and David Cho, *Obama Seeks Rest of Bailout; Request for Funds Meets Skepticism on Capitol Hill,* WASH. POST, Jan. 13, 2009, at A01, http://www.washingtonpost.com/wp-dyn/content/article/2009/01/12/AR2009011201310.html.

offered more specific assurances about how he would use the money.[20] As a result, on January 15th, Lawrence Summers sent a second letter to Senator Harry Reid (D-NV), the majority leader of the Senate.[21] The letter pledged to advise Congress before making any substantial new commitment of funds, to quickly disclose the details of any purchase of stock or assets and to force financial firms that accept the money to limit executive salaries and prove they are using any TARP funds to increase lending. Lawrence Summers also vowed to dedicate $50 to $100 billion to a "sweeping effort" to reduce foreclosures. Finally, he assured lawmakers that President Obama "has no intention of using any funds to implement an industrial policy."[22]

Hours after the second letter was sent, the Senate voted 52-42 against a measure that would have blocked release of the funds. The Senate vote meant that the second tranche of funds could be released. The House, however, pressed forward with its votes the following week and by a vote of 260-166, approved Representative Barney Frank's (D-MA) bill. The *Washington Post* reported that Representative Barney Frank (D-MA) said he still pressed forward with the bill because the House vote "gives me, frankly, more authority" to insist that President Obama voluntarily enact some of its provisions.[23]

During the months that have followed, the Obama Administration has implemented, by guideline or regulation, many of the commitments set forth in the two Lawrence Summers letters. For a further discussion of the Obama Administration's regulation of executive compensation, see Chapter 9: *Executive and Employee Compensation*. On the foreclosure front, the Home Affordable Modification Program was announced on March 4, 2009

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[20] *See* Lori Montgomery and Paul Kane, *Senate Votes To Release Bailout Funds To Obama*, WASH. POST, Jan. 16, 2009, at A01, http://www.washingtonpost.com/wp-dyn/content/article/2009/01/15/AR2009011504253.html.

[21] *See* Letter from Lawrence H. Summers, Director-Designate, Nat'l Econ. Council to Harry Reid, Majority Leader, U.S. Senate (Jan. 15, 2009), http://change.gov/newsroom/entry/letter_from_lawrence_h._summers_to_congressional_leaders/.

[22] The *Washington Post* reported that this was a reference to the concerns of many Republicans that the money would be used to prop up the failing auto industry, which had been awarded a small share of the funds. *See* Lori Montgomery and Paul Kane, *Senate Votes To Release Bailout Funds To Obama*, WASH. POST, Jan. 16, 2009, at A01, http://www.washingtonpost.com/wp-dyn/content/article/2009/01/15/AR2009011504253.html. Of course, later it was so used.

[23] If the Obama administration decides to seek funds beyond the $700 billion already approved by Congress, Frank said, "this will tell them what they need to do to get it." *See* Lori Montgomery, *House Urges Tighter Rules For Bailout Beneficiaries; Symbolic Vote Puts Pressure on Obama*, WASH. POST, Jan. 22, 2009, at D01, http://www.washingtonpost.com/wp-dyn/content/article/2009/01/21/AR2009012102989.html. Secretary Geithner has recently testified before the COP that funds beyond $700 billion will not be needed. *America's Financial Regulatory Structure: Hearing Before the Cong. Oversight Panel,* 111th Cong. (2009) (statement of Timothy Geithner, Secretary, U.S. Dep't of the Treasury), *see also Written Testimony of Secretary Timothy Geithner: Hearing Before the Cong. Oversight Panel,* 111th Cong. (2009) (statement of Timothy Geithner, Secretary, U.S. Dep't of the Treasury), http://cop.senate.gov/documents/testimony-091009-geithner.pdf.

and focused the administration's foreclosure mitigation efforts.[24] So far, the Home Affordable Modification Program, unfortunately, has had little effect in stemming the tide of foreclosures.[25]

Future Spending

Treasury's authority to purchase assets under EESA ends on December 31, 2009, unless the Secretary submits a written certificate to Congress justifying an extension and setting forth the cost to taxpayers. The longest an extension could last is until October 3, 2010, two years after EESA's enactment.

The decision whether or not to extend is, of course, highly sensitive for the Obama Administration, the financial sector and the regulators. Representative Jeb Hensarling (R-TX), a member of the COP, has introduced a bill that would eliminate the Secretary's ability to extend TARP beyond December 31, 2009.[26] Although that bill does not appear to have meaningful support, it reflects the sentiment of many. The July COP report has called "the lack of a publicly expressed position…worrisome."[27] More recently, in characterizing the return of the financial markets to normal as "partial and fragile,"[28] Treasury has commented that "uncommitted TARP resources give the government the capacity to respond to unanticipated financial shocks. The capacity to respond with TARP resources continues to provide a critical backstop for financial stability."[29] Based on these

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[24] A discussion of the steps that Treasury and the Obama administration have taken to strengthen the housing sector is beyond the scope of this Manual. For an overview of the initiatives that have been introduced, see U.S. Dep't of the Treasury Press Release, Assistant Secretary for Financial Institutions Michael S. Barr Written Testimony on Stabilizing the Housing Market before the House Financial Services Committee, Subcommittee on Housing and Community Opportunity (Sept. 9, 2009), http://www.financialstability.gov/latest/tg_279.html. For details on particular initiatives under the Making Home Affordable program, see U.S. Dep't of the Treasury Website, Making Home Affordable, http://www.financialstability.gov/roadtostability/homeowner.html (providing overview and links to initiatives).

[25] *See* Ruth Simon and Jessica Holzer, *Mortgage-Aid Plan Gets Tepid Results,* WALL ST. J., Sept. 10, 2009, http://online.wsj.com/article/SB125250943110595845.html.

[26] *See* TARP Repayment and Termination Act of 2009, H.R. 2745, 111th Cong. (2009), http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h2745ih.txt.pdf. As of the date of publication, the bill was referred to the House Committee on Financial Services.

[27] CONG. OVERSIGHT PANEL, JULY OVERSIGHT REPORT: *TARP REPAYMENTS, INCLUDING THE REPURCHASE OF STOCK WARRANTS: THE CONTINUED RISK OF TROUBLED ASSETS* (July 1, 2009), http://cop.senate.gov/documents/cop-071009-report.pdf.

[28] U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

[29] U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

comments and various reports in the press, we believe that the Secretary is laying the groundwork for a decision to extend TARP into 2010.[30]

As a technical matter, the termination of TARP does not affect the ability of Treasury to fund commitments entered into before the termination date.[31] The ability to commit but not to fund may affect the PPIP program and the TALF program, both of which rely, in part, on continued TARP funding. See Chapter 6: *The Term Asset-Backed Securities Loan Facility* and Chapter 7: *The Public-Private Investment Program.*

Revolving Funds

Treasury has taken the position that repaid TARP funds free up space under the $700 billion TARP ceiling and thus can be re-used for future expenditures by Treasury under TARP until the termination date. This position has been stated in a letter from Secretary Geithner to Senator David Vitter (R-LA).[32] As money is returned to Treasury, however, Treasury's ability to use TARP as a revolving purchase facility has become politically unpopular. A bill has been proposed by Representative Jeb Hensarling (R-TX), also a member of the COP, that would amend EESA to make it clear that repayments of TARP funds do not restore Treasury's remaining expenditure authority. In addition, in his separate statement, Representative Jeb Hensarling (R-TX) has expressed his view that the COP should "ask Treasury to provide a formal written legal opinion" supporting its authority.[33] Treasury's position is supported by the fact that the statutory text refers to the amount of troubled assets "outstanding at any one time,"[34] determined by aggregating the purchase prices of all troubled assets held at such time. This statutory text, combined with Treasury's interpretative discretion under *Chevron*, would make it difficult for the contrary position to prevail in a court of law. A judicial forum, however, may not be where this issue is decided.

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[30] *See* Bill Swindell, *Geithner Says Treasury Likely To Extend TARP Program*, NAT'L J. CONG. DAILY, Sept. 11, 2009; Phil Mattingly, *TARP Extension Still Possible, Geithner Says*, CONG. Q. TODAY, Sept. 10, 2009.

[31] Emergency Economic Stabilization Act of 2008 § 106(e), codified at 12 U.S.C.A. § 5216(e) (2008).

[32] *See* CONG. OVERSIGHT PANEL, JULY OVERSIGHT REPORT: TARP REPAYMENTS, INCLUDING THE REPURCHASE OF STOCK WARRANTS 38 n. 135 (July 10, 2009).

[33] CONG. OVERSIGHT PANEL, JULY OVERSIGHT REPORT, SECTION TWO: ADDITIONAL VIEWS 11 (statements by Rep. Jeb Hensarling and Sen. John E. Sununu) (2009), http://cop.senate.gov/documents/cop-072109-views.pdf.

[34] Emergency Economic Stabilization Act of 2008, codified at 12 U.S.C.A. 5231 § 5225(a)

Optional Guarantee Program

EESA provides that Treasury "shall establish" a program to guarantee troubled assets originated or issued before March 14, 2008.[35] This provision was a concession to the House Republicans, whose counterproposal was to center the rescue plan on a self-financing insurance guarantee program.[36] The House Republicans' plan provided for the government to insure troubled assets in return for insurance premiums paid by the financial institutions holding these assets.[37]

The final version of EESA provides that up to 100 percent of the principal and interest payments of a troubled asset may be guaranteed under a guarantee program. Premiums may vary to reflect the credit risk of different troubled assets and must, in the aggregate, be sufficient to meet anticipated claims based on actuarial analysis. The amount available to Treasury to purchase troubled assets must be reduced to reflect the difference between the total guaranteed obligations outstanding at any time and the amount remaining in a fund into which guarantee premiums have been deposited and used to make guarantee payments.

As a result of the mandate, Treasury established the Asset Guarantee Program that provides guarantees for assets held by systemically significant financial institutions that face a high risk of losing market confidence due in large part to a portfolio of distressed or illiquid assets. Treasury may, on a case-by-case basis, use this program in coordination with a broader guarantee involving one or more other agencies of the US government. Treasury determines the eligibility of participants and the allocation of resources on a case-by-case basis.

Under the Asset Guarantee Program, Treasury assumes a loss position on certain assets held by the qualifying financial institution. The set of guaranteed assets is selected by Treasury and its agents in consultation with the financial institution receiving the guarantee.

Treasury collects a premium, deliverable in a form deemed appropriate by the Treasury Secretary. As required by the statute, an actuarial analysis is used to ensure that the expected value of the premium is no less than the expected value of the losses to TARP from the guarantee. The US government also provides a set of portfolio management guidelines to which the institution must adhere for the guaranteed portfolio.

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[35] March 14, 2008 was the date of the Bear Stearns rescue. For details on the timing of major events during the financial crisis, see the Financial Crisis Legal Timeline after the Introduction.

[36] *See* Lori Montgomery and Paul Kane, *Bush Enacts Historic Financial Rescue; House Passes Plan By Wide Margin, but Stocks Keep Falling*, WASH. POST, Oct. 4, 2008, at A01, http://www.washingtonpost.com/wp-dyn/content/article/2008/10/03/AR2008100301108.html.

[37] The idea was similar in principle to the industry-financed system of debt guarantees later put in place by the FDIC. *See* Chapter 5: *The FDIC's Temporary Liquidity Guarantee Program*.

As of the publication date, the Asset Guarantee Program has only been used once. The Treasury, FDIC and Federal Reserve provided certain loss protections against losses on an asset pool of approximately $301 billion of troubled assets held by Citigroup. A similar program was announced for a pool of $118 billion in troubled assets held by Bank of America, with an executed term sheet, but the parties never executed definitive documents for the guarantee. On September 21, 2009, Bank of America announced that it would pay a $425 million fee, to be split between the Treasury, Federal Reserve and FDIC, to terminate the Asset Guarantee term sheet.[38] For a further discussion, see Chapter 3: *The Capital Twist* – Asset Guarantee Program

Political Risk

EESA, and other government reactions during the financial crisis, especially the proposals to impose heavy excise taxes on bonuses to AIG executives awarded pursuant to preexisting contracts, has created US political risk as a business concern.

For US financial institutions, managing for political risk, including confiscations, retroactive changes to contracts and retroactive laws, is a familiar concept in their dealings with other countries. It is an unfamiliar and new concept in terms of their dealings with Congress and the US government. Congress and the US government have long reflected a strong commitment to the rule of law, including prospective, rather than retrospective, rulemaking.

But the controversy over AIG bonuses and other government reactions during the financial crisis have fostered a widespread fear that Congress might be prepared to enact retroactive changes to contracts among private parties, contracts with the government or the legal rules governing various programs or actions either directly or disguised as excise taxes. Combined with the very limited constitutional protections against such retroactive actions, this fear has made the private sector extremely reluctant to enter into any sort of arrangements or partnerships with the government since the controversy over AIG bonuses erupted. This fear was the major factor behind the private sector's initial tepid response to TALF and PPIP and the decision by many financial institutions to exit TARP quickly.

The risk that contracts might be set aside, that there might be later statutory amendments to contracts, that windfall and other taxes might be applied can

[38] Bank of America Press Release, Bank of America Terminates Asset Guarantee Term Sheet (Sept. 21, 2009), http://newsroom.bankofamerica.com/index.php?s=43&item=8536. *See also* Margaret Popper and David Mildenberg, *Bank of America to Pay $425 Million for Merrill Aid (Update 1)*, BLOOMBERG, Sept. 22, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=a2c5hYE7Uv.Y.

no longer be off the table in dealing with the US government. It is true that some of the statutory amendments to the CPP contracts went both ways in the sense that sometimes the government made retroactive changes that were favorable to financial institutions and sometimes the changes were disfavorable. But there are very few constitutional protections that limit congressional power to exercise its discretion in an unfavorable way.[39] For a further discussion of warrants, see Chapter 4: *Warrants: Upside for the Taxpayer*. The intensity and scope of retroactive political risk in the US is new and it remains to be seen whether we are experiencing a paradigm shift or a phase.[40]

Political Oversight Bodies

The original Treasury draft provided for no oversight and a major element in the political compromise was the addition of technical and political oversight mechanisms. EESA provides for five distinct mechanisms to oversee the implementation and operations of TARP.

Annex B provides an overview of the following political oversight bodies: the Financial Stability Oversight Board, the COP, SIGTARP, and the GAO. It addresses their composition, authority, and reports.

Special Inspector General for TARP

EESA established a new Office of SIGTARP, and provides for the appointment by the President with the advice and consent of the Senate of an independent Special Inspector General for TARP.

SIGTARP issues quarterly reports on its oversight activities to Congress. The reports have been extremely comprehensive and influential. A full

[39] For example, the Contracts Clause of the Constitution, which prohibits any "State" from passing a law impairing the obligation of contracts, does not expressly apply to the federal government, and the Supreme Court has long since abandoned the nineteenth century doctrine that the fundamental principle underlying the Contracts Clause can be incorporated against the federal government through the Due Process Clause of the Fifth Amendment. *Compare* Sinking-Fund Cases, 99 U.S. (9 Otto) 700, 718-19 (1879) *and* United States v. Union Pac. Ry., 160 U.S. 1, 33-34 (1895), *with* Pension Benefit Guar. Corp. v. R.A. Gray & Co., 467 U.S. 717, 729-33 (1984).

[40] Statements by elected officials across the political spectrum reflect the increased political sensitivity of financial institutions. Politicians, depending on their views and party affiliations, are alternately "troubled that the private sector must now incorporate the concept of "political risk" into [their] due diligence analysis" or they are angrily denouncing "unseemly" corporations and threatening further government involvement in the private sector. *See, e.g.,* CONG. OVERSIGHT PANEL, JULY OVERSIGHT REPORT, SECTION TWO: ADDITIONAL VIEWS (statements by Rep. Jeb Hensarling and Sen. John E. Sununu), http://cop.senate.gov/documents/cop-072109-views.pdf. *See also The Newshour with Jim Lehrer: Calls Intensify on Capitol Hill to Recall AIG Bonuses* (statement by Sen. Chuck Schumer) (PBS Television Broadcast, Mar. 17, 2009), http://www.pbs.org/newshour/bb/business/jan-june09/aigfallout_03-17.html.

discussion of SIGTARP is contained in Chapter 8: *Investigations and Enforcement* – Inspectors General and Investigative Bodies.

SIGTARP's authority will terminate on the date that that last troubled asset has been sold or transferred out of the ownership of the government which implies, if some of the preferred stock investments last for several years, that SIGTARP will be around for a while.

Congressional Oversight Panel

The COP is tasked to "review the current state of the financial markets and the regulatory system" and to submit monthly reports to Congress on topics such as the Treasury Secretary's use of authority under EESA and the impact of purchases made under EESA on financial markets and institutions.[41]

Although the COP currently lacks subpoena power, Chairperson Elizabeth Warren has made clear that she seeks stronger powers. She has stated that "subpoena power would certainly strengthen the hand of the [P]anel" and that if Congress wants an oversight panel, then the panel needs subpoena power.[42] On April 20, 2009, Senators Olympia J. Snowe (R-ME) and Ron Wyden (D-OR) introduced bipartisan legislation to provide the COP with subpoena authority. The bill has since been referred to the Senate Committee on Banking, Housing, and Urban Affairs.

The COP has held public hearings on regulatory reform of the financial sector and lessons to be learned from government responses to past major financial crises. It has heard testimony from Administration officials including Secretary Geithner and Assistant Secretary of Treasury for Financial Stability Herbert Allison, Jr., and conducted field hearings in several states on the foreclosure crisis, small business lending, and corporate and commercial real estate lending.

Since the COP was formed, Chairperson Elizabeth Warren and other COP members have also testified before Congressional committees about transparency, accountability, investor protection, and other oversight issues pertinent to the COP's work.

Beginning in December 2008, as required by EESA, the COP has issued monthly reports on various topics related to EESA and financial stability. To date, the reports have covered topics such as Treasury's initial responses to the market crisis; the subsequent TALF program and investments in the financial and automotive industry; the results of the May 2009 "stress tests";

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[41] Emergency Economic Stabilization Act of 2008 §125(b), codified at 12 U.S.C.A. § 5223(b) (2008).

[42] *See Panel readies report on Fed plans to up lending to small firms*, REUTERS, Apr. 28, 2009, http://www.reuters.com/article/deborahCohen/idUSTRE53R3AT20090428.

the state of commercial farm markets and foreclosure mitigation efforts; recommendations for structuring TARP participants' repurchase of Treasury warrants; continuing risks presented by troubled assets; and potential areas for broader, long-term reform. The reports have been influential but controversial. The COP has not reached agreement on a number of issues and some of the reports have had dissenters, or "alternative views."

The COP's authority and the requirement that it issue monthly reports to Congress will terminate six months after the Treasury's authority to make new TARP investments ends. For a further discussion, see Annex B of this Chapter.

Financial Stability Oversight Board

The Financial Stability Oversight Board is charged with reviewing Treasury's implementation of TARP, making recommendations to Treasury regarding the implementation of EESA and reporting any suspected fraud, misrepresentation or malfeasance to SIGTARP. The Financial Stability Oversight Board issues quarterly reports to Congress regarding the Board's review of the Secretary's exercise of authority under TARP. For a further discussion, see Annex B of this Chapter.

GAO Audits

The Comptroller General of the United States, via the GAO, is required to conduct detailed, ongoing audits of almost every aspect of TARP. For a further discussion, see Annex B of this Chapter.

Treasury Reporting Requirements

Treasury has a number of reporting obligations under EESA. The requirements include the obligation to disclose certain information regarding its purchases of troubled assets under EESA within two business days, and the obligation to submit both monthly and quarterly reports to certain committees of Congress and to the COP. For a further discussion, see Annex B of this Chapter.

Limited Judicial Review of Treasury Actions

The initial Treasury proposal completely shielded the actions of Treasury from any judicial review. The backlash was almost instantaneous and not surprising in a society where all citizens expect to have their day in court and the courts are seen as an important bulwark for individual rights. After the political compromise, Treasury became subject to judicial review, but only in an extremely limited sense.

EESA provides for judicial review of the Treasury Secretary's actions, which will be set aside if found to be arbitrary, capricious, or otherwise inconsistent with the law or an abuse of discretion.

Under the original vision, Treasury would buy assets from troubled financial institutions and would be subject to the risk that it was interfering in pre-existing contractual relationships. Unhappy parties would have an incentive to try to stop such actions and there was a risk that an injunction might bring the entire program to a halt. As a result, EESA limited injunctive relief. Unless a constitutional issue is raised, EESA prohibits the issuance of injunctions against Treasury with respect to the purchase and/or guarantee of troubled assets, the management and sale of such assets or foreclosure mitigation efforts.

In addition, as is required for most administrative action, Treasury's actions under EESA are subject to the judicial review provisions of the APA. The APA provides different standards of judicial review for evaluating different types of agency actions. Since Treasury implements TARP through regulation, guidelines, FAQs and contracts and through actions committed to its discretion by law, the grounds for challenging many of its actions are likely to be quite narrow and subject to a restrictive standard of judicial review. In practice, and as a general matter, for discretionary actions, it is very difficult for aggrieved parties to demonstrate that agency action violates the APA. So long as an agency can show that its action was undertaken pursuant to reasoned decision-making, in most cases the action will not be found to be unlawful.

Finally, judicial review of Treasury's actions is further limited by EESA's provision that financial institutions that sell assets to Treasury or take capital from Treasury may sue Treasury only in the case of a constitutional violation *or* as determined by contract between Treasury and the financial institution.[43] For a further discussion, see Chapter 8: *Investigations and Enforcement*.

[43] The contracts for the Capital Purchase Program and guarantee program provide that the agreements are governed by federal law. For a further discussion on this topic, see Chapter 3: *The Capital Twist*. The contracts for the Capital Purchase Program, however, state that the recipient institution and its senior executive officers must waive the right to bring claims against Treasury arising from the issuance of any regulations related to enforcing the executive compensation requirements of EESA under Section 111.

Annex A: Mark-to-Market Accounting Changes

The impact of mark-to-market accounting and changes thereto has been a major and controversial element in financial crisis laws and financial crisis programs. Set forth below, is a summary of the changes to mark-to-market accounting that have occurred during the recent past. As lawyers, we are not, of course, accounting experts. Those who desire a more in-depth treatment might start with the sources set forth as footnotes in this section.[1]

Under Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities ("FAS 115"), debt securities classified as "trading securities" or "available-for-sale securities" are required to be reported at fair value and marked-to-market, whereas debt securities classified as "held-to-maturity" are reported at amortized cost.[2] As one Wall Street Journal editorial put it, "on bank balance sheets, [real-estate securities] must either be written down or held like a ball and chain that inhibits other lending."[3] Statement of Financial Accounting Standards No. 157, Fair Value Measurements ("FAS 157"), offers guidance on how to measure fair value, defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[4] Thus, government pricing of illiquid "troubled assets" was particularly important for two reasons.

First, financial institutions contemplating sales of such assets would likely have to mark-to-market remaining assets on their balance sheet at a similar price point. If the government purchase price was lower than the pricing model assumptions used by the financial institution, this could entail further write-downs and losses that financial institutions feared they did not have sufficient capital to absorb.[5] Although whole loans would continue to be held at cost under FAS 115, frozen securitization markets made new lending less feasible.

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[1] Stephen G. Ryan, *Fair Value Accounting: Policy Issues Raised by the Credit Crunch, in* RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 215 (Viral V. Acharya & Matthew Richardson eds., 2009).

[2] ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES, Statement of Fin. Accounting Standards No. 115 (Fin. Accounting Standards Bd.), http://www.fasb.org/pdf/aop_FAS115.pdf.

[3] Editorial, *The Paulson Sale*, WALL ST. J., Sept. 24, 2008, at A28, http://s.wsj.net/article/SB122221388577369225.html.

[4] FAIR VALUE MEASUREMENTS, Statement of Fin. Accounting Standards No. 157 (Fin. Accounting Standards Bd.), http://www.fasb.org/pdf/aop_FAS157.pdf.

[5] Krishna Guha and Henry Sender, *Banking on Success of Paulson's Big Idea*, FIN. TIMES, Sept. 22, 2008, http://www.ft.com/cms/s/0/1a0b47a8-880b-11dd-b114-0000779fd18c.html.

Annex A: Mark-to-Market Accounting Changes

Second, the government purchase price used in one such transaction could set the market price more broadly, as FAS 157 "requires accountants to look at market 'inputs' from sales of similar financial assets even if there isn't an active trading market."[6] The sale of assets at one financial institutions could trigger mark-to-market write-downs across the board – even for financial institution that did not participate in the program. The government faced a double-edged sword in pricing troubled assets. If the government paid then-current "fire sale prices" for the securities, financial institutions across the board could suffer further losses from mark-to-market writedowns, which could in turn trigger a "vicious cycle" of more asset sales and writedowns. Alternatively, paying a premium on such "fire sale prices" would subject the government to political backlash for overpaying.[7]

Slight modifications to mark-to-market accounting rules in April 2009 rendered much of the debate over toxic asset sales moot. After much political and lobbying pressure, FASB approved guidance relaxing the application of fair value standards "when the volume and level of activity for the asset or liability have significantly decreased" so that "transactions or quoted prices may not be determinative of fair value because in such market conditions there may be increased instances of transactions that are not orderly."[8] In such instances when "the market is broken", financial institutions would be allowed to assign "fair values" based on their own judgment of "other considerations" than the last quoted price.[9] Additionally, under the new FAS 115-2, which applies to certain permanently impaired

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[6] John Berlau, *Maybe the Banks Are Just Counting Wrong*, WALL ST. J., Sept. 20, 2008, at A15, http://online.wsj.com/article/SB122186515562158671.html.

[7] Jessica Holzer, *Bailout May Aid Bank Balance Sheets*, WALL ST. J., Sept. 24, 2008, at C6, http://online.wsj.com/article/SB122221831592769671.html.

[8] FSP FAS 157-4—Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (Fin. Accounting Standards Bd.), http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176154545450. Other FSPs regarding fair value accounting released at the same time were FSP FAS 107-1 and APB 28-1—Interim Disclosures about Fair Value of Financial Instruments (Fin. Accounting Standards Bd.), http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176154545369, and FSP FAS 115-2 and FAS 124-2—Recognition and Presentation of Other-Than-Temporary Impairments, (Fin. Accounting Standards Bd.), http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176154545419.

[9] Binyamin Applebaum and Zachary Goldfarb, *Under New Accounting Rule, Toxic Assets May Be Revalued*, WASH. POST, Apr. 3, 2009, at A15, http://www.washingtonpost.com/wp-dyn/content/article/2009/04/02/AR2009040201264.html.

Annex A: Mark-to-Market Accounting Changes

assets that a financial institution decides to hold in the hope of eventual recovery, the part of the permanent impairment attributable to market forces does not reduce either earnings or regulatory capital and, in this way, provides some additional protection to financial institutions capital from changes in the market value of the impaired assets. This accounting change allowed financial institutions' "to report higher values for some troubled assets", which made holding onto such assets more attractive and lessened the need for participation in government purchase programs.[10] Commentators also speculated that resulting higher valuations and potential for overpaying would conversely discourage private investor participation in government purchase programs.[11]

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[10] Binyamin Applebaum and Zachary Goldfarb, *Under New Accounting Rule, Toxic Assets May Be Revalued*, WASH. POST, Apr. 3, 2009, at A15, http://www.washingtonpost.com/wp-dyn/content/article/2009/04/02/AR2009040201264.html; *See also* Floyd Norris, *Banks Get New Leeway in Valuing Their Assets*, N.Y. TIMES, Apr. 3, 2009, at B1, http://www.nytimes.com/2009/04/03/business/03fasb.html?_r=1&emc=eta1; Heidi N. Moore, *Move to Ease "Mark" Rule May Subvert Treasury Plan*, WALL ST. J., Apr. 1, 2009, at C1, http://online.wsj.com/article/SB123854595878676211.html.

[11] Rachel Beck, *Bank Fix-It Plans May Collide*, ASSOCIATED PRESS, Mar. 27, 2009, http://abcnews.go.com/Business/wireStory?id=7194845.

Annex B: Political Oversight Bodies

Oversight Body	Member(s)	Authority
Financial Stability Oversight Board	▪ Five members	▪ Section 104 of EESA ▪ Terminates on the expiration of the 15-day period beginning upon the later of (a) the date the last troubled asset acquired by the Secretary of the Treasury under EESA's purchase authority has been sold or transferred out of the Federal Government's ownership or control or (b) the date of expiration of the last insurance contract issued under EESA's insurance authority.

	▪ Chairman of the Federal Reserve
	▪ Secretary of the Treasury
	▪ Director of the Federal Housing Finance Agency
	▪ Chairman of the SEC
	▪ Secretary of Housing and Urban Development
		▪ Charged with:
		  ▪ Reviewing Treasury's implementation of TARP
		  ▪ Making recommendations to Treasury regarding the implementation of EESA
		  ▪ Reporting any suspected fraud, misrepresentation or malfeasance to SIGTARP
		  ▪ May appoint a credit review committee to evaluate Treasury's use of its authority to purchase troubled assets under EESA
		  ▪ Power to ensure that the policies implemented by Treasury are in accordance with EESA and in the economic interests of the US
		  ▪ The scope of authority under this provision is not clear; the word "ensure" in the final version of EESA replaced more specific language in previous drafts giving an executive committee of the Board the power to "direct, limit or prohibit" Treasury's activities under EESA

Congressional Oversight Panel	▪ Five members appointed by Congressional leadership	▪ Section 125 of EESA ▪ Terminates six months after the expiration of the Secretary of the Treasury's purchase authority under EESA

	▪ One member appointed by the Speaker of the House
	▪ One member appointed by the minority leader of the House
	▪ One member appointed by the majority leader of the Senate
	▪ One member appointed by the minority leader of the Senate
	▪ One member jointly appointed by the Speaker of the House and the majority leader of the Senate, after consultation with the minority leader of the House and the minority leader of the Senate
	Current Members:
		▪ Tasked to "review the current state of the financial markets and the regulatory system"
		▪ Submit monthly reports to Congress regarding:
		  ▪ The Secretary of the Treasury's use of authority under EESA
		  ▪ The impact of purchases made under EESA on financial markets and institutions
		  ▪ The extent to which information made available on transactions under TARP has contributed to market transparency
		  ▪ The effectiveness of foreclosure mitigation efforts
		  ▪ The effectiveness of TARP from the standpoint of minimizing long-term costs and maximizing benefits for taxpayers
		▪ Empowered to hold hearings, take sworn testimony, review official data, and write reports on actions taken by Treasury and financial institutions
		▪ Heads of federal departments and agencies are required to furnish information necessary to enable the COP to carry out its duties
		▪ By statute, the COP receives copies of certain reports required by EESA from the Treasury Department

Annex B: Political Oversight Bodies

Oversight Body	Member(s)	Authority
	▪ Chair Elizabeth Warren, Professor of Law at Harvard University ▪ Representative Jeb Hensarling (R-TX) ▪ Richard Nieman, Superintendent of Banks, New York State Banking Department ▪ Damon Silvers, Associate Counsel, AFL-CIO ▪ Paul S. Atkins, former SEC Commissioner (replaced John E. Sununu, former Senator from New Hampshire, in August 2009)	▪ The COP also receives periodic reports from the Financial Stability Oversight Board about its ongoing review of authority exercised in connection with TARP and its related recommendations
Special Inspector General for TARP	▪ Neil M. Barofsky ▪ Confirmed by the Senate on December 8, 2008, and sworn into office on December 15, 2008	▪ Section 121 of EESA, as amended by the SIGTARP Act, which increased SIGTARP's powers ▪ Terminates on the date the last troubled asset acquired under TARP has been sold or transferred out of the ownership or control of the Federal Government. ▪ Duty to conduct, supervise, and coordinate audits and investigations of the purchase, management, and sale of assets under TARP ▪ Required to provide a report to Congress, within 60 days of the confirmation of the Special Inspector General and quarterly thereafter, describing SIGTARP's activities and providing certain information about TARP during the reporting period ▪ SIGTARP expressly has the authorities, among others, listed in Section 6 of the Inspector General Act of 1978, which includes the power to obtain documents and other information from federal agencies and to subpoena reports, documents, and other information from persons or entities outside government ▪ For a full discussion of SIGTARP, see Chapter 8: *Investigations and Enforcement.*

GAO		▪ Section 116 of EESA
		▪ Required to conduct detailed, ongoing audits of almost every aspect of TARP
		▪ Assessments of the "programs, activities, receipts, expenditures and financial transactions of … any agents and representatives of TARP"
		▪ Report on the following topics:
		  ▪ The effectiveness of TARP from the standpoint of minimizing long-term costs and maximizing benefits for taxpayers
		  ▪ TARP's performance in meeting the purposes of the Act
		  ▪ The financial condition and internal controls of TARP, its representatives, and agents

Annex B: Political Oversight Bodies

Oversight Body	Member(s)	Authority
		▪ The characteristics of both asset purchases and the disposition of assets acquired, including any related commitments that are entered into ▪ TARP's efficiency in using the funds appropriated for its operation ▪ TARP's compliance with applicable laws and regulations ▪ Efforts to prevent, identify, and minimize conflicts of interest of those involved in TARP's operations ▪ The efficacy of contracting procedures ▪ Section 116 of EESA, as amended by Section 601 of the Helping Families Save Their Homes Act of 2009, provides that the GAO shall have access to the books and records of, among others, any nongovernmental entity "participating" in a program established under the TARP as well as "the officers, employees, directors, independent public accountants, financial advisors and any and all other agents and representatives thereof." The provision requires every agreement between Treasury and any such nongovernmental entity to provide for such access.
FCIC		▪ For information related to the FCIC, which is not technically an EESA oversight body, created by the Fraud Enforcement and Recovery Act of 2009, see Chapter 8: *Investigations and Enforcement.*

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http://www.treasury.gov/press/releases/hp1175.htm

Statement by the President's Working Group on Financial Markets
http://www.treasury.gov/press/releases/hp1177.htm

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http://www.house.gov/apps/list/press/financialsvcs_dem/press011209.shtml

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http://otrans.3cdn.net/9c7731e5022478bd49_vom6bh41q.pdf

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http://www.sigtarp.gov/reports/congress/2009/SIGTARP_Initial_Report_to_the_Congress.pdf

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http://www.sigtarp.gov/reports/congress/2009/April2009_Quarterly_Report_to_Congress.pdf

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http://www.gao.gov/new.items/d09216.pdf

GAO: Presentation on The Recovery Act and TARP: GAO's Oversight Role dated June 17, 2009
http://www.gao.gov/cghome/d09846cg.pdf

GAO: Report on Troubled Asset Relief Program: January 2009 Status of Efforts to Address Transparency and Accountability Issues dated January 2009
http://www.gao.gov/new.items/d09296.pdf

GAO: Report on Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency dated December 2008
http://www.gao.gov/new.items/d09161.pdf

The Department of Treasury: Blueprint for a Modernized Financial Regulatory Structure dated March 2008
http://www.treas.gov/press/releases/reports/Blueprint.pdf

Financial Accounting Standards Board: Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities
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CHAPTER 3: THE CAPITAL TWIST

John M. Brandow, Randall D. Guynn, Michael Kaplan and Margaret E. Tahyar

Table of Contents

Introduction

Although TARP was initially created to purchase troubled real estate-related assets, the plain language of EESA permits Treasury, after giving notice to Congress, to purchase other "financial assets" if necessary to promote financial stability. For a further discussion, see Chapter 2: *Emergency Economic Stabilization Act: The Original Vision*. Once it became clear to Treasury and the Federal Reserve that the pricing mechanism for purchasing troubled assets as originally envisioned, as well as other elements in the purchase plan, would not work quickly enough to shore up financial institutions, regulators switched to capital injections.

This Chapter describes the programs that Treasury has initiated or participated in to inject capital into financial institutions, typically by purchasing from the institution preferred stock and warrants using standard terms and contracts established by Treasury. The programs were announced by term sheets, interpreted by FAQs and implemented by binding contracts with counterparties, all of which have been posted on the internet as part of Treasury's commitment to transparency. In addition, in certain instances, as described more fully in this Chapter and in Chapter 4: *Warrants: Upside for the Taxpayer*, existing contracts have been changed by statute. As a result, the applicable rules involve an interplay of statutory, contractual and regulatory sources. Lawyers reviewing existing contracts should be aware that certain terms may have been changed by statute.

The CPP served as Treasury's first injection of capital in certain qualifying financial institutions by purchasing newly issued preferred stock, resulting in Treasury's investment in hundreds of institutions. Realizing that particular institutions needed additional aid, Treasury's next programs were more targeted. The Systemically Significant Failing Institutions Program has invested only in AIG by purchasing its senior preferred stock. Similarly, Treasury has only used the Targeted Investment Program to invest in the preferred stock of Citigroup and Bank of America. Lastly, Treasury, under

The publication date of this Chapter is September 21, 2009. All terms and acronyms used in this Chapter are defined in the Glossary at the front of this Manual.

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the new Administration, established CAP to purchase convertible preferred stock from qualifying financial institutions, including institutions found to need additional capital buffers after undergoing the Federal Reserve's stress test. Thus far, however, no institution has been funded through this program, and the 10 bank holding companies found to need additional capital buffers are raising or have raised capital in the private market.

Even though the US government has an investment in the financial institutions from which it has purchased preferred stock and received warrants through these various programs, Treasury has stated it is a "reluctant shareholder." Treasury's aversion to assuming control of financial institutions is manifest in the terms of the preferred stock, contractual restrictions and repayment policies. The preferred stock generally does not confer voting rights to Treasury, except upon conversion of the preferred issued under CAP. Nor can Treasury exercise voting power with respect to common stock acquired through exercise of warrants.[1]

While Treasury's authority to inject new capital into financial institutions terminates at the end of 2009, unless extended by the Treasury Secretary to October 3, 2010, as described in Chapter 2: *Emergency Economic Stabilization Act: the Original Vision*, the capital investment programs will continue to remain relevant for many financial institutions for at least as long as Treasury continues to hold its investments in these institutions and the related contractual restrictions remain in place. Restrictions contained in agreements with Treasury are also significant for other financial institutions in that they can inform the government's adoption of new regulations and guidelines.

This Chapter covers the Treasury's CPP, Systemically Significant Failing Institutions Program, Targeted Investment Program and CAP, with its related stress tests, and TARP repayment terms. Committed to transparency, Treasury has made the terms of the securities and related contracts publicly available online. Finally, Annex A of this Chapter describes in more detail the methodology used in conducting the stress tests and criticism from the COP of such methodology. This Chapter is based solely on publicly available data.

(continued)

[1] The exceptions to this approach are AIG and, to a lesser extent, Citigroup. A trust formed for the sole benefit of Treasury owns a controlling interest in AIG. Although Treasury holds a 34% stake in Citigroup, which it received in exchange for the Citigroup preferred stock it bought under the CPP, Treasury has agreed to limit the voting rights associated with this investment, as discussed under Treasury as Shareholder section of this Chapter.

CPP Investments in the Nine Largest Financial Institutions

- The nine largest financial institutions, and the investments committed to them through CPP, include:
  - Bank of America ($15 billion, together with Merrill Lynch, $25 billion);
  - Bank of New York Mellon ($3 billion);
  - Citigroup ($25 billion);
  - Goldman Sachs ($10 billion);
  - JPMorgan ($25 billion);
  - Merrill Lynch ($10 billion);
  - Morgan Stanley ($10 billion);
  - State Street ($2 billion); and
  - Wells Fargo ($25 billion).
- As of the date of publication, Bank of New York Mellon, Goldman Sachs, JPMorgan, Morgan Stanley, and State Street have fully repaid their CPP funds.
- State Street has paid $60 million, Goldman Sachs $1.1 billion, Bank of New York Mellon $136 million and Morgan Stanley $950 million to repurchase their warrants from Treasury. For a further discussion, see Chapter 4: *Warrants: Upside for the Taxpayer*.

The Twist Into Investments – The Capital Purchase Program

Initial Announcement

From the very beginning, many economists and the vast majority of regulators in other countries criticized the US plan to purchase troubled assets, asserting that direct capital injections would be more efficient. Indeed, some commentators have speculated about a split between Federal Reserve Chairman Bernanke and then Treasury Secretary Paulson on this issue. At least one commentator has stated that Treasury Secretary Paulson had taken the decision to shift to capital injections even before EESA was enacted.[2] Whatever the timing of the shift, which we expect historians will elucidate in the coming years, it was also apparent, by mid-October 2008 that the UK and other Europeans were concentrating on capital injections.[3]

Treasury, in coordination with the FDIC and the Federal Reserve, made the decision to use a portion of the $250 billion of the first tranche of EESA funds for capital purchases, specifically of preferred stock and warrants for common stock of US financial institutions. When CPP was officially announced, regulators had already summoned the CEOs of the nation's nine largest financial institutions to a meeting in Washington to inform them that their institutions had been designated as systemically important, and that therefore they would, whether they or their boards felt their institutions needed it or not, sign the term sheets put in front of them and accept the government investment.[4] The CEOs of these institutions all signed the one-page term sheets that day, which formed the basis of securities purchase agreements for the purchase of the preferred stock and warrants that were later signed by the financial institutions.[5] Specific information about the investments in the nine largest financial institutions is set forth in the sidebar.

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[2] DAVID WESSEL, IN FED WE TRUST 227 (2009).

[3] On October 8, 2008, the UK government announced a bank rescue package that included up to £50 billion to be used for direct capital injections into struggling banks. Shortly before a meeting of the G-7 finance ministers on October 11, 2008, Secretary Paulson confirmed a US shift to capital injections, and on October 12, 2008, European leaders agreed on a plan to inject billions of euros into European banks. On October 13, 2008, Germany announced a €70 billion recapitalization fund, France announced that €40 billion would be made available to recapitalize financial firms and the UK confirmed capital injections of £37 billion to HBOS/Lloyds and the Royal Bank of Scotland. On October 16, 2008, Switzerland injected CHF 6 billion into UBS.

[4] Joe Weisenthal, *Documents Reveal How Paulson Forced Banks to Take TARP Cash*, BUS. INSIDER, May 13, 2009, http://www.businessinsider.com/uncovered-tarp-docs-reveal-how-paulson-forced-banks-to-take-the-cash-2009-5; *See also* Joanna Ossinger, *Report: Paulson Told Banks They Must Take TARP Money*, FOX BUS., May 13, 2009, http://www.foxbusiness.com/story/report-paulson-told-banks-tarp-money/; DAVID WESSEL, IN FED WE TRUST 236-241 (2009).

[5] For one version of the events leading up to the meeting where the regulators announced to the nine largest bank holding companies that they had no choice but to accept such capital, see DAVID WESSEL, IN FED WE TRUST 236-241 (2009).

For a further discussion of warrants, see Chapter 4: *Warrants: Upside for the Taxpayer*. All contracts under CPP are available online and available through hyperlinks at the end of this section.

Regional Bank Program

After Treasury set aside $125 billion for the nine largest financial institutions, regardless of any financial healthiness determination, it offered the remaining $125 billion to other US banking institutions, including regional and community banks, but only those that were determined to be "healthy." Indeed, after the initial announcement, many regional financial institutions requested CPP investments to avoid being tainted as "unhealthy." There was widespread fear that banks that did not request CPP investments would suffer deposit runs and possibly failure because their customers would conclude that they were unhealthy. In May 2009, Treasury extended CPP for small banks (defined as banks with less than $500 million of total assets) through November 21, 2009.[6] Between October 14, 2008 and September 11, 2009, Treasury invested over $240 billion into over 800 US financial institutions.

According to the September 14, 2009 Treasury Report, the current status of the regional bank program is that "Treasury continues to provide new capital to small banks under the CPP to stimulate a recovery in lending for viable businesses, large and small. Many small banks have relatively high exposures to commercial real estate loans, where credit problems are still growing, and other troubled investments."[7]

- TARP Transaction Reports
  http://www.financialstability.gov/latest/reportsanddocs.html
- Treasury Press Release on CPP
  http://www.treas.gov/press/releases/hp1207.htm

[6] U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

[7] U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

What is a "Qualifying Financial Institution"

The group of financial institutions eligible to participate in CPP is a subset of what was permitted under EESA.

Qualifying Financial Institutions

- Eligible institutions defined as qualifying financial institutions:
  - Any US bank or US savings association not controlled by a bank holding company or savings and loan holding company;
  - Any top-tier US bank holding company;
  - Any top-tier US savings and loan holding company which engages solely or predominantly in activities that are permitted for financial holding companies under relevant law; and
  - Any US bank or US savings association controlled by a US savings and loan holding company that does not engage solely or predominantly in activities that are permitted for financial holding companies under relevant law.

Eligibility

Only "qualifying financial institutions" were eligible to receive financing from Treasury through CPP. Qualifying financial institutions under CPP, as defined in the sidebar, were limited to US bank holding companies, most savings and loan holding companies and virtually all stand-alone US banks and thrifts.[8] As a result, several companies acquired banks or thrifts in order to become bank holding companies or thrift holding companies that could qualify for CPP investments. Otherwise qualifying financial institutions that are "controlled" by foreign banks or companies were excluded from the program.[9] Treasury, after consultation with the institution's primary federal banking agency, determined the eligibility and allocation for qualifying financial institutions. CPP is now closed for institutions other than small banks and no more investments can be made under the program since the application deadlines have passed, although Treasury could re-open the program at any time until December 31, 2009 or, if TARP is extended, until October 3, 2010.

- CPP Term Sheet
  http://www.financialstability.gov/docs/CPP/termsheet.pdf
- Application Guidelines for CPP
  http://www.financialstability.gov/docs/CPP/application-guidelines.pdf
- Process-Related FAQs for CPP
  http://www.financialstability.gov/roadtostability/CPPappdocs_faq1.htm

Terms of the CPP Preferred Stock

The preferred stock issued by institutions participating in CPP were subject to the following terms, which are summarized in the sidebar on the following page:

Size. The amount of preferred stock that Treasury purchased from any qualifying financial institution had to be equal to at least 1% of its risk-

[8] Thrift holding companies include insurance holding companies that control thrifts.

[9] Treasury's Process-Related FAQs for the Capital Purchase Program provide that "For purposes of determining whether a bank is controlled by a foreign bank or company, the Treasury will rely on the federal banking agencies' control determinations." U.S. Treasury, Process-Related FAQs for Capital Purchase Program, http://www.financialstability.gov/roadtostability/CPPappdocs_faq1.htm.

weighted assets and not more than the lesser of (i) $25 billion and (ii) 3% of its risk-weighted assets.

Dividends. The preferred stock is perpetual and cumulative, except that it is non-cumulative if issued by a bank or thrift that does not have a holding company, ranks senior to common stock and *pari passu* with existing senior preferred stock, and pays dividends – which are compounding in the case of cumulative preferred stock – at a rate of 5% that will step up to 9% after five years.[10] Dividend payment dates can be changed, with the consent of Treasury, from the proposed February 15, May 15, August 15 and November 15 dates, to allow a qualifying financial institution to determine the best payment dates in light of its other ongoing payment obligations.

Redemption. Under the original terms of the preferred stock, redemption was only permitted:

- On or after the first dividend payment date falling on or after the third anniversary of the issue date or
- In an amount equal to the net cash proceeds from certain offerings of perpetual preferred stock or common stock qualifying as Tier 1 regulatory capital, provided that the aggregate amount raised in such offerings exceeded 25% of the aggregate liquidation amount of the preferred stock.

In either case, any redemption of a financial institution's preferred stock was also subject to the approval of the primary federal banking agency.

Under the legislative amendment option, discussed below, ARRA eliminated the three-year no-call period and the requirement to raise a specified amount of equity proceeds, giving CPP recipients greater freedom to repay the government. The requirement to obtain prior consent from the primary federal banking agency was not changed, and, of course, the primary federal banking agency is free to condition its approval of an issuer's request to repurchase its preferred stock on the successful completion of capital raising activities. This is the approach the Federal Reserve took with all of the systemically significant financial institutions that received permission to repurchase their preferred stock in June 2009, requiring those institutions to sell specified amounts of common stock and to raise long-term senior debt without the benefit of the FDIC guarantee provided under the TLGP.

Preferred Stock Terms

- Nonvoting, cumulative perpetual preferred stock;
- Treated as Tier 1 capital;
- Subscription amounts: minimum of 1% of risk-weighted assets; maximum of lesser of 3% of risk-weighted assets and $25 billion;
- Senior to common stock and *pari passu* with existing senior preferred stock;
- 5% dividend compounding; step-up to 9% after five years;
- Redeemable, subject to the approval of the appropriate federal banking agency;
- No increase in common stock dividends for three years without Treasury approval unless preferred stock has been fully redeemed;
- No payment of common dividends if preferred stock dividends have not been paid in full;
- Treasury has right to elect two directors if preferred stock dividends unpaid for any six quarters;
- No restrictions on Treasury's transfer.

[10] The preferred stock is non-cumulative if issued by a bank or thrift that does not have a holding company. In practice, only small regional and community banks do not have holding companies. The reason for this variant is probably because only non-cumulative preferred stock qualifies as Tier 1 capital under the regulatory capital rules that apply to banks and thrifts, whereas certain types of cumulative preferred stock qualifies as Tier 1 capital for bank holding companies (there are currently no consolidated capital requirements for thrift holding companies).

Voting Rights. As is typical, the preferred stock is nonvoting except for customary consents to make changes affecting the preferred stock and the right to elect two directors if dividends are not paid for six quarters, whether or not consecutive. The right to elect directors will end when full dividends on the cumulative preferred stock have been paid for all past dividend periods. Treasury's right to elect two directors is not in addition to any director election rights of other preferred stockholders with like voting rights.

Dividend Restrictions. Also typical to the preferred stock market is a common dividend "stopper" — that is, dividends on common stock and *pari passu* preferred stock are generally not permitted unless dividends are also paid on the preferred stock.

Restrictions on Common Dividends and Repurchases. An unusual term is that issuing qualifying financial institutions are not permitted to increase their common stock dividends or buy back their common or junior or *pari passu* preferred stock for a period of three years unless the preferred stock has been redeemed or Treasury has transferred the preferred stock to a third party prior to the increase or buy back. Exceptions exist for repurchases made in connection with stockholders' rights plans, employee benefit plans and certain exchange offerings, as well as for repurchases by the institution acting in the role of a trustee or custodian for other beneficial owners or by a broker-dealer subsidiary in a market-making, stabilization or customer facilitation transaction or in an underwritten offering.

Accounting. The preferred stock is accounted for as equity under US GAAP.

Capital Treatment. The preferred stock is treated as Tier 1 capital for regulatory capital purposes, pursuant to a special Federal Reserve order, even though such preferred stock issued to any other investor would not qualify for Tier 1 capital treatment because of the step-up in interest rate and other prohibited features.[11]

Additional Contractual Terms. In a highly unusual contractual term, Treasury can unilaterally amend the terms of the securities purchase agreements to account for later changes made through legislation.[12] Since the original securities purchase agreements were entered into, two different statutes have, in effect, amended the terms of the original securities purchase agreements. As noted above, in ARRA, financial institutions gained greater freedom to repay the preferred stock. Later, the Helping

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[11] *See* Capital Adequacy Guidelines: Treatment of Perpetual Preferred Stock Issued to the United States Treasury Under the Emergency Economic Stabilization Act of 2008, 73 Fed. Reg. 62, 851 (Oct. 22, 2008) (to be codified at 12 C.F.R. pt. 225), http://edocket.access.gpo.gov/2008/pdf/E8-25117.pdf.

[12] We understand that this clause was inserted because, in the political context, Congressional action was anticipated and Treasury wanted to forestall constitutional arguments against retroactive changes to the contracts through legislation based on the Contracts Clause, the Due Process Clause or the Takings Clause.

Families Save Their Homes Act made further changes to the warrants provisions. For a further discussion of ARRA and Helping Families Save Their Homes Act changes to the warrants, see Chapter 4: *Warrants: Upside for the Taxpayer*. These statutory amendments are not reflected in the securities purchase agreements posted online by Treasury, so lawyers seeking to analyze those agreements must also, at any given time, inform themselves of later statutory changes.

Both parties under the securities purchase agreement waive the right to trial by jury, but otherwise the agreement contemplates lawsuits to enforce the agreement and EESA permits recipient institutions to sue Treasury for constitutional violations. More unusually, however, the recipient institution and its senior executive officers must waive the right to bring claims against Treasury arising from the issuance of any regulations related to enforcing the executive compensation requirements of EESA under section 111. For a further discussion on this topic, see Chapter 2: *Emergency Economic Stabilization Act: The Original Vision* – Limited Judicial Review of Treasury Actions.

Warrants. For a further discussion of the warrants granted as part of CPP as required by EESA, see Chapter 4: *Warrants: Upside for the Taxpayer*. In light of later statutory changes, changes to Treasury's CPP FAQs and a new letter agreement, lawyers should not rely solely on the signed contracts posted online.

Executive Compensation. For a further discussion of the applicable executive compensation limits, see Chapter 9: *Executive and Employee Compensation*. In light of later regulations and statutory changes, as discussed above, lawyers should not rely solely on the signed contracts posted online.

- CPP Term Sheet
  http://www.financialstability.gov/docs/CPP/termsheet.pdf
- CPP Contracts
  http://www.financialstability.gov/impact/contracts_list.htm#cppcontracts

Additional TARP Capital Injections

Both the Systemically Significant Failing Institutions Program and the Targeted Investment Program were designed to permit Treasury to provide additional assistance to certain firms beyond that provided through CPP and without the constraints of CPP's $25 billion investment cap per institution. Although Treasury describes the programs in general terms and posts guidelines and signed contracts online, both programs were developed to inject capital in only certain institutions: the Systemically Significant Failing

Institutions Program in AIG, and the Targeted Investment Program in Citigroup[13] and later Bank of America.

In order to determine which institutions are eligible for either the Systemically Significant Failing Institutions Program or the Targeted Investment Program, Treasury may consider:

- The extent to which the failure of an institution could threaten the viability of its creditors and counterparties because of their direct exposures to the institution;
- The number and size of financial institutions that are seen by investors or counterparties as similarly situated to the failing institution, or that would otherwise be likely to experience indirect contagion effects from the failure of the institution;
- Whether the institution is sufficiently important to the nation's financial and economic system that a disorderly failure would, with a high probability, cause major disruptions to credit markets or payments and settlement systems, seriously destabilize key asset prices, significantly increase uncertainty or losses of confidence thereby materially weakening overall economic performance;
- The extent and probability of the institution's ability to access alternative sources of capital and liquidity.

Eligibility

Treasury states in its guidelines that it will determine which financial institutions can participate in the Systemically Significant Failing Institutions Program or the Targeted Investment Program and the "form, terms, and conditions" of any investments made pursuant to either program on a case-by-case basis, consistent with EESA's mandate.[14] Some of the factors Treasury may consider in order to determine which institutions are eligible are set forth in the sidebar. While in practice Treasury has only used the Systemically Significant Failing Institutions Program to invest in AIG and the Targeted Investment Program to invest in Citigroup and Bank of America, in theory it could still invoke these programs to invest in other institutions. While there is no deadline for submitting applications to these programs, investments cannot be made under TARP past December 31, 2009, unless Treasury actively seeks to extend its authority to October 3, 2010 as described in Chapter 2: *Emergency Economic Stabilization Act: The Original Vision*.

Obligations and Restrictions

SIGTARP has been granted access to all TARP recipient institutions' books and records by the SIGTARP Act of 2009. For a further discussion, see Chapter 2: *Emergency Economic Stabilization Act: The Original Vision* and Chapter 8: *Investigations and Enforcement* – Inspectors General and Investigative Bodies.

The Systemically Significant Failing Institutions Program and Targeted Investment Program recipients also agree to report quarterly to Treasury on the implementation of such controls and compliance with the covenants and use of funds. Although SIGTARP has recommended that Treasury require all TARP recipients to report on the use of their TARP funds, Treasury has chosen not to require such reporting, other than in its agreements with these three institutions, because it believes that the "fungible nature of money

[13] Peter Barnes, *First on FBN: Treasury Posts Details of New Bank Rescue Program*, FOX BUS., Nov. 26, 2008, http://www.foxbusiness.com/story/markets/treasury-posts-details-new-bank-rescue-program/.

[14] Guidelines are a regulatory device, explicitly contemplated by EESA, which permit Treasury to issue, without prior notice and comment, its regulations for programs. In theory, guidelines do not have the same binding effect as a rule issued after notice and comment but, of course, once a contract is signed, that is a distinction without a difference. Guidelines can also be changed at any time.

would make such reports not 'meaningful.'"[15] For a further discussion of issues related to SIGTARP, see Chapter 8: *Investigations and Enforcement*.

Many of the executive compensation restrictions contained in the contracts with the Systemically Significant Failing Institutions Program and Targeted Investment Program recipients later became part of Treasury regulations for TARP recipients and general guidelines governing executive compensation. For a further discussion of issues related to executive compensation restrictions, see Chapter 9: *Executive and Employee Compensation*.

Capital Investments in Systemically Significant Failing Institutions

On November 10, 2008, Treasury announced a restructuring of the government's financial support to AIG. As part of that overhaul, Treasury indicated that it would purchase $40 billion of newly issued preferred shares, the AIG Series D Preferred Stock, under the Systemically Significant Failing Institutions Program, with the proceeds used in part to reduce the total amount available under AIG's September 22, 2008 senior secured revolving credit agreement with the Federal Reserve Bank of New York. For a further discussion, see Chapter 1: *Federal Emergency Intervention Authority: Old Tools Used in New Ways* – Section 13(3) of the Federal Reserve Act. The AIG Series D Preferred Stock was issued to Treasury later that month. For more information on AIG's Series C Perpetual, Convertible, Participating Preferred Stock, issued to the AIG Credit Facility Trust, which provides the government its controlling interest in AIG, see Chapter 1: *Federal Emergency Intervention Authority: Old Tools Used in New Ways.*

On April 17, 2009, AIG and Treasury exchanged the AIG Series D Preferred Stock for other preferred shares, the AIG Series E Preferred Stock, with an aggregate liquidation preference equal to the liquidation preference of the AIG Series D Preferred Stock surrendered plus accumulated and unpaid dividends thereon. On the same date, AIG also issued to Treasury another series of preferred shares, the AIG Series F Preferred Stock, pursuant to an agreement whereby Treasury committed for five years to provide immediately available funds in an amount up to $29.835 billion. This available amount will be decreased by the amount of any financial assistance that Treasury provides to AIG, any of its subsidiaries or any special purpose vehicle established for the benefit of AIG or any of its subsidiaries after the issuance of the AIG Series F Preferred Stock, unless otherwise specified under the terms of such assistance. The liquidation preference of the AIG Series F Preferred Stock was initially $0 per share, and is increased pro rata by the amount of each drawdown of the available funds by AIG. To date, AIG has drawn down $3.2 billion from this facility.

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[15] OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 186 (July 21, 2009), http://www.sigtarp.gov/reports/congress/2009/July2009_Quarterly_Report_to_Congress.pdf.

Certain Common Terms of AIG Series E and Series F Preferred Stock

- No restrictions on transfer to third party, subject to compliance with applicable securities laws;
- Dividend rate of 10% per year, when, as and if declared by the AIG board of directors;
- If AIG fails to pay dividends for four dividend periods, whether or not consecutive, the holders of the preferred stock will have the right to elect the greater of two directors and a number of directors (rounded upward) equal to 20% of the total number of directors after giving effect to such an election;[1]
- Restrictions on repurchase or redemption of common shares, junior preferred shares or preferred shares ranking *pari passu*;
- No payment of dividends or distributions on common stock without Treasury's consent for five years (except for dividends payable in common shares or distributions of rights or junior stock in connection with stockholders' rights plan), unless all preferred shares have been redeemed or transferred to a third party;
- Requirements that AIG continue to maintain policies limiting corporate expenses, lobbying activities and executive compensation; and
- Non-voting except for class votes on certain matters, such as amendments that adversely affect the rights of the preferred stock or authorization of senior or *pari passu* capital stock that is not issued to Treasury.

1. The four dividend period requirement includes the period (starting November 25, 2008) during which the AIG Series D Preferred Stock was outstanding.

The terms of the AIG Series E Preferred Stock and AIG Series F Preferred Stock are substantially the same, except the liquidation preferences per share differ and only the AIG Series E Preferred Stock is subject to a replacement capital covenant. Certain common terms of the AIG Series E and Series F Preferred Stock are set forth in the sidebar.

In connection with the issuance of the AIG Series D Preferred Stock and AIG Series F Preferred Stock, Treasury received warrants to purchase, in the aggregate, approximately 2.69 million shares of AIG common stock. As required by EESA, Treasury has agreed that it will not exercise any voting rights with respect to the AIG common stock issued upon exercise of the AIG warrants. For a further discussion of warrants, see Chapter 4: *Warrants: Upside for the Taxpayer*.

In the September 14, 2009 Treasury Report, Treasury stated that its investment in AIG is "limited and temporary" and that it will seek to dispose of this interest "as soon as practicable."[16]

- AIG Term Sheet
  http://www.ustreas.gov/press/releases/reports/111008aigtermsheet.pdf

Targeted Investment Program

Treasury first issued guidelines for the Targeted Investment Program on January 2, 2009, after previously announcing its investment in Citigroup on November 23, 2008 and beginning discussions with Bank of America about additional TARP investments in December 2008 in anticipation of the closing of its purchase of Merrill Lynch on January 1, 2009. Citigroup entered into its securities purchase agreement with Treasury on December 31, 2008. Bank of America entered into its securities purchase agreement on January 15, 2009.

Preferred Securities

Treasury has invested $20 billion each via the Targeted Investment Program in both Citigroup and Bank of America by purchasing perpetual preferred securities. Treasury's investment supplements the initial TARP investments made under the CPP in these financial institutions. Citigroup has since exchanged these preferred securities for trust preferred securities.

The preferred shares pay cumulative quarterly dividends of 8% per year. The shares are redeemable in stock or cash if Treasury agrees. Otherwise the redemption terms of the CPP preferred apply, which means repayments are permitted in accordance with the conditions discussed in the Exit section

16 U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

of this Chapter. Under the terms of the preferred, a financial institution may not pay common stock dividends exceeding $.01 per share per quarter for three years, unless Treasury consents to the dividend.

The preferred shares do not generally give Treasury voting rights, except for certain specified class voting rights mirroring those rights afforded to holders of the preferred issued to Treasury by AIG under the Systemically Significant Failing Institutions Program. The holders of the preferred shares may also elect two directors pursuant to the same dividend non-payment conditions as under CPP.

There are no contractual restrictions on the transfer of the preferred shares. Finally, the ranking of the shares in relation to other outstanding stock and repurchase restrictions mirror the terms set forth in the preferred issued pursuant to CPP.

Asset Guarantee Program

The Asset Guarantee Program was announced as a package with the Targeted Investment Program. Under the Asset Guarantee Program, the US government entered into a definitive agreement with Citigroup to share losses with respect to a pool of $301 billion in assets of Citigroup. Although the government agreed to the terms of a similar program with Bank of America with respect to a pool of $118 billion of assets, the majority of which were assumed as a result of the Merrill Lynch acquisition, the parties never executed definitive documents for that program. On September 21, 2009, Bank of America announced that it had reached an agreement with regulators to pay a $425 million fee to terminate the term sheet.[17]

The Citigroup contract is available online and information contained in this section is based on public data. The covered assets consist principally of loans and securities backed by residential and commercial real estate. Under the agreement, the assets remain on Citigroup's books but are "ring-fenced." Unless terminated early upon mutual agreement by Citigroup, Treasury, Federal Reserve and FDIC, the loss sharing arrangements are to remain in effect for 10 years for covered residential assets, and five years for covered non-residential assets. Citigroup paid a "fee" for the asset guarantee by issuing approximately $7 billion of additional preferred shares with an 8% dividend rate to Treasury and the FDIC and, to Treasury, a warrant to purchase Citigroup common shares.

Citigroup agreed to absorb the first losses in its covered asset portfolio up to $39.5 billion. The Federal Reserve Bank of New York, Treasury and FDIC

[17] Bank of America Press Release, Bank of America Terminates Asset Guarantee Term Sheet (Sept. 21, 2009), http://newsroom.bankofamerica.com/index.php?s=43&item=8536. *See also* Margaret Popper and David Mildenberg, *Bank of America to Pay $425 Million for Merrill Aid (Update 1)*, BLOOMBERG, Sept. 22, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=a2c5hYE7Uv.Y.

share any additional losses with Citigroup, with the government absorbing 90% of that loss and Citigroup 10%. The various federal parties have agreed to divvy up the government's 90% risk of loss among themselves, with Treasury and the FDIC absorbing the first $5 billion and $10 billion of the remainder of such 90%, and the Federal Reserve Bank of New York funding the remaining pool of assets through a limited-recourse loan, as to which Citigroup would be required to pay, as a recourse obligation, 10% of the amount of any loss and the Federal Reserve Bank of New York having recourse only to the asset pool for the remainder of the loan. The interest rate on the loan equals the overnight index swap rate plus 300 basis points.

Citigroup must manage the assets in the pool in accordance with guidance from a template issued by the government, including mortgage modification procedures adopted by the FDIC. Citigroup retains the income stream from the guaranteed assets, at least prior to the making of the limited-recourse loan by the Federal Reserve Bank of New York, if that occurs, and risk weighting for the assets protected by loss-sharing is 20%.

- Asset Guarantee Program Description: http://www.financialstability.gov/roadtostability/assetguaranteeprogram.htm
- Citigroup Asset Guarantee Contract (January 15, 2009): http://www.financialstability.gov/docs/AGP/Citigroup_01152009.pdf
- Bank of America Asset Guarantee Term Sheet: http://www.treas.gov/press/releases/reports/011508bofatermsheet.pdf
- Treasury Notice 2008-PSSFI http://www.treas.gov/press/releases/reports/exec%20comp%20pssfi%20notice%20revised.pdf
- Treasury Press Release for the Targeted Investment Program http://www.ustreas.gov/press/releases/hp1338.htm
- Targeted Investment Program Description http://www.financialstability.gov/roadtostability/targetedinvestmentprogram.html
- Citigroup Asset Guarantee Term Sheet http://www.ustreas.gov/press/releases/reports/citigroup_termsheet_112308.pdf
- Citigroup Securities Purchase Agreement http://www.financialstability.gov/docs/TIP/Citigroup_12312008.pdf
- Bank of America Securities Purchase Agreement http://www.sec.gov/Archives/edgar/data/70858/000119312509009753/dex101.htm

Treasury as Shareholder

By history and philosophy, the US government is not accustomed to owning stakes in major US companies and, indeed, without express statutory authorization may not do so.[18] The US taxpayer and the US Congress are similarly uncomfortable.[19] The original text of EESA reflected this discomfort by explicitly requiring that any common stock obtained by the exercise of warrants obtained with the purchase of a troubled asset be non-voting.[20]

This reluctance has continued to influence the way Treasury manages its investments. The preferred stock is, following market custom, non-voting.[21] Even where Treasury has taken a significant equity stake it has announced that the investment is "limited and temporary."[22] Secretary Geithner described Treasury as a "reluctant shareholder," in all of its capital investments and stated that "the government will manage its financial interests in a hands-off, commercial manner" and "will not interfere with or exert control over day-to-day company operations and … will only vote on core governance issues, including the selection of a company's board of directors and major corporate events or transactions."[23] And, in sharp contrast to the Europeans, the US government has not sought board seats on the financial institutions in which it has invested.[24]

Although Treasury has generally avoided voting common stock ownership in financial institutions it has invested in, Citigroup's exchange offers to the US government and private holders, which closed on July 23-24, 2009, and its

The Citigroup exchange agreement allows Treasury to vote its common stock on:

- The election and removal of directors;
- Any merger, consolidation, statutory share exchange or similar transaction;
- A sale of all or substantially all of the assets or property of Citigroup;
- A dissolution of Citigroup;
- Any issuance of securities; and
- Any amendment to Citigroup's organizational documents.

On all other matters, Treasury is required to vote its common stock in the same proportion as Citigroup's other common shares.

[18] *See* Youngstown Sheet & Tube Co. v. Sawyer, 343 U.S. 579 (1952) (striking down President Truman's executive order seizing control of certain steel manufacturing plants during the Korean War because the order was not backed by congressional approval or any grant of authority under the Constitution).

[19] *See, e.g.,* Laura Meckler, *Public Wary of Deficit, Economic Intervention,* WALL ST. J., June 18, 2009, http://online.wsj.com/article/SB124527518023424769.html#mod=testMod. *See also* Government Ownership Exit Plan Act of 2009, H.R. 2904, 111th Cong. (2009) (introduced in House), http://www.govtrack.us/congress/bill.xpd?bill=h111-2904.

[20] Emergency Economic Stabilization Act of 2008 § 113(d), codified at 12 U.S.C.A. § 5223(d).

[21] For a further discussion see the Terms of the CPP Preferred Stock – Voting Rights section of this Chapter.

[22] U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf. *See also* U.S. Dep't of the Treasury Press Release, Treasury Announces Participation in Citigroup's Exchange Offering (Feb. 27, 2009), http://www.ustreas.gov/press/releases/tg41.htm.

[23] Letter from Timothy Geithner, Secretary, U.S. Dep't of the Treasury, to Elizabeth Warren, Chair, Cong. Oversight Panel (July 21, 2009), *appendix to* CONG. OVERSIGHT PANEL, AUGUST OVERSIGHT REPORT: THE CONTINUED RISK OF TROUBLED ASSETS 135 (Aug. 11, 2009), http://cop.senate.gov/reports/library/report-081109-cop.cfm.

[24] The situation in the automotive industry is different. *See* Tomoeh Murakami Tse and Peter Whoriskey, U.S. to Wield Significant Sway over Reorganized GM, WASH. POST, May 28, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/05/27/AR2009052701275.html.

offer to public holders, which closed on July 24, 2009, gave the US government a 34% stake in Citigroup. Treasury has voting rights in Citigroup in line with Secretary Geithner's statements quoted above and summarized in the sidebar on the previous page. While it has generally agreed to vote its voting common stock in the same proportion as Citigroup's other common shares, it has retained the right to vote in its discretion on certain matters, such as the election and removal of Citigroup directors. Treasury cannot, however, appoint directors or observers to Citigroup's board and has gained no special contractual veto or consent rights regarding operations of the business.

Another way that the US government has sought to distance itself from companies receiving government assistance is through the use of a voting trust. Its investment in AIG is held through a trust with independent trustees appointed by the US government.[25] When the Obama Administration announced its Financial Stability Plan it announced that it would be forming a trust to hold all of its investments in financial institutions, although no such trust has yet been formed.[26] Recently, the TARP Recipient Ownership Trust Act of 2009 has been introduced in both the House and the Senate by multiple co-sponsors that would require that the government hold its investments in any company in which it holds more than 15% through a trust.[27] The TARP Recipient Ownership Trust Act of 2009 would require that the President appoint three independent trustees to manage the government's TARP investments "separate and apart" from the federal government. Although the trustees are required to be "independent," they would serve at the pleasure of the President and could be removed at will. The Act would also require that all investments be sold by December 24, 2011 unless, under a fast track procedure, Congress resolves to continue the investment.

Trustees would be required to select a representative on the TARP recipient's board of directors and would have a fiduciary duty to the taxpayer to maximize returns as if they were a director of a private company.

SIGTARP is now undertaking an audit, as requested by Senator Max Baucus (D-MT), to examine governance issues at particular institutions in which the US government has taken a large ownership interest. The audit will look at the government's involvement in management of companies, whether there are sufficient risk management, internal controls and monitoring programs in place to protect the government's interests, whether

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[25] The Federal Reserve Bank of New York has released this agreement. *See* Fed. Reserve Bank of N.Y., AIG Credit Facility Trust Agreement (Jan. 16, 2009) http://www.ny.frb.org/newsevents/news/markets/2009/AIGCFTAgreement.pdf.

[26] *See* U.S. Dep't of the Treasury Press Release, Secretary Geithner Introduces Financial Stability Plan (February 10, 2009), http://www.financialstability.gov/latest/tg18.html.

[27] TARP Recipient Ownership Trust Act of 2009, H.R. 3594, 111th Cong. (2009) (introduced in House), http://republicans.financialservices.house.gov/images/bachus_hr%203594_xml.pdf.

performance measures are in place to track the government's ability to unwind its investment, and whether there is adequate transparency.

- Press Release on Citigroup Exchange Offering
  http://www.financialstability.gov/latest/tg41.html
- Citigroup Exchange Transaction Outline
  http://www.treas.gov/press/releases/reports/transaction_outline.pdf
- Citigroup Exchange Form S-4
  http://www.sec.gov/Archives/edgar/data/831001/000119312509150642/ds4a.htm
- AIG Credit Facility Trust Agreement
  http://www.ny.frb.org/newsevents/news/markets/2009/AIGCFTAgreement.pdf
- TARP Recipient Ownership Trust Act of 2009
  http://republicans.financialservices.house.gov/images/bachus_hr%203594_xml.pdf

Capital Assistance Program and Stress Tests

CAP was announced by Secretary Geithner on February 10, 2009. There are two main components of CAP:

- stress tests to determine whether certain institutions need additional capital buffers, and
- a capital assistance program through which eligible public institutions may apply for capital infusions from Treasury.

The program's emphasis on capital composition in the stress tests and preferred stock terms that add the ability to convert to common stock demonstrate Treasury's continued concern with increasing tangible common equity in recipient financial institutions.

Capital Assessment – the "Stress Test"

Creating a Buffer to "Comfortably Absorb Losses"

The Obama Administration decided to apply stress tests to the 19 largest bank holding companies to diagnose their financial health and ensure that these banks had sufficient capital to handle worse-than-expected economic conditions, while continuing to lend. Treasury has recently stated that the bank holding companies "did not welcome the exercise" and that "while

markets were initially skeptical, an unprecedented level of transparency in this supervisory exercise contributed to the program's credibility"[28]

Ahead of the May 7, 2009 announcement of stress test results by the Federal Reserve, market participants had been speculating about the extent to which the stress test, now termed the "Supervisory Capital Assessment Program," would differ from the current reviews conducted by federal banking agencies and financial institutions on a regular basis. The Federal Reserve clarified that the capital assessment conducted for each of the 19 largest US bank holding companies complements traditional capital assessments in several ways:

- it uses certain more adverse economic assumptions;
- it focuses, among other aspects, on capital composition; and
- it aims at creating a more substantive buffer that would help the institution to "comfortably absorb" losses during times of economic stress.

Aside from ensuring that the institution itself can "comfortably absorb losses," the additional capital buffer made available following the assessment would also serve to reduce the domino effect under which, according to Treasury, "a very small number of counterparties" may cause "otherwise viable institutions" to fail.[29] Treasury distinguished the approach from capital provided on a when-needed basis, claiming that with the forward-looking nature of the new capital assessment, "market participants will gain confidence from the major US banking organizations having undergone a systematic disciplined exercise designed to prepare them for a more severe and protracted recession."[30]

The Federal Reserve has suggested the following points be kept in mind when interpreting results of the capital assessment:

- The estimates reported are those of teams of supervisors, economists, and analysts, and therefore may not be consistent with the results of external analysts or researchers;
- The estimates are not forecasts or expected outcomes;
- The capital assessment was designed to be deliberately stringent in order to account for highly uncertain financial and economic conditions; and
- The capital assessment focused both on the amount and composition of capital each bank holding company held.

Results of the Capital Assessment

Under the program, the 19 US bank holding companies with assets of $100 billion or more, representing roughly two-thirds of aggregate US bank holding company assets, were required to participate in the assessment. The results of the capital assessment were used to determine whether a bank holding company needed to raise additional capital to create a buffer "to comfortably absorb losses."

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[28] U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES 7 (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

[29] U.S. DEP'T OF THE TREASURY, TREASURY WHITE PAPER: THE CAPITAL ASSISTANCE PROGRAM AND ITS ROLE IN THE FINANCIAL STABILITY PLAN (2009), http://www.ustreas.gov/press/releases/reports/tg40_capwhitepaper.pdf.

[30] U.S. DEP'T OF THE TREASURY, TREASURY WHITE PAPER: THE CAPITAL ASSISTANCE PROGRAM AND ITS ROLE IN THE FINANCIAL STABILITY PLAN (2009), http://www.ustreas.gov/press/releases/reports/tg40_capwhitepaper.pdf.

The Federal Reserve released detailed results from the capital assessment in a report issued May 7, 2009. The Federal Reserve has also suggested certain points to be considered when interpreting results of the capital assessment. The results publicized were only those based on economic assumptions from the "adverse scenario." Under the adverse scenario, only 10 of the 19 bank holding companies needed to add $75 billion in the aggregate to capital buffers to reach the target capital buffer by the end of 2010.[31] Most of the $75 billion was needed to compensate for a shortfall in Tier 1 common equity capital at these bank holding companies, whose capital structures were too heavily composed of capital that was not common equity. Nine of the bank holding companies did not need to raise any additional capital. Nevertheless, all of these nine bank holding companies have since strengthened their capital positions.

Capital Raising

The 10 bank holding companies identified by the capital assessment as needing to raise additional capital had until June 8, 2009 to develop a detailed capital plan and November 9, 2009 to raise private capital. If they could not raise capital privately within this time frame, they were required to accept financing from Treasury through CAP. According to the September 14, 2009 Treasury Report, the 19 financial institutions have raised over $80 billion in high-quality capital.[32] Indeed, regulators encouraged the bank holding companies to actively seek to raise capital from private sources.

The Future of Stress Testing

Regulators had initially assured that stress tests were a one-time coordinated interagency effort with a set end date, and that the stress tests did not represent a new capital standard that would be maintained on an ongoing basis. Regulators also had suggested that smaller financial institutions would not be tested because they "generally maintain capital levels, especially common equity, well above regulatory standards."[33]

The Obama Administration in its white paper titled *A New Foundation: Rebuilding Financial Supervision and Regulation*, however, indicated that

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[31] Initially, the capital assessment determined that the bank holding companies needed to raise $185 billion in additional capital. Since the end of 2008, however, some firms had sold assets, restructured capital instruments, and demonstrated increased pre-provision net revenues. As a result, adjustments were made that resulted in a reduced additional capital buffer of $75 billion.

[32] U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

[33] Bd. of Governors of the Fed. Reserve Sys. Press Release, Joint Statement by Secretary of the Treasury Timothy F. Geithner, Chairman of the Board of Governors of the Federal Reserve System, Ben S. Bernanke, Chairman of the Federal Deposit Insurance Corporation Sheila Bair, and John C. Dugan, Comptroller of the Currency (May 6, 2009), http://www.federalreserve.gov/newsevents/press/bcreg/20090506a.htm.

stress-testing using "severe stress scenarios" would become a permanent part of supervision under new regulation. The COP has also recommended that regulators monitor the capital levels even at smaller banks, contending that if smaller banks go untested, the 19 bank holding companies will be unduly favored by market participants and that small banks "face special risks with respect to problems in the commercial real estate loan sector."[34] Therefore, we might anticipate stress testing in the future of both large and small banks. Those smaller institutions may nonetheless access CAP, as described in more detail under The Capital Assistance Program below.

The Capital Assistance Program

Purpose

CAP enables qualifying financial institutions to issue mandatory convertible preferred stock to Treasury in order to provide such institutions with contingent common equity "as a bridge to private capital in the future," as is necessary to "retain the confidence of investors or to meet supervisory expectations regarding the amount and composition of capital."[35] The capital infusions are meant to increase capital buffers at qualifying financial institutions to guard against economic conditions that are worse than expected. Qualifying financial institutions that issue mandatory convertible preferred securities under CAP are also required to issue to Treasury warrants to purchase shares of the institution's common stock. For a further discussion of these warrants, see Chapter 4: *Warrants: Upside for the Taxpayer*. No qualifying financial institution has asked for funds under CAP, whose purpose, according the Treasury, was to provide a government commitment to a capital backstop that would increase the capital raising ability in the private markets.[36] Absent unusual circumstances or an extreme change in economic circumstances, we do not expect any CAP preferred to be issued.

Eligibility

CAP is open to applications from all public qualifying financial institutions, and the eligibility requirements are meant to be consistent with the criteria of CPP. At the time of publication, only the term sheet applicable to publicly

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[34] CONG. OVERSIGHT PANEL, AUGUST OVERSIGHT REPORT: THE CONTINUED RISK OF TROUBLED ASSETS (Aug. 11, 2009), http://cop.senate.gov/reports/library/report-081109-cop.cfm.

[35] Bd. of Governors of the Fed. Reserve Sys. Press Release, Joint Statement by Secretary of the Treasury Timothy F. Geithner, Chairman of the Board of Governors of the Federal Reserve System, Ben S. Bernanke, Chairman of the Federal Deposit Insurance Corporation Sheila Bair, and John C. Dugan, Comptroller of the Currency (May 6, 2009), http://www.federalreserve.gov/newsevents/press/bcreg/20090506a.htm.

[36] CONG. OVERSIGHT PANEL, JULY OVERSIGHT REPORT: TARP REPAYMENTS, INCLUDING THE REPURCHASE OF STOCK WARRANTS (July 1, 2009), http://cop.senate.gov/documents/cop-071009-report.pdf.

traded institutions had been made available. Separate term sheets are expected to be made available for institutions that are not publicly traded or are organized as subchapter S corporations or in mutual form.

Issuance Scenarios

CAP opened immediately when it was announced on February 25, 2009. At the time of publication, however, no financial institution had availed itself of this program. There are at least three scenarios in which institutions could issue mandatorily convertible preferred stock to Treasury under CAP.

- **Raising additional capital following the capital assessment.** For a discussion of capital raising by the 10 stress-tested bank holding companies that require additional capital buffers, see the Capital Raising section above.
- **Raising additional capital with the approval of relevant federal banking agencies.** US financial institutions with assets below $100 billion, who were not subject to the mandatory capital assessment, are eligible to obtain capital consistent with the criteria and the "deliberative process" established for identifying institutions qualified to participate in the existing CPP, *i.e.*, pursuant to a process that is designed to provide capital to strong and solvent banking institutions.
- **Exchange of CPP securities with supervisory approval.** Financial institutions of any size are allowed to apply to "exchange" senior preferred shares sold under CPP by redeeming such shares with the proceeds of an issuance of mandatorily convertible preferred stock. Proceeds from the issuance of mandatorily convertible preferred stock that are used to redeem the preferred shares sold under CPP will count towards the proceeds that are required to be raised in order to reduce the number of shares of common stock underlying the warrants issued to Treasury under CPP. Such proceeds may also be used to redeem preferred shares issued under the Targeted Investment Program. For a further discussion, see the Targeted Investment Program section of this Chapter.

Application

On February 25, 2009, Treasury published the application for institutions to request participation in CAP. The application for CAP is similar to that of CPP. As part of the application process, financial institutions must submit a plan for how they intend to use the capital to be obtained under CAP to preserve and strengthen their lending capacity – specifically, to increase lending above the levels that would have been possible without government support. Financial institutions must submit the application to their primary federal banking agency.

Treasury will post the capital plans on its website after the closing of the investment under CAP. Treasury has said it will publish electronic reports

detailing any completed transactions, including the name of the financial institution and the amount of the investment, within 48 hours of such closing. Treasury will not release the names of institutions who apply for CAP or those which are not approved.

Deadline

The deadline for all institutions to submit their plan is now November 9, 2009. Institutions that receive preliminary approval from Treasury have until November 9, 2009 to close the transaction.

Executive Compensation, Transparency, Accountability and Monitoring

The financial institution and its covered officers and employees must agree to comply with the rules, regulations, and guidance that were conditions for assistance. For a further discussion on the current state of these conditions with regard to executive compensation, see Chapter 9: *Executive and Employee Compensation*.

Terms of the Mandatorily Convertible Preferred Stock

The terms of the mandatorily convertible preferred stock under CAP are much less attractive to institutions contemplating additional capital injections than the terms used in prior programs. For instance, the dividend payment rate is higher than the rate under CPP, making it more expensive for institutions to participate in the program. The CAP mandatorily convertible preferred stock is cumulative, ranks *pari passu* with the most senior preferred shares of the financial institution currently outstanding, and converts into common shares automatically after seven years or earlier at the option of the issuer or the holder under certain circumstances. The convertibility features make the preferred stock a source of potential common equity, or "contingent equity." The mandatorily convertible preferred stock qualifies as Tier 1 capital for bank and thrift holding companies.

The mandatorily convertible preferred stock includes the following terms:

Subscription Amounts. Each qualifying institution may issue an amount of mandatorily convertible preferred stock that is not less than 1% of its risk-weighted assets and not more than 2% of its risk-weighted assets plus any amount of mandatorily convertible preferred stock to the extent the proceeds are used to redeem senior preferred sold under CPP and, if applicable, the Targeted Investment Program.

- An institution that needs capital in excess of this investment limit will be categorized as needing "exceptional assistance." Treasury, in consultation with the primary federal banking agency, will determine whether an institution qualifies for "exceptional assistance" on a case-by-case basis. Such assistance will be provided pursuant to institution-

specific negotiated agreements with Treasury that may include additional terms and conditions, which, based on previous statements of the current Administration as well as the terms of past interventions, could include additional restrictions with respect to dividends, executive compensation or corporate expenditures and possibly corporate governance.

- CAP does not impose a fixed cap such as that imposed under CPP, which limited the investment to $25 billion per institution.

Convertibility. Unlike the preferred shares issued under CPP, the mandatorily convertible preferred stock is convertible in whole or in part into shares of common stock at the financial institution's option, subject to the approval of the issuer's primary federal banking agency, "if needed to preserve lending in [a] worse-than-expected economic environment." [37] Treasury will publish how it will exercise its rights as a common stockholder of a qualifying financial institution before closing any transaction under CAP.

- The conversion price is set at a 10% discount to the average closing price for the common stock for the 20 trading day period ending February 9, 2009, subject to reduction in the event stockholder approval is required and not received and subject to customary anti-dilution adjustments.

- Mandatorily convertible preferred stock is convertible at the conversion price at the option of the holder upon "specified corporate events, including certain sales, mergers or changes of control" of the issuer. [38]

- After seven years, the mandatorily convertible preferred stock will automatically convert at the conversion price if not redeemed or converted before that date.

- Upon conversion, the issuer must also pay accrued and unpaid dividends at the issuer's option in either cash or common stock, with shares valued at the closing price on the second preceding trading day.

Dividends. The mandatorily convertible preferred stock pays cumulative dividends at a rate of 9% per year, compounding quarterly, subject to increase if stockholder approval is required and not received. This makes assistance under CAP more costly than under CPP, which carried a 5% dividend for the first five years prior to stepping up to 9% thereafter.

Redemption. Subject to the approval of the issuer's primary federal banking agency, the mandatorily convertible preferred stock may be redeemed, in whole or in part, with the proceeds of one or more issuances

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[37] *See* U.S. Dep't of the Treasury, Financial Stability Plan Fact Sheet (2009), http://www.financialstability.gov/docs/fact-sheet.pdf

[38] U.S. Dep't of the Treasury, Application Guidelines for Capital Assistance Program (2009), http://www.financialstability.gov/docs/CAP_App-Guidelines.pdf.

of common stock for cash, which results in aggregate gross proceeds to the issuer of not less than 25% of the issue price of the mandatorily convertible preferred stock. The mandatorily convertible preferred stock may also be redeemed with additions to retained earnings, but not with proceeds from the sale of Tier 1 qualifying perpetual preferred stock.

- During the first two years from issuance, the mandatorily convertible preferred stock will be redeemable at par, plus any accrued and unpaid dividends.
- Beyond two years from issuance, the mandatorily convertible preferred stock will be redeemable at the greater of either par plus any accrued and unpaid dividends or the as-converted value.
- The more favorable terms for redemption during the first two years provide an incentive for certain financial institutions to redeem early.

Repurchases of CAP Common Stock. Following the conversion of the mandatorily convertible preferred stock into common stock, the issuer has the right, subject to the approval of its primary federal banking agency, to repurchase any such shares of common stock at a price equal to the greater of the conversion price and the average closing price for the common stock for the 20 trading day period beginning on the day after notice of repurchase is given. Such repurchases must be made from the same sources available for redemption of the mandatorily convertible preferred stock.

Dividend Restrictions. For so long as any mandatorily convertible preferred stock is outstanding and owned by Treasury or Treasury owns any common stock under CAP, dividends declared and paid on the issuer's common stock must be no greater than $0.01 per share per quarter unless Treasury consents to a higher amount. Restrictions on dividend payments for preferred and common shares otherwise mirror the CPP terms.

Restrictions on Repurchases. For so long as Treasury owns any mandatorily convertible preferred stock or common stock of the issuer, Treasury's consent is required for repurchases of equity securities or trust preferred securities, subject to exceptions similar to those available under CPP. Additional restrictions on the repurchase and redemption of preferred and common shares replicate the CPP terms.

Restrictions on Cash Acquisitions. Financial institutions that receive assistance under CAP are restricted in pursuing cash acquisitions. This restriction is consistent with the Financial Stability Plan term sheet, which indicated that institutions receiving capital assistance would be restricted from pursuing cash acquisitions of "healthy" firms until the government is repaid, subject to exceptions for "explicit supervisor-approved restructuring

plans."[39] However, this restriction does not appear in the CAP term sheet or White Paper, so its extent and applicability remain unclear.

Mandatorily Convertible Preferred Stock Voting Rights. The mandatorily convertible preferred stock will be nonvoting except for customary consent and director appointment rights.

Stockholder Consent. Stockholder consent may be required under the relevant exchange rules or under state law to authorize a sufficient number of common shares to permit conversion of the mandatorily convertible preferred stock and settlement of the warrants. Therefore, where necessary, the issuer covenants to call a meeting of its stockholders as soon as practicable.

Failure to obtain any required stockholder consent has the following adverse effects:

- the conversion price of the mandatorily convertible preferred stock will be reduced by up to 45%, in 15% increments every six months;
- the dividend rate on the mandatorily convertible preferred stock will increase to 20% per year if such consent has not been received within six months; and
- the exercise price on the warrants will be reduced by up to 45%, in 15% increments every six months.

Common Stock Voting. To the extent Treasury holds common stock as a result of conversion of the mandatorily convertible preferred stock, Treasury will vote such shares. Treasury will publish a set of principles governing its exercise of any voting rights obtained upon conversion before closing any transaction under CAP. In contrast, and consistent with the provisions of EESA, Treasury will not exercise its voting power with respect to any common stock it holds upon exercise of the warrants.

Mandatory Sale. Consistent with Treasury's goal to "keep the period of government ownership as temporary as possible,"[40] after the mandatory conversion date, Treasury will make reasonable efforts to sell 20% of the common stock it owns each year until it owns no common stock.

- Press Release on CAP and the Stress Tests
  http://www.financialstability.gov/latest/tg91.html
- Results of the Stress Tests
  http://www.financialstability.gov/docs/SCAPresults.pdf

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[39] *See* U.S. Dep't of the Treasury, Financial Stability Plan Fact Sheet (2009), http:www.financialstability.gov/docs/fact-sheet.pdf.

[40] Rebecca Christie and Robert Schmidt, *U.S. Sets a Six-Month Deadline for New Bank Capital (Update 5)*, BLOOMBERG, Feb. 25, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=az64zr5U0X.E.

- CPP and CAP FAQs
  http://www.financialstability.gov/docs/FAQ_CPP-CAP.pdf
- Methodology of Stress Tests
  http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090424a1.pdf
- CAP Program Description
  http://www.financialstability.gov/roadtostability/capitalassistance.html
- Treasury White Paper on CAP and its Role in the Financial Stability Plan
  http://www.treas.gov/press/releases/reports/tg40_capwhitepaper.pdf
- Terms of the Convertible Preferred Stock under CAP
  http://www.treas.gov/press/releases/reports/tg40_captermsheet.pdf
- FAQs on CAP
  http://www.treas.gov/press/releases/reports/tg40_cap_faq.pdf
- Application Guidelines for CAP
  http://www.financialstability.gov/docs/CAP_App-Guidelines.pdf
- Congressional Oversight Panel June Report on the Stress Tests
  http://cop.senate.gov/documents/cop-060909-report.pdf

Lobbying, Conferences and Luxury Expenses

For a further discussion of restrictions on lobbying, conferences and luxury expenses applicable to TARP recipients, see Chapter 9: *Executive and Employee Compensation*.

Subchapter S Holding Companies and Mutual Holding Companies

Treasury also invested in S corporations and mutual holding companies through CPP. The application deadline for S corporations was February 13, 2009, and for mutual holding companies it was May 7, 2009.

Terms of the Subordinated Debt

Treasury is funding both S corporations and mutual holding companies with subordinated debt instead of preferred stock [41] The subordinated debentures, called "senior securities," have a principal amount of $1,000, a

[41] S corporations can have only one class of equity held by natural persons and, as a result, Treasury cannot own preferred stock in S corporations without jeopardizing their S corporation status.

maturity of 30 years, and pay a quarterly interest rate of 7.7% per year for five years, after which the rate steps up to 13.8% per year. The interest rate is higher than the dividend rate of the preferred stock issued by other institutions participating in CPP because the rate takes into account the fact that interest payments are tax deductible.

The senior securities rank senior to common stock of S corporations and mutual capital certificates and other capital instruments of mutual holding companies, and are subordinated to senior indebtedness. S corporations that are bank holding companies or savings and loan holding companies and all participating mutual holding companies may defer interest on the senior securities for as many as 20 quarters. The unpaid interest will cumulate and compound at the then effective interest rate, and while interest is being deferred the institution cannot pay certain dividends. The senior securities also contain restrictions on repurchases and dividends and provisions on voting rights similar to the securities issued under CPP.

A qualifying S corporation must also be one of the following:

- A top-tier bank holding company, or top-tier savings and loan holding company that engages solely or predominantly in activities permissible for financial holding companies under relevant law;
- A US bank or US savings association that is not controlled by a bank holding company or savings and loan holding company; or
- A US bank or US savings association that is a qualifying S-Corp subsidiary which is controlled by a bank holding company or savings and loan holding company which itself is an S corporation and which does not engage solely or predominantly in activities that are permitted for financial holding companies under relevant law.

Regulatory Capital Status

For both S corporations and companies organized under mutual form, the senior securities qualify as Tier 1 capital for holding companies and Tier 2 capital for stand-alone banks. On May 22, 2009, the Federal Reserve announced the adoption of an interim final rule allowing these companies to include in Tier 1 capital all subordinated debt issued to Treasury under TARP, so long as the subordinated debt counts towards the limit on the amount of other restricted core capital elements included in Tier 1 capital. The Federal Reserve also said: "The interim final rule also will allow small bank holding companies that are S-Corps or that are organized in mutual form to exclude subordinated debt issued to Treasury under TARP from treatment as 'debt' for purposes of the debt-to-equity standard under the Board's Small Bank Holding Company Policy Statement."[42]

S Corporations and CPP

Qualifying Financial Institution. For purposes of CPP, a Qualifying Financial Institution is a bank, savings association, bank holding company, or savings and loan holding company that has validly elected to be taxed under Subchapter S of Chapter 1 of the US Internal Revenue Code. Qualifying Financial Institutions do not include institutions that are foreign controlled.

[42] Bd. of Governors of the Fed. Reserve Sys. Press Release, Federal Reserve Announces Final Rule on Senior Perpetual Preferred Stock Issued by Banking Holding Companies to the Treasury and an Interim Final Rule on Subordinated Debt Issued by S-Corp and Mutual Bank Holding Companies to Treasury (May 22, 2009), http://www.federalreserve.gov/newsevents/press/bcreg/20090522a.htm.

Mutual Holding Companies

Qualifying Financial Institution. A Qualifying Financial Institution for CPP includes any bank holding company or savings and loan holding company that "(i) is mutual in organization, (ii) engages solely or predominantly in activities permissible for financial holding companies under relevant law, and (iii) does not directly own and control a bank holding company or savings and loan holding company."[43] Qualifying Financial Institutions do not include institutions controlled by a foreign bank or company.

Separate term sheets are available for public and non-public holding companies with a mutual top-tier parent that can issue perpetual preferred stock under CPP.

- S Corporations
  - CPP S Corp Term Sheet
    http://www.financialstability.gov/docs/CPP/scorp-term-sheet.pdf
  - S Corp FAQs
    http://www.financialstability.gov/roadtostability/CPPappdocs_faq3.htm
  - CPP Application Documents
    http://www.financialstability.gov/roadtostability/CPPappdocs.html
- Mutual Holding Companies
  - CPP Senior Preferred Terms
    http://www.financialstability.gov/docs/CPP/MHC_Senior_Preferred_Terms.pdf
  - CPP Preferred Terms
    http://www.financialstability.gov/docs/CPP/MHC_Preferred_Terms.pdf
  - CPP Senior Securities Terms
    http://www.financialstability.gov/docs/CPP/MHC_Senior_Securities_Terms.pdf
  - Process-Related CPP Mutual Holding Company FAQs
    http://www.financialstability.gov/docs/CPP/MHC_faqs.pdf

[43] See U.S. Dep't of the Treasury, TARP Capital Purchase Program (Mutual Holding Companies) Senior Securities Term Sheet (Apr. 14, 2009), http://www.financialstability.gov/docs/CPP/MHC_Senior_Securities_Terms.pdf.

Exit

Repayment of CPP Investments

A financial institution that has received CPP investments is permitted to repay the funds pursuant to its securities purchase agreement as amended by ARRA. Before ARRA, CPP terms permitted institutions to redeem their preferred stock only after three years or with proceeds from a qualified equity offering, meaning the sale of Tier 1 perpetual preferred stock or common stock for cash. The repayment terms under ARRA, however, "provide greater flexibility" to recipient institutions "by removing time restrictions and no longer requiring the financial institution to demonstrate that it has received private equity investment in proportion to the funds that it seeks to repay."[44]

Bank supervisors have stated that in approving the repayment, they will "weigh carefully an institution's desire to redeem outstanding CPP preferred stock…against its overall soundness, capital adequacy and ability to lend."[45] All financial institutions requesting approval must have a comprehensive internal capital assessment process, and financial institutions subject to the stress test must have a post-repayment capital base consistent with the stress test buffer and demonstrate a capacity to meet funding needs by "issuing senior unsecured debt not backed by FDIC guarantees."[46]

The September 14, 2009 Treasury Report states that 38 of the 672 recipients of CPP funds have repaid the CPP capital investment.[47] Thus far, Treasury reports that the proceeds of the repayment have exceeded $70

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[44] OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS (Apr. 21, 2009), http://www.sigtarp.gov/reports/congress/2009/April2009_Quarterly_Report_to_Congress.pdf.

[45] Bd. of Governors of the Fed. Reserve Sys. Press Release, Joint Statement by Secretary of the Treasury Timothy F. Geithner, Chairman of the Board of Governors of the Federal Reserve System, Ben S. Bernanke, Chairman of the Federal Deposit Insurance Corporation Sheila Bair, and John C. Dugan, Comptroller of the Currency (May 6, 2009), http://www.federalreserve.gov/newsevents/press/bcreg/20090506a.htm. *See also* CONG. OVERSIGHT PANEL, AUGUST OVERSIGHT REPORT: THE CONTINUED RISK OF TROUBLED ASSETS (Aug. 11, 2009), http://cop.senate.gov/reports/library/report-081109-cop.cfm.

[46] Bd. of Governors of the Fed. Reserve Sys. Press Release, Joint Statement by Secretary of the Treasury Timothy F. Geithner, Chairman of the Board of Governors of the Federal Reserve System Ben S. Bernanke, Chairman of the Federal Deposit Insurance Corporation Sheila Bair, and Comptroller of the Currency John C. Dugan (May 6, 2009), http://www.federalreserve.gov/newsevents/press/bcreg/20090506a.htm. *See also* CONG. OVERSIGHT PANEL, AUGUST OVERSIGHT REPORT: THE CONTINUED RISK OF TROUBLED ASSETS (Aug. 11, 2009), http://cop.senate.gov/reports/library/report-081109-cop.cfm.

[47] U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf. As of the August 11, 2009 COP Report, 33 banks had repaid their CPP investments in full. CONG. OVERSIGHT PANEL, AUGUST OVERSIGHT REPORT: THE CONTINUED RISK OF TROUBLED ASSETS (Aug. 11, 2009), http://cop.senate.gov/reports/library/report-081109-cop.cfm.

billion, and Treasury "expect[s] banks to repay another $50 billion over the next 12 to 18 months."[48]

Process of Repayment. An institution that wants to repay its CPP investment must notify its primary federal banking agency and Treasury. In determining whether or not a qualifying financial institution will be allowed to repay its CPP investments, supervisors will consider the contribution the Treasury's capital makes to the qualifying financial institution's soundness, capital adequacy, and ability to lend. Supervisors will also look at whether the institution has in place a comprehensive internal capital assessment process.

Treasury and the primary federal banking agency will consult and then contact the institution to discuss the redemption request. If the supervisors determine that the institution will have sufficient capital after repayment, the institution may choose to either pay back the entire investment in a lump sum, or pay back over time, so long as each payment consists of at least 25% of the original total investment. The institution will be responsible for paying any accrued and unpaid dividends on cumulative senior preferred shares, and accrued and unpaid dividends for the current dividend period for non-cumulative senior preferred, even if no dividends are declared for that period. The institution must also show that it is weaning itself off of TLGP support by issuing senior unsecured debt with a term greater than five years without FDIC guarantees. For a further discussion on the TLGP, see Chapter 5: *The FDIC's Temporary Liquidity Guarantee Program*.

Information on repayment of CPP investments by specific institutions will be made publicly available on the Financial Stability website in TARP Transaction Reports. Repurchase documents for both public and private institutions to repay CPP investments can be found on the Financial Stability website.

CAP and TARP Repayment

Qualifying financial institutions that require CAP funds will not be permitted to repay their CPP funds as described above. In order to repay their CPP funds, the 19 bank holding companies that participated in the capital assessment must demonstrate that:

- their capital base post-repayment at minimum meets the required capital buffer, and
- they have sufficient financial strength to issue senior unsecured debt with a maturity greater than five years without FDIC guarantees, and

[48] U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

> "in amounts sufficient to demonstrate a capacity to meet funding needs independent of government guarantees."[49]

At the time of publication, 10 of these 19 bank holding companies had repaid $68 billion in CPP investments to Treasury. For a further discussion, see Chapter 4: *Warrants: Upside for the Taxpayer* – Repurchase of Warrants.

- Repurchase Press Release
  http://www.federalreserve.gov/newsevents/press/bcreg/20090601b.htm
- CPP and CAP Repayment FAQs
  http://www.financialstability.gov/docs/FAQ_CPP-CAP.pdf
- Repurchase Document for Public Institutions
  http://www.financialstability.gov/docs/CPP/UST%20Acknowledgement%20of%20Repurchase%20(Public%20Issuers).pdf
- Repurchase Document for Private Institutions
  http://www.financialstability.gov/docs/CPP/UST%20Acknowledgement%20of%20Repurchase%20%28Private%20Issuers%29.pdf
- TARP Transaction Reports:
  http://www.financialstability.gov/latest/reportsanddocs.html

[49] Bd. of Governors of the Fed. Reserve Sys. Press Release, Joint Statement by Secretary of the Treasury Timothy F. Geithner, Chairman of the Board of Governors of the Federal Reserve System, Ben S. Bernanke, Chairman of the Federal Deposit Insurance Corporation Sheila Bair, and John C. Dugan, Comptroller of the Currency (May 6, 2009), http://www.federalreserve.gov/newsevents/press/bcreg/20090506a.htm.

Economic Scenarios: Baseline and More Adverse Alternative

Real GDP

	2009	2010
Average Baseline	-2.0%	2.1%
More Adverse	-3.3%	0.5%

Civilian Unemployment Rate

	2009	2010
Average Baseline	8.4%	8.8%
More Adverse	8.9%	10.3%

House Prices

	2009	2010
Baseline	-14.0%	-4.0%
More Adverse	-22.0%	-7.0%

Factors in Assessing Capital Adequacy

- Uncertainty about the potential impact on earnings and capital from current and prospective economic conditions;
- Asset quality and concentrations of credit exposures;
- The potential for unanticipated losses and declines in asset values;
- Off-balance sheet and contingent liabilities (*e.g.*, implicit and explicit liquidity and credit commitments);
- The composition, level and quality of the institution's existing capital;
- The ability of the institution to raise additional common stock and other forms of capital in the market; and
- Other risks that are not fully captured in regulatory capital calculations.

Annex A: Stress Test Methodology

The Federal Reserve, the FDIC, the Office of the Comptroller of Currency and the Office of Thrift Supervision performed a coordinated assessment exercise on the major financial institutions for which they are the primary Federal regulators to "ensure [that] each institution [had] the amount and quality of capital necessary to perform [its] vital role in the economy."[1] Interagency coordination was designed to ensure that capital assessments were carried out in a timely and consistent manner, considering that holding companies and their subsidiaries are supervised by different primary Federal regulators.

Methodology of the Capital Assessment

Scenario Analysis and Economic Assumptions. Examiners conducted the capital assessment under two different economic scenarios: (1) a "baseline" scenario, and (2) a "more adverse" scenario. Details about the baseline and more adverse scenarios are set forth in the top sidebar on this page. The baseline scenario estimated losses using economic assumptions following the consensus estimate from February, 2009. The adverse scenario assumed worse conditions, reflecting the possibility that the economy would become significantly weaker than the outlook had projected under the baseline scenario, though it was not intended to reflect a "worst case" scenario. Some commentators have criticized both the baseline and adverse scenarios for relying on assumptions that were overly optimistic given that the economy has declined further since the stress tests began. The COP has also questioned whether the assumptions supplied sufficient information to properly analyze the "sensitivity of a firm's business to changes in economic conditions."[2]

The 19 bank holding companies adapted the macroeconomic assumptions of each scenario to their own specific business activities in order to project their individual losses and resources over 2009 and 2010. The supervisors then used the values projected by the bank holding companies to develop their own loss and resource estimates under each scenario. In doing so, more than 150 people from supervisory agencies reviewed the data submitted by the bank holding companies to ascertain the quality of the data, method, and assumptions used by each bank holding company. More specifically, they would try "to understand the particular parameters and assumptions employed and their consistency with the macroeconomic scenarios provided, as well as the models and methodologies used to

[1] FDIC, Frequently Asked Questions: Supervisory Capital Assessment Program (2009), http://www.fdic.gov/news/news/press/2009/pr09025a.pdf.

[2] BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: DESIGN AND IMPLEMENTATION 10-11 (Apr. 24, 2009), http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090424a1.pdf.

Annex A: Stress Test Methodology

generate the loss and resource estimates."[3] A team of staff from the agencies each focused on a different aspect of the loss and resource projections. The teams also used independent benchmarks to evaluate the bank holding companies' submissions, including detailed firm-specific benchmarks.

In sum, supervisors "ensure[d] that the loss and resource estimates reflected the risk and business lines of each bank holding company, and that they were consistent with the macroeconomic environment specified in the two economic scenarios,"[4] particularly the adverse scenario which was used to determine the capital buffers.

The test estimated a bank's losses resulting from:

- Debtors defaulting on loans;
- Decreases in the value of a bank holding company's securities investments;
- Revenues of falling transactional volume; and
- Losses due to trading in securities for bank holding companies with a large trading business.

Estimating Losses. The capital assessment involved estimating the losses, as described in the sidebar, that the 19 bank holding companies would likely suffer between now and the end of 2010.[5] Supervisors then forecasted the amount of capital at each bank holding company after absorbing the losses, and from this determine how much additional capital buffer was needed. If the test revealed that a bank held Tier 1 capital in an amount less than six percent of risk weighted assets, or Tier 1 common equity capital in an amount less than four percent, that bank was required to obtain additional capital.

Loan Loss Projections

Supervisors instructed bank holding companies to estimate their losses from the failure of borrowers to pay obligations through 2012 for 12 loan categories.[6] To help guide the bank holding companies in projecting loan loss rates, supervisors provided "indicative two-year cumulative loss rates"[7] for each category of loan under both the baseline and adverse scenarios. Bank holding companies then estimated the loss on their loans for each category using the loss rates as guidance. They were permitted to predict loss rates outside of the indicative two-year range if they substantiated their estimate with strong evidence. After reviewing these estimates and other

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[3] BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: DESIGN AND IMPLEMENTATION 10-11 (Apr. 24, 2009), http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090424a1.pdf.

[4] BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: OVERVIEW OF RESULTS 4 (May 7, 2009), http://www.federalreserve.gov/newsevents/bcreg20090507a1.pdf.

[5] Losses projected are forward-looking; they are not losses over the "lifetime" of assets.

[6] Supervisors also had bank holding companies include in their loan inventory potential additional loans from the drawing down of existing credit lines by borrowers, and liabilities held in special purpose vehicles that might need to be included on balance sheets due to the economically stressed environment or accounting changes. Note, however, that supervisors did not disclose the proportion of estimated losses from "on-boarding" special purpose vehicles.

[7] CONG. OVERSIGHT PANEL, JUNE OVERSIGHT REPORT: STRESS TESTING AND SHORING UP BANK CAPITAL (June 1, 2009), http://cop.senate.gov/documents/cop-060909-report.pdf.

Annex A: Stress Test Methodology

information provided by bank holding companies, including "granular data" about the bank holding companies' portfolios, supervisors assessed the reasonableness of the estimates and ultimately produced their own estimates of loss projections that were the same across institutions for similar asset classes.

In measuring loan losses, the loans were not "marked-to-market." Instead, Treasury valued the loans at their book value. As a result, the capital assessment only measured losses caused by a failure of borrowers to pay obligations, not by a drop in market value of existing loans. The estimated required capital buffer for each bank holding company, therefore, could have been substantially different if a different valuation method had been used for measuring loan losses.

Projected Losses on Securities

The capital assessment also required bank holding companies to estimate the losses their securities portfolios would incur through 2010 under both the baseline and adverse scenarios. Each bank holding company estimated possible impairment with respect to net unrealized losses on securities categorized as "held to maturity" and on securities classified as "available for sale," with securities carried at "fair value" marked-to-market as of December 1, 2008. Bank holding companies also estimated their decrease in income due to losses from impairment. As with the loan loss estimates, the supervisors used the data provided by the bank holding companies to make their final projections, which would ensure consistency across institutions for similar asset classes.

Trading-Related Exposures

Firms with trading assets of over $100 billion were also asked to project losses on their trading-related exposures. Such losses included those from counterparty credit risk exposures, potential counterparty defaults, and credit valuation adjustments taken against exposures to counterparties whose probability of default would be expected to increase under the adverse scenario.

Resources Available to Absorb Losses. As part of the capital assessment, supervisors also instructed bank holding companies to project the income and reserves they would have available to absorb losses. Bank holding companies estimated the main components of their "pre-provision net revenue" and resources available from the allowance for loan and lease losses under both the baseline and adverse scenarios, reporting the assumptions used in their calculations.

Calculating the Capital Buffer. After estimating bank holding companies' gains and losses, the supervisors projected the resulting changes in the bank holding companies' capital levels. Supervisors computed a bank

Annex A: Stress Test Methodology

holding company's required "capital buffer" by calculating the additional amount needed to reach the capital ratio of six percent for Tier 1 capital and four percent for Tier 1 common capital. Adjustments were made to the amount of capital buffers required after some bank holding companies raised capital and exhibited somewhat stronger operating results in the first quarter of 2009. For example, Citigroup's buffer changed after the firm converted $58.1 billion of preferred stock held by the Treasury into Citigroup common stock. The adjustments also in part reflected changes in accounting adopted in April, 2009, but the resulting impact on capital buffers was not substantial.

The Congressional Oversight Panel

Comments on Stress Test Methodology. The COP commissioned experts in risk analysis, Professor Eric Talley and Professor Johan Walden, to evaluate the stress test methodology. The COP, relying on the experts' analysis, concluded that the stress test model used by the Federal Reserve was generally "conservative and reasonable," and that it supplied "helpful information about the possible risks faced by bank holding companies and a constructive way to address those risks."[8] The COP also, however, raised some "serious concerns" regarding the following aspects of the stress tests:

- **Process.** The COP's main concern was that the stress tests cannot be replicated due to a lack of transparency in the way the models were applied. As a result, the stress tests results are extremely difficult to evaluate and confirm. The COP also commented that there could have been greater transparency in the process of calculating adjustments to the initial estimates after first quarter 2009 earnings and accounting changes. Specifically, rather than presenting adjustments on a net basis, regulators could have made the process more transparent by revealing what specifically contributed to the adjustment.

- **Time Horizon.** The COP questioned whether two years was too short a time horizon for projecting loss and resource estimates, suggesting that longer-term stress tests might have proven more informative.

- **Valuation.** The COP, along with other commentators, criticized the stress test model for failing to take into account mark-to-market values for "toxic assets," which results in "undervalu[ing] bank

[8] CONG. OVERSIGHT PANEL, JUNE OVERSIGHT REPORT: STRESS TESTING AND SHORING UP BANK CAPITAL (June 1, 2009), http://cop.senate.gov/documents/cop-060909-report.pdf.

Annex A: Stress Test Methodology

liabilities to the extent that those liabilities result in losses after 2010."[9]

- **Data.** The COP expressed skepticism about the usefulness of supervisors relying on data that was provided by the bank holding companies themselves.

Recommendations. After evaluating the design and implementation of the capital assessment, the COP offered several recommendations going forward:

- **Repeating the Stress Tests.** The COP concluded that "a strong case [could] be made for six-month repetitions of the stress tests for the next few years,"[10] especially since the adverse scenario may have relied on economic assumptions that were too optimistic, and since the value of many of the bank holding companies' assets remains uncertain. The COP recommended repeating the stress tests, particularly if the unemployment rate continues to increase throughout 2009 above the 8.9 percent average assumed under the more adverse scenario, or if the banks continue to hold large amounts of toxic assets on their books. Banks should additionally be required to run internal stress tests in between the formal ones conducted by regulators, and regulators should be permitted to apply stress tests on an ad hoc basis for all banks.

- **Transparency.** The Federal Reserve should improve its transparency by releasing more information about the stress tests, such as the results under the baseline scenario and additional details about methodology. The COP also urged greater transparency with regard to repayment under CPP.

[9] CONG. OVERSIGHT PANEL, JUNE OVERSIGHT REPORT: STRESS TESTING AND SHORING UP BANK CAPITAL (June 1, 2009), http://cop.senate.gov/documents/cop-060909-report.pdf.

[10] CONG. OVERSIGHT PANEL, JUNE OVERSIGHT REPORT: STRESS TESTING AND SHORING UP BANK CAPITAL (June 1, 2009), http://cop.senate.gov/documents/cop-060909-report.pdf.

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CHAPTER 4: WARRANTS: UPSIDE FOR THE TAXPAYER

John M. Brandow and Michael Kaplan

Table of Contents

Introduction

From almost the very beginning of the discussions about EESA, the policy decision was taken to require Treasury to receive warrants from any financial institution receiving government assistance so that taxpayers could share in any upside. There was historical precedent for this decision as the US government had received warrants in the original Chrysler rescue in 1979. The requirements for warrants are set forth in the EESA statutory text and have since been supplemented by the terms of the warrants themselves and the securities purchase agreements signed by the financial institutions receiving assistance, referred to in this Chapter as the warrant documents, as well as Treasury's CPP Repayment FAQs and a letter agreement that Treasury requires any financial institution repurchasing its preferred stock to sign. Although the warrants represent only about 15% of the value of Treasury's initial investments in financial institutions, their role in providing upside to the taxpayer has focused attention upon warrant valuation and the timing of Treasury repurchases, as many financial institutions seek to exit from the TARP investments and repurchase their warrants or allow Treasury to auction them off. As of July 2009, Treasury has received warrants that it estimates are worth about $6 billion in aggregate[1] from the nine US bank holding companies that it considers to be systemically important, as well as additional warrants from numerous regional and community banks.

The publication date of this Chapter is September 21, 2009. All terms and acronyms used in this Chapter are defined in the Glossary at the front of this Manual.

Research assistance has been provided by Grant Harm, Adam Mehes and Gabriel Rosenberg.

[1] David Lawder, *Treasury Sold Warrants Below Market Value: Panel*, REUTERS, July 10, 2009, http://www.reuters.com/article/newsOne/idUSTRE5690KB20090710.

Statutory Requirements for the Creation of the Warrants

EESA, as amended, sets out general parameters for the terms of the warrants issued to the government but leaves significant discretion to Treasury to establish detailed terms. Under the legislation, Treasury has discretion to determine the number and price of warrants issued.

EESA treats publicly listed financial institutions and non-public institutions differently. In the case of financial institutions that are listed on a US stock exchange, the Act grants Treasury the choice of receiving a warrant with the right to purchase preferred stock, non-voting common stock or voting common stock that Treasury agrees not to vote. If an institution is not listed on a US stock exchange, Treasury has the additional option to take equity or senior debt.[2]

In addition, EESA sets out specific requirements that the warrants or other instruments must satisfy, all as determined by Treasury, including:

- The warrants must be designed to provide for reasonable participation in equity appreciation, or, if in the form of debt, must provide a "reasonable interest rate premium;"
- The securities must be designed to provide additional protection against taxpayer losses and to cover administrative costs;
- The warrants must have customary anti-dilution provisions and contain appropriate protections to ensure Treasury is compensated if the underlying common stock is no longer listed on an exchange; and
- The exercise price is to be set by Treasury, in the interest of taxpayers.

The EESA warrant provisions are more detailed than many other parts of the statute and, in particular, the "financial instrument" language upon which the preferred stock contacts are based. This is because Treasury's original proposal was to buy mortgage-related assets and receive warrants, which meant that the warrant provisions were more explicitly contemplated at the time of enactment than the preferred stock provisions. See Repurchase of Warrants below for the statutory provisions on repurchase.

[2] There is an exception allowing Treasury to exempt institutions that sell assets to Treasury worth less than $100 million in aggregate.

Warrant Terms under CPP as Implemented by the Warrant Documents

Treasury supplemented the statutory terms in the warrant documents negotiated in the context of CPP. No warrants in publicly listed companies have been exercised by Treasury and, in the case of institutions that are not publicly traded, Treasury received warrants to purchase preferred stock or debt and exercised them immediately. The contractual terms of the warrants that Treasury received as a result of its preferred stock purchases through CPP, which are summarized in the sidebar, generally include the following:

Type of Warrant. In the case of publicly listed institutions, Treasury has opted to receive warrants exercisable for common stock it agrees not to vote. In the case of non-public institutions, Treasury has generally opted to receive warrants to purchase preferred stock, with special terms applying to S corporations and some mutual organizations.

No Voting of the Underlying Common Stock. Treasury has agreed that upon exercise, it would receive voting common stock that it has agreed not to vote, even to aid in meeting quorum requirements.[3]

Duration. All warrants have a duration of ten years, making currently outstanding warrants exercisable anytime before 2018 or 2019, depending on the purchase date.

Exercise Price. For publicly traded institutions, the aggregate market price of the shares underlying the warrants equals 15% of the liquidation amount of preferred stock being purchased by Treasury. The market price of the shares was calculated by averaging the daily closing prices of the 20 trading days preceding the day Treasury accepted the financial institution's application for a preferred stock investment.

Reduction by Half if Enough Capital Raised. As an incentive to raise equity in the capital markets, any financial institution that raises perpetual preferred stock or common stock qualifying as Tier 1 regulatory capital before December 31, 2009, in an amount equal to 100% of the liquidation amount of the preferred stock purchased from it by Treasury, will have the number of shares underlying the warrants reduced by 50%.[4]

Capital Purchase Program Warrant Terms

- 10-year warrant to purchase common stock;
- Immediately exercisable and transferable by Treasury, except as described below;
- Exercisable for common stock with a value at preferred stock purchase date equal to 15% of liquidation amount of preferred stock;
- Exercise price equal to value of common stock at the preferred stock purchase date, subject to adjustment;
- Warrant amount cut in half if funds raised in Tier 1 perpetual preferred or common stock offerings before December 31, 2009 equal or exceed liquidation amount of preferred stock; and
- Treasury agrees not to vote any common stock it receives on exercise of the warrants.

[3] The voting stock that Treasury received in Citigroup was as a result of an exchange of the Citigroup stock that Treasury acquired under the CPP. For a further discussion, see Chapter 3: *The Capital Twist*.

[4] Financial institutions seeking to repurchase their preferred stock must agree to waive this provision as a condition of the repurchase. See the Repurchase of Warrants section of this Chapter.

Exercisability and Transferability. The warrants are immediately exercisable, in whole or in part, and are not subject to any contractual restrictions on transfer,[5] with one exception: In order to preserve the financial institution's right to have the number of shares underlying the warrant reduced by half as described above, Treasury can only exercise or transfer the warrants with respect to up to half of the initial underlying shares before December 31, 2009. In addition, the 50% reduction, while calculated on the basis of Treasury's total initial investment, is applied only to the portion of the warrants then held by Treasury. For example, if the financial institution raises the required amount and Treasury had transferred half of the warrants to third parties, Treasury's portion of the warrants would be reduced to zero while the third parties' warrants would not be affected, achieving a 50% reduction in the total number of underlying shares.[6]

Settlement of Exercise. Any exercise of the warrants will be net share settled unless Treasury and the financial institution agree to gross physical settlement. The closing price of the financial institution's common stock on the date of exercise will be used to determine the number of shares to be withheld in order to effect the net share settlement.

Shareholder Approval. If a financial institution is required, under exchange rules or under state law, to obtain shareholder approval in order to issue a sufficient number of shares to settle the warrants and does not do so, the exercise price of the warrants will be reduced in 15% increments every six months up to a maximum of 45%. This provision strongly encourages shareholders to authorize sufficient capital for issuance of the warrants.

While this provision is not a major issue for large banks, it has been an issue for those smaller publicly traded regional and community banks because of New York Stock Exchange and NASDAQ rules. Under those rules, the warrants cannot convey the right to purchase shares in an amount exceeding 19.9% of the issuer's common stock outstanding at the time the warrants are issued unless there is shareholder approval, or the issuer invokes a "financial viability" exception. Certain financial institutions have needed to obtain shareholder approval as a result.

Anti-Dilution. The warrants include several customary anti-dilution adjustments, including adjustments for stock splits and dividend payments in excess of the last dividend paid before the issue date of the warrants, but two are unusual:

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[5] Of course, any transfer would have to comply with the requirements of the Securities Act of 1933. The stock purchase agreements grant registration rights to Treasury and require the issuer to participate in an underwritten offering of warrants even when Securities Act registration is no longer required.

[6] This restriction is to be eliminated from any warrants issued by a financial institution that repurchases its preferred stock but does not repurchase its warrants. *See* the Repurchase of Warrants section of this Chapter.

- **Below Market Issuances of Common Stock or Convertible Securities.** Until the earlier of the third anniversary of the issue date and the date Treasury no longer holds any portion of the warrants, the number of shares underlying the warrants and the exercise price will be adjusted in favor of the warrant holder if the financial institution issues common stock or convertible securities for consideration per share, or having a conversion price per share, that is less than 90% of the then current market value of the financial institution's common stock. Non-cash consideration will count towards the 90% threshold and there are certain exceptions to this adjustment provision for issuances related to benefit plans, acquisitions of businesses, public or broadly marketed offerings for cash, and securities issued upon exercise of preemptive rights already existing on the issue date of the warrants. This anti-dilution provision could restrict the financial institution from obtaining financing in private transactions that require a discount of more than 10%.
- **Catch-All.** The warrants include a catch-all adjustment requiring that, for so long as Treasury holds any portion of the warrants, the financial institution's board of directors shall make such adjustments to the anti-dilution provisions not otherwise covered as are "reasonably necessary, in the good faith opinion of the [board],"[7] to protect the purchase rights of the warrant holders. For so long as the Treasury holds any portion of the warrants, it can invoke third-party appraisal procedures to determine the fair market value of any non-cash distributions on the financial institution's common stock for the purpose of determining the applicability of this anti-dilution adjustment.

No Make-Whole or Fundamental Change Adjustments. Unlike most capital-markets convertible securities, the warrants do not contain a provision that increases the conversion ratio if the financial institution undergoes a cash merger, known as a "make-whole," or if the financial institution undergoes certain changes of control, known as a "fundamental change" adjustment.

Substitution. The warrants contain an unusual term that requires the warrants to be substituted for another economic interest if the financial institution's common stock is no longer listed on a national securities exchange or any necessary stockholder approval is not obtained within 18 months of the issue date of the warrants. In order to avoid any US GAAP requirements to treat the warrants as a liability due to the potential substitution of the warrants for a debt security as set out in the term sheets originally circulated by Treasury, the final terms of the warrants provide that

[7] U.S. Dep't of the Treasury, TARP Capital Purchase Program, Securities Purchase Agreement Standard Terms, Annex D: Form of Warrant to Purchase Common Stock, http://www.financialstability.gov/docs/CPP/warrant.pdf.

the new security will be an "economic interest" that is classified as permanent equity under US GAAP, with a value equal to the fair market value of the warrants as determined by Treasury. Following this change, the SEC and the FASB have confirmed that they will not object to treating the warrants as permanent equity.

Warrant Repurchase Trigger. The financial institution's right to purchase the warrants or common stock issued pursuant to any exercise of the warrants held by Treasury is triggered by the financial institution's redemption in whole of the preferred stock, or by Treasury's transfer of all the preferred stock to one or more third parties. As of the publication date, Treasury has made no such transfers but, as discussed in the Repurchase of Warrants section below, financial institutions are beginning to invoke their right to repurchase.

Warrant Terms under the CAP

The terms of the CAP warrants, none of which have been issued, would be similar to the terms of the CPP warrants, with the following notable differences:

- **Amount of Shares.** Treasury will receive warrants to purchase shares of common stock having an aggregate market price—based on the conversion price—equal to 20% of the amount of the mandatorily convertible preferred stock being purchased, compared to 15% under the CPP. The more generous economic terms for the taxpayer are in line with the other more generous terms of the CAP. For a further discussion, see Chapter 3: *The Capital Twist* – Capital Assistance Program and Stress Tests.
- **No Option to Reduce Warrants by Raising Independent Capital.** Unlike with CPP, Treasury is not offering CAP participants the option to reduce the number of shares underlying the warrants if they independently raise a certain amount of capital. This change is understandable since a related term of the warrants, the requirement of a qualified equity offering before a financial institution could redeem its preferred, has been amended by ARRA.

Absent unusual circumstances or an extreme change in economic conditions, we do not expect any CAP preferred to be issued. For a further discussion, see Chapter 3: *The Capital Twist* – Capital Assistance Program and Stress Tests. As a result, the focus of this Chapter is on CPP warrants.

Repurchase of Warrants —Timing, Valuation and Process

As financial institutions have repurchased their preferred shares, they have also sought to exit TARP completely by repurchasing their warrants. Some features of such warrant repurchases are set forth in the sidebar. Even

Capital Purchase Program Warrant Repayment

- Financial institutions have right to repurchase warrants upon redemption in whole or transfer to third party of preferred;
- Option to repurchase is at fair market value, based on opinion of independent valuation and with agreement of Treasury; and
- Treasury may liquidate warrants if institution chooses not to repurchase.

though Treasury's sale of the preferred stock lifts the most onerous of the employment compensation restrictions, there may be a number of reasons why financial institutions would seek to repurchase warrants immediately upon repurchase of their preferred.[8] These might include a concern about the future dilutive effect on stockholders were the warrants to be exercised, which concern could impact current market prices of the common stock, a concern that the government might try to use its ownership of the warrants as a means to influence the issuer's business or a concern that any government involvement could give rise to future, unanticipated statutory restrictions. The COP has also pointed to a conflict of interest that arises when the government is both the regulator of a financial institution and has an equity stake in the institution.[9] These exits from TARP have raised issues of timing, the process for repurchases and the difficult issues of warrant valuation.

Timing. Both EESA, as amended, and the securities purchase agreements apply to the timing of warrant repurchases and, as EESA has been twice amended in this respect, there has been an interplay between the statute and contracts over time. Originally, EESA permitted Treasury to exercise its warrants when it decided that "the market [was] optimal for selling such assets in order to maximize the value for taxpayers."[10] The ARRA amendment to EESA that eliminated the securities purchase agreement requirement that a financial institution either wait to redeem its preferred stock or engage in a "qualified equity offering" in order to redeem the preferred also required Treasury to liquidate the warrants at the moment the preferred stock was repaid.[11] Later, in the Helping Families Save Their Homes Act, the language was again changed to provide that Treasury "may liquidate warrants associated with such assistance."[12]

Notwithstanding these amendments, Treasury has informed the COP that it views itself as bound by the language set forth in the securities purchase agreement, which gives a financial institution the right to redeem the warrants once it repurchases its preferred stock whether or not Treasury

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[8] Although EESA, as amended, provided that the statutorily-imposed employment compensation restrictions fall away once a financial institution repurchases its preferred stock, the securities purchase agreement provides that the restrictions imposed under the agreement remain in place until the institution repurchases its warrants or Treasury transfers them to one or more third parties.

[9] CONG. OVERSIGHT PANEL, JULY OVERSIGHT REPORT: TARP REPAYMENTS, INCLUDING THE REPURCHASE OF STOCK WARRANTS (July 10, 2009), http://cop.senate.gov/reports/library/report-071009-cop.cfm.

[10] Emergency Economic Stabilization Act of 2008 §113(a)(2)(A), codified at 12 U.S.C.A. §5223(a)(2)(A).

[11] The American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §7002, 123 Stat. 521 (2009), http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ005.111.pdf.

[12] *See* CONG. REC. S51,14 (daily ed. May 5, 2009) (Statement of Sen. Jack Reed) and CONG. REC. S51,15 (daily ed. May 5, 2009) (Statement of Sen. Christopher Dodd), http://frwebgate.access.gpo.gov/cgi-bin/getpage.cgi?dbname=2009_record&page=S5087&position=all.

determines such time is optimal.[13] This view is also reflected in the Treasury Repurchase FAQ.[14] The securities purchase agreement gives the issuer the right to repurchase its warrants once it repurchases its preferred stock without imposing any deadline on the issuer's exercise of that right. In order to control the process of liquidating the warrants, however, Treasury now requires a financial institution that has repurchased its preferred stock and wishes to repurchase its warrants to start the process within 15 calendar days of the preferred stock repurchase date. For a further discussion, see the Process section of this Chapter below.

Treasury valuation of the warrants is based on the following factors:

- Observable market prices of the warrants or of comparable securities, such as traded warrants, traded options, or common equity issued by the participating institution or similar institutions;
- Quotations for the warrants from other market participants;
- Financial models such as the binomial and Black-Scholes options pricing model; and
- Independent valuations by outside consultants.

Valuation. The EESA statutory language, as amended, permits Treasury to liquidate the warrants "at market price," once a financial institution repurchases its preferred stock, whereas the securities purchase agreement allows a repurchasing financial institution to repurchase its warrants at "fair market value." We do not believe that there is any necessary conflict between these two provisions, especially since Treasury has stated that it will give financial institutions the opportunity to repurchase their warrants as contemplated by the securities purchase agreements. It is widely acknowledged that determining the market price of warrants is a difficult task and in light of this fact, the securities purchase agreement sets forth an appraisal procedure, since amended by a letter agreement and Treasury Repurchase FAQs, as described below. A summary of Treasury's public statements on its valuation factors is set forth in the sidebar. Several Wall Street firms have, however, disputed Treasury's valuation methods and argued that Treasury is demanding too high a price for the warrants.[15] At the same time, some members of the COP have accused Treasury of repurchasing warrants from smaller banks at only 66 percent of their market value, costing taxpayers about $10 million.[16]

Process. Set forth below is the process for the valuation, repurchase or auction of the warrants as set forth in the securities purchase agreement, the Treasury Repurchase FAQs and the letter agreement that any financial institution that repurchases its preferred stock must sign.

Under the securities purchase agreement, as modified by the letter agreement, a financial institution wishing to repurchase its warrants following its repurchase of its preferred stock starts the process by sending

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[13] CONG. OVERSIGHT PANEL, JULY OVERSIGHT REPORT: TARP REPAYMENTS, INCLUDING THE REPURCHASE OF STOCK WARRANTS 14 (July 10, 2009), http://cop.senate.gov/reports/library/report-071009-cop.cfm.

[14] This view is in line with Treasury's policy to dispose of government investments in private companies as soon as possible. *See* U.S. Dep't of the Treasury Press Release, Treasury Announces Warrant Repurchase and Disposition Process for the Capital Purchase Program (June 26, 2009), http://www.financialstability.gov/latest/tg_06262009.html.

[15] Deborah Solomon and Robin Sidel, *J.P. Morgan to Send Warrants to Market*, WALL ST. J., July 13, 2009, at A23, http://online.wsj.com/article/SB124718361931620349.html.

[16] David Lawder, *Treasury Sold Warrants Below Market Value: Panel*, REUTERS, July 10, 2009, http://www.reuters.com/article/newsOne/idUSTRE5690KB20090710.

a notice to Treasury within 15 calendar days of its preferred stock repurchase date.[17]

The notice must set forth the financial institution's board of director's proposal for the fair market value of the warrants, which must be based on the opinion of an independent, nationally-recognized investment banking firm.[18] The COP has asserted that if such independent expert were a financial institution that is or is an affiliate of a financial institution that has received TARP funds, a serious conflict of interest would arise. The Treasury has 10 days to object to the valuation.[19] Given the difficulty of warrant valuation, Treasury quite reasonably decided to work with outside advisors to determine valuation, some of which are affiliates of financial institutions that have received TARP funds.[20]

If there is no agreement, Treasury and the financial institution have 10 days to agree on a fair market value. If Treasury and the financial institution cannot agree, the securities purchase agreement's appraisal procedures, which are summarized in the sidebar, can be invoked. Goldman Sachs chose to negotiate with Treasury, and, according to news sources, ultimately agreed to Treasury's asking price of $1.1 billion for the repurchase of its outstanding warrants.[21] Morgan Stanley later agreed to repurchase its warrants for $950 million.

The contractual appraisal procedures, which are based on relatively common market norms, permit a financial institution to require Treasury to sell the warrants as long as the repurchase is made as soon as practicable after the fair market value is determined under the appraisal procedures. The appraisal procedures are set out in the side bar.

Treasury has, however, indicated that financial institutions can opt out of a repurchase of the warrants even after the appraisal procedure has run its course by withdrawing its repurchase notice. As a result, if the parties cannot agree on a purchase price and neither chooses to invoke the appraisal procedure, or if the financial institution withdraws its repurchase notice, then in light of Treasury's expressed policy to sell the warrants as

Appraisal Procedures:

- Either the financial institution or the government may invoke an appraisal procedure within 30 days of Treasury's objection to the financial institution's proposed price.
- The appraisal procedure requires two independent appraisers, one chosen by the financial institution and one by Treasury, to agree upon the fair market value for the warrants.
- If the appraisers cannot agree, a third appraiser must be appointed by mutual consent of the first two appraisers.
- In that case, the average appraisal of all three appraisers shall be binding, unless the disparity between one appraiser's determination and the median determination is more than twice as great as the disparity between the other appraiser's determination and the median determination.
- In such a case, the determination furthest from the median will be ignored, and the average of the remaining two will be binding.

[17] The letter agreement also provides that if the issuer declines to repurchase its warrants, if the issuer and Treasury are unable to agree on the fair market value of the warrants or if the issuer withdraws its notice, it must deliver a substitute warrant to Treasury that is not subject to the limits on transfer or exercise described above and that is no longer subject to a 50% reduction if the issuer raises sufficient qualifying equity proceeds before December 31, 2009.

[18] U.S. Dep't of the Treasury, TARP Capital Purchase Program, Securities Purchase Agreement: Standard Terms § 4.9, http://www.financialstability.gov/docs/CPP/spa.pdf.

[19] U.S. Dep't of the Treasury, TARP Capital Purchase Program, Securities Purchase Agreement: Standard Terms § 4.9(a), http://www.financialstability.gov/docs/CPP/spa.pdf.

[20] Treasury has informed the COP that when it uses outside experts to solicit quotes, it uses a mix of financial institutions who have, directly or indirectly, received CPP funds and that "Treasury has put in place careful conflict of interest rules governing firms that assist Treasury with the warrant valuation process."

[21] Greg Farrell, *Goldman Sheds Bail-out Legacy*, FIN. TIMES, July 22, 2009, http://www.ft.com/cms/s/0/0d72b8b2-7722-11de-b23c-00144feabdc0.html.

soon as possible as set forth in the Treasury Repurchase FAQ,[22] Treasury will auction the warrants. JPMorgan has elected to pursue this option.[23] Treasury has said it will issue auction process guidelines shortly. As a statutory and contractual matter, Treasury could keep the warrants but has decided, by policy, to follow a different course.

[22] U.S. Dep't of the Treasury Press Release, Treasury Announces Warrant Repurchase and Disposition Process for the CPP (June 26, 2009), http://www.financialstability.gov/docs/CPP/Warrant-Statement.pdf.

[23] Deborah Solomon and Robin Sidel, *J.P. Morgan to Send Warrants to Market*, WALL ST. J., July 13, 2009, at A23, http://online.wsj.com/article/SB124718361931620349.html.

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Term Sheet for TARP Capital Purchase Program
http://www.financialstability.gov/docs/CPP/termsheet.pdf

Term Sheet for Capital Assistance Program
http://www.treas.gov/press/releases/reports/tg40_captermsheet.pdf

Standard CPP Securities Purchase Agreement
http://www.financialstability.gov/docs/CPP/spa.pdf

Treasury FAQ on Capital Purchase Program Repayment
http://www.financialstability.gov/docs/CPP/FAQ_CPP_guidance.pdf

Warrant Repurchase and Disposition Process for the Capital Purchase Program
http://www.financialstability.gov/docs/CPP/Warrant-Statement.pdf

CPP Repurchase Letter Agreement for Public Institutions
http://www.financialstability.gov/docs/CPP/UST%20Acknowledgement%20of%20Repurchase%20(Public%20Issuers).pdf

CHAPTER 5: THE FDIC'S TEMPORARY LIQUIDITY GUARANTEE PROGRAM

Luigi L. De Ghenghi, John L. Douglas and Reena Agrawal Sahni

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Overview of TLGP

The FDIC Board approved TLGP in October 2008 as part of an effort by the FDIC, the Treasury and the Federal Reserve to stabilize the nation's financial system. Through TLGP, the FDIC guarantees certain senior unsecured debt issued by participating insured depository institutions, their holding companies and/or their affiliates through the Debt Guarantee Program and provides unlimited deposit insurance for certain transaction accounts at participating insured depository institutions through the Transaction Account Guarantee Program.

Popularity of TLGP

The stated purpose of TLGP is to provide liquidity to the inter-bank lending market and promote stability in the unsecured bank funding market. Although liquidity in the financial markets remains at a lower level than it was before the financial crisis, TLGP is generally viewed as a success.[1] Federal Reserve Chairman Ben Bernanke said TLGP significantly contributed to stabilizing the financial markets,[2] and bank executives acknowledged the central role TLGP played in ensuring their institutions' survival.[3] According to the FDIC, 56% of eligible entities opted to participate in the Debt Guarantee Program.[4] As of August 31, 2009, 92 participating entities had $306.989 billion in guaranteed debt outstanding, and $9.350 billion in fees and surcharges had been assessed by the FDIC.[5]

The Debt Guarantee Program has been highly attractive to participating entities, particularly the larger bank holding companies, because it provides access to funding at a relatively low cost. Regardless of the participating entity's credit rating, the three major credit rating agencies rate debt issued under TLGP with their respective highest ratings based on the FDIC guarantee. As a result, it has been argued that participating entities receive a subsidy in the form of a substantially lower interest rate on FDIC-

The publication date of this Chapter is September 21, 2009. All terms and acronyms used in this Chapter are defined in the Glossary at the front of this Manual.

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guaranteed debt issuances. Most fixed-rate debt issued under the Debt Guarantee Program bears an annual interest rate between 1.5% and 3%.[6]

As discussed in great detail later in this Chapter, recently only a few participating entities have continued to issue debt under the Debt Guarantee Program, while many have successfully issued non-guaranteed debt. Treasury reported that issuances under the Debt Guarantee Program had fallen from $113 billion in December 2008 to $5 billion in August 2009.[7] As of August 31, 2009, aggregate debt outstanding under the Debt Guarantee Program of all participating entities was down to 38.9% of their aggregate available issuance cap, described below, from its high of 44% as of May 31, 2009.

Over 7,000 insured depository institutions participate in the Transaction Account Guarantee Program, and the FDIC estimates that roughly $700 billion in deposits benefit from the guarantee.

Core Features of TLGP

There are two parts to TLGP: the Debt Guarantee Program and the Transaction Account Guarantee Program.

Entities participating in the Debt Guarantee Program may issue certain FDIC-guaranteed debt during a specified issuance window. The issuance window depends upon the type of participating entity and its previous participation in the Debt Guarantee Program. The Debt Guarantee Program is in the form of a "payment when due" guarantee by the FDIC.

(continued)

[1] Nicole Bullock, *Little Appetite for Banks' Debt Without US Federal Guarantee*, FIN. TIMES, Mar. 10, 2009, http://www.ft.com/cms/s/0/30151792-0dab-11de-a10d-0000779fd2ac.html?nclick_check=1.

[2] Rebecca Christie, *FDIC Shelves Its Plan to Extend Bank-Debt Guarantees (Update 1)*, BLOOMBERG, May 15, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aoeSvikbdGfs.

[3] Louise Story, *U.S. Program Lends a Hand to Banks, Quietly*, N.Y. TIMES, Apr. 14, 2009, at B1, http://www.nytimes.com/2009/04/15/business/economy/15bank.html (quoting David A. Viniar, CFO of Goldman Sachs).

[4] Kellie Geressy-Nilsen, *Some Big Banks Turn Backs On FDIC-Guaranteed Debt*, WALL ST. J., June 19, 2009, http://english.capital.gr/news.asp?id=760271.

[5] In this Chapter, we employ the terminology adopted in the FDIC's regulations, 12 C.F.R. Part 370, and use the term "eligible entity" to refer to any insured depository institution, holding company or affiliate eligible to participate in any part of TLGP, and the term "participating entity" to refer to any insured depository institution, holding company or affiliate that has not opted out of the applicable part of TLGP.

[6] Marshall Eckblad, *Banks Repaying TARP Still Enjoy Vast Government Debt Aid*, WALL ST. J., June 12, 2009, http://www.nasdaq.com/aspx/stock-market-news-story.aspx?storyid=200906121341dowjonesdjonline000736&title=banks-repaying-tarp-still-enjoy-vast-government-debt-aid

[7] U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf

Timeline of TLGP

- **Oct. 14, 2008** – TLGP effective
- **Oct. 23, 2008** – Interim rule implementing TLGP published
  - **Nov. 26, 2008** – Final rule published (adopted with substantial changes)
- **Dec. 5, 2008** – Opt-out deadline
- **Mar. 4, 2009** – Interim rule expanding TLGP to include mandatory convertible debt published
  - **June 5, 2009** – Final rule published (adopted with a minor, clarifying change)
- **Mar. 23, 3009** – Interim rule extending TLGP and implementing surcharges published
  - **June 3, 2009** – Final rule published (adopted without change)
- **June 30, 2009** – Application deadline for participating in the extension and final day for entities not participating in the extension to issue guaranteed debt
- **August 26, 2009** – Final rule extending the Transaction Account Guarantee Program until June 30, 2010
- **September 9, 2009** – Notice of Proposed Rulemaking suggesting possible establishment of limited, six-month emergency guarantee facility after expiration of Debt Guarantee Program on October 31, 2009
- **Oct. 31, 2009** – Last day for any entity participating in the extension to issue guaranteed debt
- **November 2, 2009** – Last day to opt out of extended Transaction Account Guarantee Program
- **June 30, 2010** – Transaction Account Guarantee Program expires
- **June 30, 2012** – Guarantee on debt issued by entities not participating in the extension expires
- **Dec. 31, 2012** – Guarantee on debt issued by insured depository institutions and other entities participating in the extension expires

Under the Transaction Account Guarantee Program, the FDIC provides unlimited deposit insurance coverage for non-interest bearing transaction accounts at participating entities. This enhanced deposit insurance coverage is scheduled to expire on June 30, 2010. In addition, by statute, the FDIC insurance coverage limit for deposit accounts of up to $250,000 per person per institution, previously set at $100,000, has been extended through the end of 2013.[8]

The FDIC has stated that TLGP will be entirely self-funded. Fees and surcharges are assessed on participating entities. While TLGP fees are deposited in a fund designated for covering potential TLGP losses, additional surcharges on issuances of guaranteed debt after a certain date are deposited in the Deposit Insurance Fund. If the fees collected are inadequate to cover TLGP's costs, including any FDIC recoveries from failed institutions' estates, the difference will be covered by one or more special assessments on all insured depository institutions, depository institution holding companies, or both.[9] In addition to TLGP's surcharges, the FDIC has approved a systemic risk special assessment to replenish the Deposit Insurance Fund, as discussed in more detail under Debt Guarantee Fees and Surcharges below.

The FDIC has reported that the cost of providing guarantees for non-interest bearing transaction accounts at failed insured depository institutions since the inception of the Transaction Account Guarantee Program has already exceeded projected total Transaction Account Guarantee Program revenue through the end of December 2009. Further, the FDIC projects that additional failures through the end of the year will result in overall Transaction Account Guarantee Program losses that are expected to considerably exceed revenues. Revenues from fees associated with the Debt Guarantee Program are expected to cover Transaction Account Guarantee Program losses as well as losses under the Debt Guarantee Program.

All eligible entities were required to opt in or out of the Debt Guarantee Program and the Transaction Account Guarantee Program by December 5, 2008. All eligible entities in a bank or thrift holding company structure had to make the same opt-out election for each part of TLGP and were deemed to have opted out if their elections differed from each other. If an eligible entity failed to opt out or affirmatively opted in to one or both of the guarantees, participation became mandatory. According to the FDIC, 6,501 eligible entities opted out of the Debt Guarantee Program (less than half of all

[8] *See* Helping Families Save Their Homes Act of 2009, Pub. L. 111-22, 123 Stat. 1632 (2009) (amending § 13(c)(4)(G)(ii) of the Federal Deposit Insurance Act, 12 U.S.C. 1823(c)(4)).

[9] FDIC, Temporary Liquidity Guarantee Program; Final Rule, 73 Fed. Reg. 72,244, 72,271 (Nov. 26, 2008) (codified at 12 C.F.R. Part 370), http://www.fdic.gov/news/board/08BODtlgp.pdf; Helping Families Save Their Homes Act of 2009, Pub. L. 111-22, 123 Stat. 1632 (2009) (amending § 13(c)(4)(G)(ii) of the Federal Deposit Insurance Act, 12 U.S.C. 1823(c)(4)).

eligible entities), and 1,110 eligible entities opted out of the Transaction Account Guarantee Program (about 14% of all eligible entities). Entities participating in the Transaction Account Guarantee Program have an opportunity to opt out of the six-month extension of that guarantee, against increased fees, through June 30, 2010. The opt-out, which is irrevocable, must be exercised no later than November 2, 2009.

Terms of the Debt Guarantee

Key Features of the Debt Guarantee

- "Payment when due" guarantee;
- Guarantee does not cover short-term (less than thirty days or "one month") debt issued after December 5, 2008;
- Exceeding debt guarantee limit results in penalties;
- Once debt limit is reached, issuances must be disclosed as non-guaranteed;
- Participating entities retained the option to issue non-guaranteed senior debt with maturity date after June 30, 2012 by making election and paying up-front fee;
- Tiered fees based on guaranteed debt's maturity; and
- SEC granted no-action relief, exempting debt securities guaranteed under TLGP that mature on or before June 30, 2012 from registration under Section 3(a)(2) of the Securities Act.

Eligible Entities

Under the terms of TLGP, insured depository institutions were eligible to participate in both parts of TLGP. US bank holding companies and US savings and loan holding companies were also eligible to participate in the Debt Guarantee Program, provided that they had at least one chartered and operating insured depository institution within their holding company structure and, in the case of savings and loan holding companies, satisfied other conditions.

Insured branches of non-US banks could participate only in the Transaction Account Guarantee Program. Uninsured US branches and agencies of non-US banks were excluded from participation in both parts of TLGP.

FDIC-Designated Eligible Entities

Affiliates of participating entities and entities that became eligible to participate after October 13, 2008 were admitted to TLGP only after individually applying to and receiving approval from the FDIC, in consultation with the entity's primary federal banking agency. Where the FDIC determined an entity's admission and debt guarantee limit on an individualized basis, the FDIC conditioned access to guaranteed debt on the entity's satisfaction of various conditions.

Affiliates

Affiliates of insured depository institutions could participate in the Debt Guarantee Program if approved by the FDIC, in consultation with the insured depository institution's primary federal banking agency. To receive FDIC approval, an affiliate had to submit a written application that contained a summary of its strategic operating plan and a description of the proposed use of the debt proceeds. When reviewing the application, the FDIC considered, among other factors, the level of financial activity of the entities within the holding company structure, the rating strength of the debt the affiliate sought to issue as FDIC-guaranteed debt, and the size and extent of the affiliate's activities. The FDIC also retained discretion to consider any other relevant factors and impose conditions on approval, as it deemed appropriate.

One such FDIC-approved affiliate is GE Capital. GE's finance arm was approved as a participating entity because it was a savings and loan holding company and was affiliated with a Utah industrial bank. The FDIC initially hesitated to expand TLGP over concerns that doing so would add more risk to TLGP. But GE argued that, as one of the nation's largest lenders, its participation was essential to achieving TLGP's goals of increasing liquidity in the credit markets. GE's appeal was successful. According to news reports, GE Capital has saved billions in interest expense through TLGP. As of June 30, 2009, GE had over $69 billion in FDIC-guaranteed debt outstanding, issued at lower interest rates than it would have paid on non-guaranteed debt while paying a little over $1 billion in fees to the FDIC.[10]

Issuances Under Debt Guarantee Program as of August 31, 2009

- Insured depository institutions with assets ≤ $10 billion issued $1.617 billion of guaranteed debt
  - 0.53% of the outstanding FDIC-guaranteed debt.
- Insured depository institutions with assets > $10 billion issued $57.223 billion of guaranteed debt
  - 18.64% of the outstanding FDIC-guaranteed debt.
- Bank and thrift holding companies and uninsured affiliates issued $248.149 billion of guaranteed debt
  - 80.83% of the outstanding FDIC-guaranteed debt.

Entities Eligible After October 13, 2008

The FDIC individually admitted entities that became eligible after October 13, 2008 and established the debt guarantee limit for those entities. Initially, these entities were presumed to have a debt guarantee limit of zero. However, the entity could participate in TLGP if it applied to increase its debt guarantee limit and the FDIC, in consultation with the entity's primary federal banking agency, approved the request. The written application had to include a summary of the entity's strategic operating plan and a description of the proposed use of the debt proceeds. When increasing the entity's debt guarantee limit, the FDIC considered, among other relevant factors it deemed appropriate, the proposed use of the proceeds and the financial condition and supervisory history of the entity. The FDIC exercised its right to impose such additional conditions when it approved GMAC's participation in TLGP.[11]

The Master Agreement

To participate in the Debt Guarantee Program, eligible entities had to enter into a Master Agreement with the FDIC, which set out the terms of participation in the program. The Master Agreement required, among other things, the participating entity to enter into certain covenants, including promises to reimburse the FDIC; waive certain defenses; adopt certain mandatory terms for its guaranteed debt; make standard representations and warranties; and comply with the Master Agreement's notice

[10] Jeff Gerth and Brady Dennis, *How a Loophole Benefits GE in Bank Rescue*, WASH. POST, June 29, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/06/28/AR2009062802955.html.

[11] In connection with receiving FDIC approval, GMAC agreed to develop a funding plan showing GMAC's management of the funding and deposit costs of its Ally Bank subsidiary, formerly GMAC Bank. GMAC and Ally Bank also committed to maintain a level of bank capital significantly above the regulatory minimums. *See* FDIC Press Release, *FDIC Approves GMAC Financial Services Participation in TLGP*, May 21, 2009, http://www.fdic.gov/news/news/press/2009/pr09073.html; *See* GMAC Press Release, GMAC Financial Services Announces Key Capital and Liquidity Actions, (May 21, 2009), http://media.gmacfs.com/index.php?s=43&item=331.

requirements. These obligations are in addition to a participating entity's obligations under TLGP, which include complying with FDIC on-site reviews and requests for information for compliance with the terms and requirements of TLGP, and being bound by the FDIC's decisions, in consultation with the primary federal banking agency, regarding the management of TLGP.

Types of Senior Unsecured Debt Outstanding as of August 31, 2009

- Commercial Paper – $12.934 billion, 4.2% of total;
- Interbank Eurodollar Deposits – $49 million, 0.0% of total;
- Medium Term Notes – $262.123 billion, 85.4% of total;
- Other Interbank Deposits – $3.131 billion, 1.0% of total;
- Other Senior Unsecured Debt – $7.065 billion, 2.3% of total; and
- Other Term Notes – $21.687 billion, 7.1% of total.

Senior Unsecured Debt

Only certain senior unsecured debt may be issued through the Debt Guarantee Program. To be eligible for the government guarantee, the debt must:

- have a certain maturity date or, in the case of mandatory convertible debt, have a conversion date which complies with the rules discussed under Mandatory Convertible Debt below;
- be a type of debt the FDIC qualifies as senior unsecured;
- satisfy certain legal and structural requirements; and
- contain certain terms.

Only debt with a maturity greater than thirty days or "one month" is covered by the debt guarantee.

On the *types* of debt that can be guaranteed, TLGP provides non-exhaustive lists of instruments which are and are not included in the definition of senior unsecured debt. Retail debt securities are not considered senior unsecured debt. The FDIC has clarified that retail debt securities are securities marketed *exclusively* to retail investors, typically in small denominations. Debt that is more broadly marketed, even if it is subsequently held by retail investors through secondary market trading, is eligible for the debt guarantee.

Legal and Structural Requirements

Senior unsecured debt issued through TLGP must also meet certain legal and structural requirements, including the following:

- it cannot contain any embedded options or other derivatives. For a further discussion, see Mandatory Convertible Debt below;
- it must be evidenced by a written agreement or a trade confirmation;
- it must contain a specified and fixed principal amount to be paid on a date certain (excluding, *e.g.*, revolving credit agreements); and
- it must be non-contingent and not subordinated by its terms to another liability.

Senior unsecured debt may pay a fixed or floating interest rate based on a single index (*e.g.*, T-bill, prime or LIBOR), may be denominated in foreign currency (except for deposits) and may contain a negative pledge clause.

A participating entity issuing guaranteed debt evidenced by a trade confirmation must use commercially reasonable efforts to have its counterparties execute a written instrument evidencing their agreement to be bound by the terms of the Master Agreement.

Debt issued by a participating entity to that entity's affiliates, entity-affiliated parties or insiders is excluded from the debt guarantee, as the FDIC does not believe that guaranteeing such issuances is a means of enhancing inter-bank lending. This restriction is not intended to prevent underwriting activity by affiliates of participating entities. Affiliates may therefore act as underwriters for offerings of guaranteed debt of their affiliated participating entity, and the guarantee becomes effective when the underwriter completes its sale of the debt to third parties not affiliated with the participating entity.

Finally, in order to qualify for the debt guarantee, senior unsecured debt must contain certain contractual terms specified in the Master Agreement.

Mandatory Convertible Debt

Despite TLGP's original exclusion of many debt instruments, including convertible debt, from the definition of senior unsecured debt, the FDIC expanded TLGP to include certain issuances of mandatory convertible debt on or after February 27, 2009. For reasons discussed in this section, there appear to have been no issuances of mandatory convertible debt under TLGP.

To be FDIC-guaranteed, the mandatory convertible debt must provide in the debt instrument for the mandatory conversion of the debt into common shares of the issuer on a fixed date, unless the issuer defaults on any payment required under the debt instrument or the issuer is the non-surviving entity in a merger or consolidation. The specified conversion date must be on or before the expiration of the guarantee. After adopting the interim rule expanding TLGP to include certain issuances of mandatory convertible debt, the FDIC received several comments suggesting that it make structural enhancements to mandatory convertible debt so that the debt instrument would qualify for the federal interest rate tax deduction. Specifically, commenters had suggested that mandatory convertible debt could take the form of mandatory convertible preferred stock or mandatory equity units consisting of senior debt and a forward contract to purchase common stock, and some had suggested expanding the Debt Guarantee Program to cover senior unsecured debt convertible to equity at the option of the holder. The FDIC declined to follow these suggestions and continued to require that mandatory convertible debt provide in the underlying debt instrument for the conversion of the debt into equity on a specified date in

order to be eligible for the guarantee. When adopting the final rule without the suggested change, the FDIC said that the Debt Guarantee Program modification was not intended to expand the definition of senior unsecured debt to include hybrid debt and equity securities with complex structures.

Before issuing mandatory convertible debt, a participating entity must apply for and receive approval from the FDIC, in consultation with the entity's primary federal banking agency. Entities participating in the extension of the Debt Guarantee Program must apply to issue mandatory convertible debt by October 31, 2009. For a further discussion, see Issuance Window and Expiration of the Guarantee below. Entities not participating in the extension were required to apply by June 30, 2009 to issue mandatory convertible debt. The entity's application must include the details of the request, a summary of its strategic operating plan, and a description of the proposed use of the debt proceeds. In addition to these requirements, the application must also include the proposed date of issuance, the total amount of mandatory convertible debt to be issued, the mandatory conversion date, the conversion rate, a confirmation that all necessary applications and notices in connection with the proposed issuance have been submitted to the entity's primary federal banking agency and any other information the FDIC deems appropriate. When evaluating such applications, the FDIC considers the proposed use of the proceeds, the financial condition and the supervisory history of the entity.

The stated purpose for including mandatory convertible debt in TLGP is to enable participating entities to obtain funding from investors with a longer-term investment horizon and to alleviate the potential funding needs that could result from concentrations of FDIC-guaranteed debt maturing in mid-2012. However, largely because of the negative tax consequences to an issuer of the type of mandatory convertible debt that can be issued under TLGP, this program expansion has had no practical effect.

Collateralized Guaranteed Debt Program

The FDIC also considered, but ultimately abandoned, expanding TLGP to allow participating entities to issue guaranteed collateralized debt. In January 2009, the FDIC announced a plan to extend the Debt Guarantee Program from three to ten years for issuances of certain secured debt to support new consumer loans. The extension would have broadened the scope of FDIC-guaranteed financial products and ultimately might have increased funding for student loans and credit cards.[12] The FDIC guarantee of senior unsecured debt would have remained unchanged.[13] Four months

[12] Damian Paletta, *FDIC Hopes to Kickstart Consumer Lending Through New Debt Guarantee*, WALL ST. J., Jan. 26, 2009, http://online.wsj.com/article/SB123212352364990631.html.

[13] Alison Vekshin, *FDIC Adding Covered Bonds to Liquidity Guarantee Plan (Update 2)*, BLOOMBERG, Jan. 16, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=acuw6oiWXLvw&refer=home.

later, FDIC Chairman Sheila Bair said that the FDIC would not proceed with the earlier plan because the Treasury was uncomfortable with it.[14]

Discussions in the press of the proposal to guarantee collateralized debt referred to it as creating a "quasi-covered bond product," which may have been a misnomer. Covered bonds, which are debt securities secured by a collateral pool of high-quality mortgages or other assets kept on the issuer's balance sheet, have been extensively used in Europe as a means of mortgage financing, and were recently considered by the Treasury and the FDIC as a potential candidate for mortgage financing in the United States.[15] Unlike covered bonds, in which the collateral pool is secured in the investors' interest, the collateral in the FDIC proposal would primarily have served to protect the FDIC's reimbursement claim against the issuer after payment under the guarantee. It is unclear to what extent investors would have benefited from the collateral. Also unlike covered bonds, which historically have only included high-quality mortgages, public entity debt and similar receivables as collateral, the FDIC proposal would have included consumer receivables.[16]

Terms of the Debt

The Master Agreement mandates the inclusion of certain provisions in all FDIC-guaranteed debt offerings. Under the Master Agreement, participating entities covenant not to modify certain terms of the guaranteed debt, including, but not limited to, provisions related to the principal, interest, payment, default and ranking of the guaranteed debt, without the express written consent of the FDIC.

The Master Agreement also requires all governing documents (*e.g.*, indentures, notes) of a guaranteed offering to include the statement, "[t]his debt is guaranteed under the FDIC Temporary Liquidity Guarantee Program and is backed by the full faith and credit of the United States,"[17] as well as other disclosure language.

In addition to the mandated disclosure, the governing documents for guaranteed debt issuances are required to designate a representative

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[14] Rebecca Christie, *FDIC Shelves Its Plan to Extend Bank-Debt Guarantees (Update 1)*, BLOOMBERG, May 15, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=agOCYRttKJY8.

[15] U.S. DEP'T OF THE TREASURY, BEST PRACTICES FOR RESIDENTIAL COVERED BONDS (July 2008), http://www.treas.gov/press/releases/reports/USCoveredBondBestPractices.pdf; FDIC Press Release, Final Covered Bond Policy Statement (Apr. 23, 2008) http://www.fdic.gov/news/news/press/2008/pr08060a.html.

[16] *"TLGP-secured" a mixed blessing for covered bonds*, THE COVER, Mar. 17, 2009, www.coveredbondnews.com/article/2134660/TLGP-secured-a-mixed-blessing-for-covered-bonds.html.

[17] *See* FDIC, Frequently Asked Questions: Temporary Liquidity Guarantee Program (2009), http://www.fdic.gov/regulations/resources/TLGP/faq.html.

(typically the indenture trustee, paying agent or equivalent) for purposes of making claims for the debt holders under the guarantee, set forth the terms of the FDIC's subrogation, include the required assignment of claims and provide for the surrender of the debt's certificate or similar instrument.

Finally, guaranteed debt documents cannot include terms that would result in the automatic acceleration of guaranteed debt upon the issuer's default on *any* of its debt while the guarantee is in effect or the FDIC is making guarantee payments.

Issuance Window and Expiration of the Guarantee

Categories into which a participating entity may fall:

- Entities that participate in the Debt Guarantee Program's extension – either as a result of being an insured depository institution, issuing FDIC-guaranteed debt before April 1, 2009, or receiving FDIC-approval to participate in the extension – may issue senior unsecured debt through October 31, 2009. The FDIC guarantee of debt issued on or after April 1, 2009 expires on the earliest of the mandatory conversion date for mandatory convertible debt, the maturity date or December 31, 2012.
- Entities that participated in the Debt Guarantee Program, but not in its extension, could issue senior unsecured debt through June 30, 2009. The FDIC guarantee expires on the earliest of the mandatory conversion date for mandatory convertible debt, the maturity date or June 30, 2012.

If adopted, under a six-month emergency facility, described in a Notice of Proposed Rulemaking adopted on September 9, 2009, certain entities unable to issue non-guaranteed debt could, subject to certain conditions issue guaranteed debt between November 1, 2009 and April 30, 2010.

Issuance Window and Expiration of the Guarantee

On March 17, 2009, the FDIC extended the Debt Guarantee Program to allow participating entities to issue senior unsecured debt through October 31, 2009. The extension applied automatically to all insured depository institutions and those entities that had issued FDIC-guaranteed debt before April 1, 2009. Participating entities, other than insured depository institutions, that had not issued FDIC-guaranteed debt before April 1, 2009 were required to apply by June 30, 2009 for approval from the FDIC to participate in the extension. The application had to include, among other things, a description of an entity's current condition and future prospects, capital, management and risks presented to the FDIC. The FDIC could condition its approval on any requirement it deemed appropriate.

In light of the extension, the Debt Guarantee Program contains two categories in which a participating entity may fall. The categories, as shown in the sidebar, determine both the issuance window and the guarantee's expiration.

On September 9, 2009, the FDIC adopted a Notice of Proposed Rulemaking that seeks comment on the possible establishment of a limited, six-month emergency guarantee facility following the expiration of the Debt Guarantee Program on October 31, 2009. This emergency facility would only be available upon FDIC approval of an application, submitted by a participating insured depository institution or a participating entity that had issued FDIC-guaranteed debt on or before September 9, 2009, providing "conclusive evidence"[18] demonstrating an inability to issue non-guaranteed debt to replace maturing senior unsecured debt as a result of market disruptions or other circumstances beyond the entity's control. The application would also need to include, among other things, a summary of the participating entity's contingency plans, a description of collateral available to secure the entity's obligation to reimburse the FDIC for any payments made pursuant to the guarantee, and a plan for retirement of the FDIC-guaranteed debt. Entities

[18] FDIC Memorandum, Notice of Proposed Rulemaking proposing alternatives for concluding the debt guarantee program of the TGLP (Sept. 9, 2009), http://www.fdic.gov/news/board/NoticeSept9no5.pdf.

Non-Guaranteed Debt Issuance

- Entities participating in the extension that made the election by December 5, 2008 under the original long-term non-guaranteed debt option and paid the related fees may issue non-guaranteed debt as follows:
  - Before June 30, 2009, the entity was allowed to issue non-guaranteed debt with maturities after June 30, 2012 (but was prohibited from issuing any non-guaranteed debt with maturities on or before June 30, 2012);
  - After June 30, 2009, the entity may issue non-guaranteed debt with maturities after June 30, 2012 without FDIC approval and without paying additional fees. After June 30, 2009, the entity may issue non-guaranteed debt with maturities on or before June 30, 2012 only after applying for and obtaining FDIC approval, but without paying additional fees.
- Entities participating in the extension that did not make the election under the original long-term non-guaranteed debt option may issue non-guaranteed debt as follows:
  - Before June 30, 2009, the entity was prohibited from issuing non-guaranteed debt of any maturity;
  - After June 30, 2009, the entity may issue non-guaranteed debt of any maturity only after applying for and obtaining FDIC approval, but without paying any related fees.
- Entities participating in the Debt Guarantee Program but not in its extension may issue non-guaranteed debt as follows:
  - Before June 30, 2009, the entity was allowed to issue non-guaranteed debt with maturities after June 30, 2012 only if the participating entity made the election under the original long-term non-guaranteed debt option and paid the related fees;
  - After June 30, 2009, the entity may issue non-guaranteed debt of any maturity without FDIC approval as the Debt Guarantee Program no longer applies to this category of issuers.

that participate in the emergency facility may be subject to other conditions and restrictions imposed by the FDIC, including limits on executive compensation, bonuses, or the payment of dividends. Debt issued under the emergency guarantee facility would be assessed an annualized fee of at least 300 basis points. The FDIC expects the fee to be an "appropriate deterrent" to applications based on less severe circumstances.[19] Considering the fee, the onerous application requirements as well as the potential other conditions, this emergency facility, if adopted, may indeed prove to be a last resort for participating entities.

Entities that issue debt under the emergency guarantee facility would be permitted to issue FDIC-guaranteed debt through April 30, 2010. The FDIC guarantee of debt issued under the emergency facility would, like the guarantee for any debt issued during the extended issuance window ending October 31, 2009, expire on the earliest of the mandatory conversion date for mandatory convertible debt, the maturity date or December 31, 2012. The comment period for the Notice of Proposed Rulemaking ends on October 1, 2009.

Long-Term Non-Guaranteed Debt Issuance

The extension of TLGP also amended participating entities' ability to issue non-guaranteed debt. Before the extension, the TLGP provided for the election of a "long-term non-guaranteed debt option." Upon election, the participating entity paid a non-refundable fee equal to 37.5 basis points of the entity's senior unsecured debt outstanding as of September 30, 2008 with a maturity date on or before June 30, 2009 or, if the entity had no such debt, 37.5 basis points of the entity's otherwise determined debt guarantee limit. The non-refundable fee offset the participating entity's debt issuance fees to the FDIC for guaranteed debt, if any, until the non-refundable fee was exhausted.

Recognizing that only some participating entities had elected to participate in the "long-term non-guaranteed debt option," TLGP now provides for the issuance of non-guaranteed debt as described in the sidebar.

After October 31, 2009, no new issuance by any category of participating entity will be guaranteed, except to the extent the emergency facility described above is adopted.

[19] FDIC Memorandum, Notice of Proposed Rulemaking proposing alternatives for concluding the debt guarantee program of the TGLP (Sept. 9, 2009), http://www.fdic.gov/news/board/NoticeSept9no5.pdf.

Non-Guaranteed Debt Issuances by Participating Entities Seeking to Repay TARP Funds

Non-guaranteed debt issuances have increased as participating entities have begun to repay TARP funds. Before a participating entity's primary federal banking agency will allow a participating entity to repay its TARP funds, the entity will, as a practical matter, have to demonstrate that it is weaning itself from the Debt Guarantee Program. For further details on TARP repayment, see Chapter 3: *The Capital Twist*. To demonstrate its independence, the participating entity must issue debt for a term greater than five years that is not backed by the FDIC guarantee. The amount of this non-guaranteed issuance must show the entity's ability to meet its funding needs without relying upon government guarantees.

In April and May 2009, there were a series of non-guaranteed debt offerings by participating entities seeking to repay TARP funds. It has been reported that the Debt Guarantee Program's largest participants have issued more than $81.3 billion in medium-term non-guaranteed debt outside of the program. GE Capital alone has issued about $18 billion in non-guaranteed debt[20] and Citigroup has issued $13.4 billion of non-guaranteed debt.[21]

Certain participating entities have announced that they will issue no additional FDIC-guaranteed debt, and most others have reduced issuances under TLGP. As of September 10, 2009, there had reportedly been only eight issuances of FDIC-guaranteed debt in the third quarter.[22]

Debt Guarantee Limit

Except as described below, the maximum amount of FDIC-guaranteed debt a participating entity may issue is 125% of the par or face value of its senior unsecured debt outstanding as of the close of business on September 30, 2008 scheduled to mature before June 30, 2009. "Senior unsecured debt" has the same meaning in the context of the debt guarantee limit for eligibility purposes discussed above, except that debt with a maturity of thirty days or less is included when determining the debt guarantee limit but outstanding mandatory convertible debt, if any, is excluded from this calculation. For debt issued in a foreign currency, the exchange rate in effect on the date the debt is funded is used for purposes of calculating the amount of debt outstanding in determining the debt guarantee limit.

Determining the Debt Guarantee Limit

- "125% test": a participating entity's debt guarantee limit is 125% of its senior debt outstanding at September 30, 2008 scheduled to mature before June 30, 2009.
- If a participating entity has no debt outstanding (or only federal funds purchased) on September 30, 2008, then:
  - If the participating entity is an FDIC-insured depository institution, its debt guarantee limit is 2% of its consolidated total liabilities at September 30, 2008;
  - Otherwise, the participating entity must request the FDIC to establish a debt guarantee limit.

[20] Damian Paletta and Mark Gongloff, *Banks Face Loss of Debt Guarantee*, WALL ST. J., Sept. 10, 2009, http://online.wsj.com/article/SB125253151037397187.html.

[21] Bradley Keoun and Robert Schmidt, *Citigroup Said to Consider Weaning From FDIC Debt Guarantees*, BLOOMBERG, Sept. 16, 2009, http://www.bloomberg.com/apps/news?pid=20601103&sid=ar6FJSWpZ1X8.

[22] Damian Paletta and Mark Gongloff, *Banks Face Loss of Debt Guarantee*, WALL ST. J., Sept. 10, 2009, http://online.wsj.com/article/SB125253151037397187.html.

Alternatives to the 125% Test

For an otherwise eligible insured depository institution with no qualifying debt (or only federal funds purchased) outstanding at September 30, 2008, the debt guarantee limit is 2% of its consolidated liabilities at September 30, 2008. Eligible entities that are not insured depository institutions and that have no qualifying debt must submit a written application to the FDIC for a debt guarantee limit, which includes a discussion of the entity's financial condition, supervisory history, the size of its activities and its ratings strength. The FDIC will determine the entity's debt guarantee limit. A participating entity may also request an increase in its debt guarantee limit by written request to the FDIC. The FDIC retains the discretion, in consultation with the participating entity's primary federal banking agency, to increase or decrease the entity's debt guarantee limit, once established, on a case-by-case basis, and to impose other limits or requirements as it believes to be appropriate.

Corporate Structure and the Debt Guarantee Limit

The debt guarantee limit is calculated for each participating entity. Entities that are not insured depository institutions are limited to their own individual caps. However, an insured depository institution may issue debt under both its debt guarantee limit and the debt guarantee limits of any of its participating parent entities, absent contrary direction by the FDIC. To do so, an insured depository institution must provide written notice to the FDIC and any participating parent entity indicating the amount of the increase, the name of each contributing participating parent entity and the starting and ending dates of the increase. Increases in the insured depository institution's limit are offset by reductions in the relevant participating parent entities' debt guarantee limits.

In the event of a merger of participating entities, the surviving entity's debt guarantee limit is the sum of the debt guarantee limits of the merging entities, subject to FDIC review following consultation with the surviving entity and the primary federal banking agency.

Exceeding the Debt Guarantee Limit

No debt issued by a participating entity in excess of its debt guarantee limit may be identified as FDIC-guaranteed. If a participating entity exceeds its debt guarantee limit and mistakenly or intentionally issues excess debt identified as guaranteed by the FDIC, the FDIC's assessments on all of the participating entity's outstanding guaranteed debt are increased by 100%. The FDIC can reduce the 100% assessment increase if a participating entity shows good cause for an issuance of guaranteed debt beyond its debt guarantee limit. Representing debt as guaranteed when issued in excess of the debt guarantee limit may subject the participating entity to enforcement actions and civil money penalties, including termination of the entity's participation in the Debt Guarantee Program. If the FDIC terminates an

Fees Under the Debt Guarantee

- *Annualized Assessment on Guaranteed Debt:*
  - Debt with maturity of "one month" or 30 days or less: not guaranteed and no fee if issued after December 5, 2008.
  - Debt with maturity of 180 days or less: 50 bps.
  - Debt with maturity of 181 days to 364 days: 75 bps.
  - Debt with maturity of 365 days or more: 100 bps.
- *Add-On Fee*: Additional 10 bps charge on guaranteed debt for holding companies and affiliates other than insured depository institutions if combined assets of all affiliated depository institutions are <50% of consolidated holding company assets.
  - The asset comparison test is determined as of September 30, 2008, or the date of eligibility if the entity became eligible after October 13, 2008.
  - The add-on fee predominantly affected recently created bank holding companies or financial holding companies.
- *Annualized Surcharges:*
  - Debt issued after April 1, 2009, not under the extension, with a maturity ≥ one year: 10 bps charge on insured depository institutions and 20 bps charge on other entities.
  - Debt issued after April 1, 2009 under the extension with a maturity ≥ one year: 25 bps charge on insured depository institutions and 50 bps charge on other entities.
- 100% increase on *all* guaranteed debt if the debt guarantee limit is exceeded, but can be lowered upon showing of good cause.
- For those entities that chose the long-term non-guaranteed debt option, 37.5 bps of 100% of all senior unsecured debt outstanding at September 30, 2008 with a maturity date on or before June 30, 2009.
- No fees on entities that opted out by December 5, 2008.

entity's participation in TLGP, the termination is solely prospective, and all previously issued guaranteed debt remains guaranteed. From the debt holder's perspective, the FDIC has stated that debt issued in excess of the debt guarantee limit is protected if the holder received the required guarantee disclosure.

Debt Guarantee Fees and Surcharges

Amount Due

Debt guarantee fees are assessed at an annualized rate multiplied by the amount of eligible debt issued and the debt's term. Participating entities issuing certain guaranteed debt on or after April 1, 2009 must also pay surcharges.

As shown in the sidebar, the applicable annualized rate varies depending on the maturity of the debt. The FDIC's stated intent was to price the debt guarantee at a level slightly above normal market conditions, but "well below" the then abnormally high credit default spreads.[23]

In addition to the guaranteed debt fees, a participating entity must also pay surcharges to issue debt with a maturity of one year or more on or after April 1, 2009. As shown in the sidebar, the amount of the surcharge depends upon whether the guaranteed debt is issued under the debt guarantee extension and upon the type of participating entity.

The Notice of Proposed Rulemaking adopted on September 9, 2009 provides that guaranteed debt issued under the proposed six-month emergency guarantee facility would be assessed an annualized participation fee of at least 300 basis points, with the FDIC retaining the right to assess a higher fee on a case-by-case basis.

Payment Method

Participating entities must pay TLGP fees on the first business day after the notice of issuance is given to the FDIC and the corresponding invoice is posted on *FDICconnect*. The designated account of an affiliated insured depository institution is the account through which all assessments will be paid to the FDIC for all members of a group that are not themselves insured depository institutions. To avoid violations of Section 23A of the Federal Reserve Act applicable to covered transactions with affiliates, bank holding companies are expected to fund their affiliated insured depository

[23] A similar program in the UK uses a sliding scale for premiums. For a discussion of the differences between the UK and the US debt guarantee programs, see Viral V. Acharya and Rangarajan K. Sundaram, *The Financial Sector Bailout: Sowing the Seeds of the Next Crisis?, in* RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 327, 329-330 (Viral V. Acharya & Matthew Richardson eds., 2009).

institutions' Automated Clearing House account in advance of the FDIC's collection of assessments through direct debit.

Fees are not refundable for debt retired before its stated maturity or conversion date.

Surcharges Benefiting the Deposit Insurance Fund

While guaranteed-debt and add-on fees are generally deposited in a fund created to cover potential losses under TLGP, additional surcharges on debt issued under the extension are deposited into the Deposit Insurance Fund. The surcharge recognizes, according to the FDIC, that a relatively small portion of the industry is actively using TLGP, while all insured depository institutions bear the risk of systemic risk assessment should such an assessment become necessary to recover program losses. In the same vein, Section 204(d) of the Helping Families Save Their Homes Act of 2009 amended the Federal Deposit Insurance Act to give the FDIC broad discretion to levy any systemic risk special assessment it deems appropriate on insured depository institutions. This special assessment authority can include FDIC assessments on depository institution holding companies, but any such holding company assessments require Treasury's concurrence.

On May 22, 2009, the FDIC approved a special assessment on insured depository institutions to help rebuild the Deposit Insurance Fund. The special assessment, which will be collected on September 30, 2009, will be five basis points on each FDIC-insured depository institution's assets less its Tier 1 capital as of June 30, 2009.[24] The assessment is capped at ten basis points of an institution's domestic deposits[25] and is expected to generate about $5.6 billion.[26] By basing the special assessment on an institution's assets rather than its domestic deposits, the assessment imposed a greater economic burden on larger insured depository institutions that tend to rely more heavily on non-deposit funding.[27]

Designing the special assessment to target insured depository institutions with large asset portfolios generated substantial criticism. The Comptroller of the Currency, the only FDIC board member to vote against the

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[24] FDIC Press Release, FDIC Adopts Final Rule Imposing a Special Assessment on Insured Depository Institutions (May 22, 2009), http://www.fdic.gov/news/news/press/2009/pr09074.html.

[25] FDIC Press Release, FDIC Adopts Final Rule Imposing a Special Assessment on Insured Depository Institutions (May 22, 2009), http://www.fdic.gov/news/news/press/2009/pr09074.html.

[26] *F.D.I.C. Charges Banks New Fee to Replenish Fund*, N.Y. TIMES DEALBOOK, May 22, 2009, http://dealbook.blogs.nytimes.com/2009/05/22/fdic-charges-banks-new-fee-to-replenish-fund/

[27] Joe Adler, *FDIC Levies Special Premium*, AM. BANKER, May 22, 2009, http://www.americanbanker.com/issues/174_102/-378956-1.html.

assessment,[28] noted that smaller institutions' failures have depleted the Deposit Insurance Fund and large institutions are not responsible for the Deposit Insurance Fund's decline. FDIC Chairman Sheila Bair defended the fairness of the assessment's allocation by crediting many government programs with having stabilized the larger institutions.[29]

Subsidizing the Deposit Insurance Fund with the surcharges and the special assessment will provide the Deposit Insurance Fund with much-needed revenue. The Deposit Insurance Fund is traditionally funded through quarterly assessments on insured depository institutions' deposits,[30] but the failure of twenty-five insured depository institutions in 2008[31] and the failure of 92 insured depository institutions in 2009 as of September 12, 2009[32] have substantially depleted the Deposit Insurance Fund. Bank failures this year have cost the Deposit Insurance Fund over $13.5 billion,[33] and the FDIC projects that the Deposit Insurance Fund will sustain over $70 billion in losses in the next five years.[34] In the second quarter of 2009, the Deposit Insurance Fund's ratio of reserves to insured deposits fell from 0.36% at the end of 2008 to 0.22%, and the Deposit Insurance Fund's balance declined from $17.3 billion at the end of 2008 to $10.4 billion on June 30, 2009.[35] In response, the FDIC has approved a restoration plan under which it will raise the Deposit Insurance Fund's reserve ratio to 1.15% within seven years.[36]

Given the extent of the depletion, the special assessment was originally proposed to be twenty basis points.[37] The rate was lowered after the Helping Families Save Their Homes Act of 2009 tripled the amount of the

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[28] *F.D.I.C. Charges Banks New Fee to Replenish Fund*, N.Y. TIMES DEALBOOK, May 22, 2009, http://dealbook.blogs.nytimes.com/2009/05/22/fdic-charges-banks-new-fee-to-replenish-fund/.

[29] Joe Adler, *FDIC Levies Special Premium*, AM. BANKER, May 22, 2009, http://www.americanbanker.com/issues/174_102/-378956-1.html; *F.D.I.C. Charges Banks New Fee to Replenish Fund*, N.Y. TIMES DEALBOOK, May 22, 2009, http://dealbook.blogs.nytimes.com/2009/05/22/fdic-charges-banks-new-fee-to-replenish-fund/.

[30] Joe Adler, *FDIC Levies Special Premium*, AM. BANKER, May 22, 2009, http://www.americanbanker.com/issues/174_102/-378956-1.html.

[31] Joe Adler, *Four More Failures Hit Industry: Closures bring an estimated cost of $1.1 billion to the FDIC*, AM. BANKER, July 20, 2009, http://www.americanbanker.com/issues/174_137/-1000138-1.html.

[32] Ben Rooney, *3 More Down: Bank Failure Tally Hits 92,* CNN MONEY, Sept. 12, 2009, http://money.cnn.com/2009/09/11/news/economy/bank_failure/index.htm?postversion=2009091121.

[33] Ari Levy and Margaret Chadbourn, *Lender Failures Reach 64 as Georgia Shuts Security Bank's Units*, BLOOMBERG, July 25, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aTvSvyYr_sEE.

[34] Joe Adler, *FDIC Levies Special Premium*, AM. BANKER, May 22, 2009, http://www.americanbanker.com/issues/174_102/-378956-1.html.

[35] FDIC QUARTERLY BANKING PROFILE (Second Quarter 2009), http://www2.fdic.gov/qbp/2009jun/qbp.pdf.

[36] FDIC Press Release, FDIC Extends Restoration Plan; Imposes Special Assessment (Feb. 27, 2009), http://www.fdic.gov/news/news/press/2009/pr09030.html.

[37] Joe Adler, *Senate Approves Higher Borrowing Limit for FDIC*, AM. BANKER, May 7, 2009, http://www.americanbanker.com/issues/174_91/-378339-1.html.

FDIC's borrowing authority from Treasury, allowing the FDIC to borrow up to $100 billion, and temporarily allowing the FDIC to borrow up to $500 billion through the end of 2010 if the Federal Reserve and Treasury agree that such borrowing is necessary.[38] Although the FDIC has never had to borrow from Treasury to meet its obligations,[39] this increased line of credit provides the FDIC with additional flexibility if the Deposit Insurance Fund nears insolvency.[40]

Since the first special assessment of 2009 was adopted, FDIC Chairman Sheila Bair has repeatedly warned that a second special assessment in the fourth quarter of 2009 is likely given the health of the Deposit Insurance Fund. However, FDIC Chairman Sheila Bair has since come under pressure from lawmakers not to charge such an assessment. In response, she has announced that the FDIC would soon publish a proposal considering several alternatives, including using the borrowing authority with Treasury, borrowing from the banking industry or asking insured depository institutions to prepay their assessment for next year.[41]

FDIC Payment of Claims Under the Debt Guarantee

Payment Obligation

The FDIC's payment obligation for guaranteed debt occurs on the uncured failure of a participating entity to make a timely payment of principal or interest, as defined in the debt's governing documents, on its debt guaranteed under TLGP (referred to as a payment default).

The Master Agreement requires a participating entity to report within one business day any default in payment on *any of its indebtedness*, including debt not covered by the guarantee, without giving effect to any cure period, if that default in payment would result, or would reasonably be expected to result, in a default on guaranteed debt. The participating entity is also required to provide in the governing documents that the representative will notify the FDIC of any payment default under the guaranteed debt within one business day of such default. Once a payment obligation is triggered, the representative or, in certain cases, individual debt holders, have 60 days

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[38] Joe Adler, *Senate Approves Higher Borrowing Limit for FDIC*, AM. BANKER, May 7, 2009, http://www.americanbanker.com/issues/174_91/-378339-1.html; Margaret Chadbourn, *Obama Signs Mortgage Law Expanding FDIC Credit Line (Update 1)*, BLOOMBERG, May 20, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aVH.iGiyyw0Y&refer=home.

[39] FDIC Press Release, FDIC Extends Restoration Plan; Imposes Special Assessment (Feb. 27, 2009), http://www.fdic.gov/news/news/press/2009/pr09030.html.

[40] David Serchuk, *Bair Proposes Systemic Risk Council*, FORBES, June 19, 2009, http://www.forbes.com/2009/06/19/bair-citi-losses-intelligent-investing-pandit.html.

[41] Joe Adler, *FDIC May Seek to Avoid New Assessment*, AM. BANKER, September 21, 2009, http://www.americanbanker.com/news/fdic-may-seek-to-avoid-new-assessment-1002193-1.html.

to submit a demand notice to the FDIC or else they will lose all rights under the FDIC guarantee. To exercise its rights, the debt holder may submit a Demand and Proof of Claim form as specified on the FDIC's website.

If demand is made by an authorized representative, the Proof of Claim must include evidence of the authorized representative's capacity to act as representative, its exclusive authority to act on behalf of every debt holder and its fiduciary duty to such debt holders. In the Proof of Claim, all claimants must include evidence of the payment default and proof of ownership. The demand must also be accompanied by a copy of the governing document of the debt instrument and an assignment of the debt holder's rights, title and interest and the transfer of the debt holder's claim under an insolvency proceeding of the participating entity, including any and all distributions on the debt from the receivership or bankruptcy estate. As described below, Standard & Poor's took the position that more stringent demand requirements were necessary for the guaranteed debt to qualify for its AAA rating.

Satisfaction of the Payment Obligation

Upon a payment default and a delivery of a timely and conforming demand notice, the FDIC will make scheduled payments of principal and interest on the guaranteed debt through maturity. A payment default will not accelerate the interest and principal payments. In the case of mandatory convertible debt, the FDIC will make scheduled payments through the mandatory conversion date and will limit any principal payment to amounts paid by holders under the issuance. Under the Master Agreement, guarantee payments will be paid directly to the representative or, in the absence of a representative or for those opting not to be represented, directly to the registered holders, never to the participating entity. If guaranteed debt matures beyond the guarantee cut-off date, and the participating entity defaults before the cut-off date, the FDIC may, at its option, accelerate the indebtedness after the applicable guarantee cut-off date of either June 30, 2012 or December 31, 2012 and make a final payment of all principal and interest due without being liable for any prepayment penalty. The FDIC is not obligated to pay any additional amounts under any default or penalty provisions of the guaranteed debt. By accepting payment from the FDIC, debt holders release the FDIC from any further claim under TLGP. Any determination by the FDIC regarding the payment process may be appealed to a proper court within 60 days of the determination.

Recoupment Mechanisms on a Payment Default

The FDIC may recover guarantee payments made to debt holders through subrogation or assignment. The Master Agreement requires the governing documents to provide that, upon payment under the guarantee, the FDIC will be subrogated to the debt holder's rights against the participating entity for any amounts paid and that the debt holder or representative must also

FDIC's Rights Upon Payment

- The FDIC has two means of recovering from a participating entity that defaults on its debt:
  - Assignment or subrogation; or
  - Make-whole reimbursement payments.
- Indebtedness to the FDIC arising out of make-whole payments is an unsecured obligation of the participating entity ranking *pari passu* with existing senior unsecured debt.

execute an assignment of all of its rights to the FDIC, including the right to receive payments.

In addition, the participating entity is required to reimburse the FDIC for guarantee payments, including interest on unpaid reimbursement obligations, at the rate of the guaranteed debt instrument plus 1%, and for any reasonable expenses. Pursuant to the Master Agreement, participating entities agree to a general waiver of claims and further waive any defenses to payment obligations under guaranteed debt until all make-whole payments have been received by the FDIC.

Settling Defaults on Guaranteed Commercial Paper

The FDIC, the Depository Trust Company, the Federal Reserve Bank of New York and Treasury established a special process for settling defaults on commercial paper guaranteed under TLGP. On the day an issuing and paying agent notifies the Depository Trust Company of a refusal to pay, all holders of the defaulting entity's FDIC-guaranteed commercial paper will be paid as scheduled.

All future maturities of the defaulting entity that were in place before the default remain FDIC-guaranteed and eligible for settling a claim through the established payment process.

Use of Proceeds

The FDIC has declared that the debt guarantee should help to ensure that participating entities are able to replace pre-existing, senior unsecured debt as it comes due, but not earlier. Proceeds from the issuance of guaranteed debt cannot be used to prepay debt that is not FDIC-guaranteed.

Ratings

The three major rating agencies announced that they would generally assign the same rating given to US government debt to debt guaranteed under TLGP scheduled to mature on or before either June 30, 2012 or December 31, 2012.[42]

[42] In light of TLGP's criteria of "unconditional, irrevocable and timely" payment, backed by the "full faith and credit of the US government," Moody's Investors Service and Fitch Ratings assigned backed-AAA and backed-Prime-1 ratings (Moody's) and AAA/F1+ (Fitch) long-term and short-term ratings, respectively, to debt issues guaranteed under TLGP where the maturity of the debt is on or before either June 30, 2012 or December 31, 2012. Standard & Poor's announced that it would assign debt guaranteed under TLGP the same rating as US government obligations (AAA for long-term debt and A-1+ for short-term debt), so long as the representative was "required to demand payment . . . upon the uncured failure by the issuer to make a timely payment." In our view, in order to ensure receiving the highest rating from Standard & Poor's, the representative should be required to deliver its demand notice upon the earlier of the date that the applicable cure period ends and 60 days following the payment default.

All three rating agencies indicated that the guarantee would not affect ratings assigned to debt issuances with a maturity beyond the guarantee's expiration. Moody's viewed the debt guarantee positively for bank financial strength ratings as well as for participating entities' non-guaranteed debt. For entities that opted out of the Debt Guarantee Program, Fitch individually reviewed each case on its merits and believes that non-participants did not face negative pressure solely as a result of their decision to opt out.

Risk Weighting and Collateral Capital Treatment

Senior unsecured debt that is guaranteed under TLGP has a risk weighting of 20% as, according to the FDIC and the other federal banking agencies, the purpose of TLGP is to encourage liquidity in the market, not to provide capital relief. FDIC-guaranteed debt is accepted as collateral by the Federal Reserve's discount window.

FDIC Reporting Requirements for Participating Entities

Entities participating in the Debt Guarantee Program must file certain notifications and ongoing reports with the FDIC via *FDICconnect*.

Before a participating entity reported its first issuance of guaranteed debt, the entity had to report its debt guarantee limit, certified by its CFO. Other than insured depository institutions, participating entities also had to report whether the combined assets of all insured depository institutions affiliated with the entity constituted less than 50% of consolidated holding company assets as of the later of September 30, 2008 or the date the entity became eligible to participate in the Debt Guarantee Program.

Reporting Due at Each Guaranteed Debt Issuance

For any issuance of guaranteed debt after December 5, 2008, the participating entity must notify the FDIC of the issuance via *FDICconnect* within five calendar days of the date of issuance, as shown in the sidebar.

After completing the submission, the participating entity must certify that the debt issued does not exceed its debt guarantee limit.

Reporting Due at Month End

Within thirty days of the end of each month, all participating entities that have issued FDIC-guaranteed debt under the Debt Guarantee Program at any point must report via *FDICconnect* the total outstanding balance of FDIC-guaranteed debt and any interest accrued and unpaid on that debt as of the last day of each month. This monthly reporting obligation applies regardless of the amount of debt matured or outstanding. If a participating entity has issued no FDIC-guaranteed debt at any time during TLGP, the entity need not file a report at the end of the month.

FDIC Reporting Required Under the Debt Guarantee

Reporting Required for Guaranteed Debt Issuance:

- For each guaranteed debt issuance after December 5, 2008:
  - Participating entity must notify the FDIC of issuance; and
  - CFO or equivalent must certify that issuance does not exceed guaranteed limit.
- Information participating entity must report on *FDICconnect* upon each issuance:
  - The CUSIP number for the debt issued;
  - A description of the debt issued;
  - The type of debt issued;
  - The number of instruments;
  - The total amount of debt being reported in the submission rounded to the nearest dollar;
  - The issue date;
  - The maturity date;
  - The stated coupon or interest rate;
  - The rate type;
  - The reference rate and the spread if the reference rate indicated is "floating";
  - The interest payment frequency;
  - The date the first interest payment is due;
  - The currency denomination; and
  - The payment agent or trustee for the debt instrument.

Additional Debt Guarantee Program Reporting Requirements:

- Participating entity must report information on outstanding guaranteed debt on a monthly basis; and
- Participating entity must report any payment default that would or would be expected to result in a default on guaranteed debt within one business day.

The reporting screens on *FDICconnect* require the participating entity to report the total amount of FDIC-guaranteed debt issued and outstanding as of the period-end date and to report whether the entity has issued any non-guaranteed debt.

Participating entities also must provide additional information relating to outstanding debt as may be reasonably requested by the FDIC within ten business days of the receipt of such a request.

Disclosure to Market Participants Mandated by the Debt Guarantee

The FDIC provides mandatory disclosure language for participating entities, as described in the sidebar.

Disclosure Mandated by the Debt Guarantee

- Disclosure required for entities that have opted out: none required.
- Disclosure required for participating entities:
  - Must clearly identify the debt as either guaranteed or not guaranteed; and
  - Mandatory disclosure language provided in TLGP must be used for all issuances on or after December 19, 2008.
- Documents governing guaranteed debt must include acknowledgment by parties that the participating entity has not opted out, and, as a result, the debt is guaranteed under TLGP.

Disclosure to Potential Lenders and Investors on Each Issuance of Guaranteed Debt

Each participating entity must include a specific statement in all written materials provided to lenders or creditors regarding its FDIC-guaranteed debt issued during the applicable issuance period, including a statement that "[t]his debt is guaranteed under the FDIC Temporary Liquidity Guarantee Program and is backed by the full faith and credit of the United States."[43]

The Master Agreement requires that all governing documents for the issuance of guaranteed debt include an acknowledgment between the parties that the participating entity has not opted out, and, as a result, the debt is guaranteed under TLGP.

Disclosure to Potential Lenders and Investors on Each Issuance of Non-Guaranteed Debt

When issuing debt that is not guaranteed under TLGP, an entity participating in the Debt Guarantee Program must give disclosure to that effect. TLGP requires a mandatory disclosure statement clearly identifying that the "debt is not guaranteed under the Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Program."[44] This disclosure must be included in all written materials underlying any senior unsecured debt the entity issues during the applicable issuance period that is not covered under the Debt Guarantee Program.

[43] FDIC, Frequently Asked Questions: Temporary Liquidity Guarantee Program, http://www.fdic.gov/regulations/resources/TLGP/faq.html.

[44] FDIC, Frequently Asked Questions: Temporary Liquidity Guarantee Program, http://www.fdic.gov/regulations/resources/TLGP/faq.html.

The Transaction Account Guarantee

Coverage

The Transaction Account Guarantee provides an unlimited FDIC guarantee above the existing deposit insurance limit through June 30, 2010 for funds held at participating insured depository institutions in non-interest bearing transaction accounts, which are described in the sidebar. Under the FDIC's general deposit insurance rules, deposits that are not subject to the transaction account guarantee are insured for up to $250,000 per person per institution, through December 31, 2013. A non-interest bearing transaction account is defined as a transaction account on which interest is neither accrued nor paid and on which the participating entity does not reserve the right to require advance notice of an intended withdrawal. This definition is designed to encompass traditional demand deposit checking accounts that allow for an unlimited number of deposits and withdrawals at any time and official checks issued by an insured depository institution. As described in more detail below, the Transaction Account Guarantee Program also covers two types of interest-bearing accounts – IOLTAs and NOW accounts paying an interest rate at or below 0.5%. The Transaction Account Guarantee Program was created, in part, to help offset the competitive disadvantage that covered accounts faced in light of Treasury's Temporary Guarantee Program that provided insurance for qualifying mutual funds' money market funds.

The Transaction Account Guarantee Program was scheduled to end on December 31, 2009, but it has been extended for six months until June 30, 2010. Entities participating in the Transaction Account Guarantee have an opportunity to opt out of the extension by notifying the FDIC by November 2, 2009. The extension period was presented as an opportunity to provide for an orderly phase-out of the program, and the opt-out provision allows each participating entity the opportunity to decide whether continued participation is desirable based on that entity's condition and business plan.

IOLTAs

The definition of a non-interest bearing transaction account includes IOLTAs because, from the perspective of the law firm and clients, the account produces the same economic result as a non-interest bearing transaction account. The FDIC's protection of IOLTAs also includes attorney trust accounts designated as Interest on Lawyer Accounts. For purposes of the Transaction Account Guarantee Program, all such accounts are treated as IOLTAs.

Non-Interest Bearing Transaction Accounts

- Characteristics:
  - Interest is neither accrued nor paid (except in the case of IOLTAs and NOW accounts);
  - The entity does not reserve the right to require advance notice of an intended withdrawal.
- Examples of accounts included:
  - Payroll accounts;
  - Traditional demand deposit checking accounts;
  - Official checks issued by an insured depository institution;
  - Sweeps into certain non-interest bearing accounts;
  - Escrow accounts if they are non-interest bearing transaction accounts;
  - IOLTAs and NOW accounts that have an interest rate, from January 1, 2009 onwards, of 0.50% or lower.
- Examples of accounts excluded:
  - Interest-bearing money market deposit accounts;
  - Interest-bearing accounts offering zero interest.

NOW Accounts

NOW accounts qualify as non-interest bearing transaction accounts eligible for coverage under the Transaction Account Guarantee Program only if the participating entity commits to maintain an interest rate at or below fifty basis points through the expiration of the program.

The board of directors or other authorized officials can make such a commitment by following the participating entity's own decision-making procedures. The commitment should be in writing and reflected in the participating entity's books and records.

If a NOW account's interest rate structure is tiered or tied to an index, the account will only be fully covered by the FDIC if it is structured such that the interest rate cannot exceed fifty basis points. If the possibility exists that the interest rate may rise above fifty basis points, regardless of what level the interest rate actually reaches, the NOW account is ineligible for coverage under the Transaction Account Guarantee Program.

Sweep Accounts

The Transaction Account Guarantee Program covers only certain, limited sweep accounts provided they remain non-interest bearing. To determine whether the Transaction Account Guarantee Program covers a sweep account, the FDIC treats the funds as being in the account to which the funds were transferred. Funds are considered "swept" if the funds are transferred from one account to another account or if the non-interest bearing transaction account is reclassified.

The unlimited FDIC guarantee applies to funds swept from a non-interest bearing transaction account to any other non-interest bearing transaction account, a non-interest bearing savings deposit account or a non-interest bearing money market deposit account. The Transaction Account Guarantee Program's coverage applies even if the funds are classified on the participating entity's general ledger as a non-interest bearing savings account. The inclusion of funds swept to a non-interest bearing savings deposit account is based upon the premise that the sweep of the funds for reserve purposes does not change the basic nature of the funds. Consequently, if funds in a guaranteed low-interest NOW account are swept into a low-interest savings deposit account, with an interest rate no higher than fifty basis points, the funds will not lose the benefit of the unlimited FDIC guarantee.

Calculation of Fees

The fee assessed on insured depository institutions participating in the Transaction Account Guarantee Program through December 31, 2009 is an annualized ten basis points on balances in non-interest bearing transaction accounts that exceed the $250,000 FDIC deposit insurance limit, as

determined on a quarterly basis by reference to the institution's call reports or equivalent. The fee is based on the balances in the accounts at the end of each quarter, not the average amount of the balances during the quarter.[45] The amount includes any amounts swept from a non-interest bearing transaction account into a non-interest bearing savings deposit account at quarter end. Accounts with pass-through coverage are assessed considering each beneficiary's balance separately.

Each entity participating in the Transaction Account Guarantee Program extension through June 30, 2010 is subject to increased fees for the extension period, based on the risk category to which the entity is assigned for purposes of the risk-based premium system. All participating entities assigned to Risk Category I of the risk-based premium system will be charged an annualized fee of 15 basis points on their deposits in non-interest bearing transaction accounts for the portion of the quarter in which they are assigned to Risk Category I. Participating entities in Risk Category II will be charged an annualized fee of 20 basis points, and participating entities in Risk Category III or IV will be charged an annualized fee of 25 basis points.

Disclosure Requirements

Every participating entity that offers non-interest bearing transaction accounts must provide, in the lobby of its main office and its domestic branches and, if it offers Internet deposit services, on its website, a notice of whether or not it is participating in the Transaction Account Guarantee Program. The postings and notices must be updated to reflect whether an entity is participating in the extended Transaction Account Guarantee Program. If the entity uses sweep arrangements or takes other actions that result in funds being transferred or reclassified to an account that is not guaranteed under the program, the entity must disclose those actions to affected customers and clearly advise them, in writing, that such actions will void the FDIC's guarantee for such funds.

Payments in Receivership

The FDIC's payment obligations in connection with the Transaction Account Guarantee Program follow established procedures. The FDIC is generally required to pay claims of depositors holding non-interest bearing transaction accounts "as soon as possible" upon the failure of the insured depository

[45] As a result, it is possible for some deposits — if made after the end of one quarter and withdrawn before the end of the next quarter — to benefit from the unlimited insurance coverage under the Transaction Account Guarantee Program without payment of the related fee by the participating entity. Conversely, if deposits are made just before the end of a quarter, the participating entity will have to pay the full fees on those balances as of the end of the quarter, even if the average balances of those deposits calculated for the full quarter would have been significantly lower.

institution. In most cases, the FDIC expects payment to be made within one business day following a participating entity's failure, by making a new insured deposit of like amount available at another insured depository institution. If the account cannot be transferred to another insured depository institution, the FDIC will mail a check for the full amount of the guaranteed deposit "within days." Although the FDIC retains the discretion to require a depositor to file a proof of claim, the FDIC has stated that it does not anticipate that a proof of claim would ordinarily be required.

The FDIC's determination of the guaranteed amount will be considered final, but a non-interest bearing transaction account depositor may seek judicial review of the FDIC's determination on payment of the guaranteed amount in the United States district court for the federal judicial district where the principal place of business of the insured depository institution is located within 60 days of the date on which the FDIC's final determination is issued.

FDIC Oversight and Enforcement

All entities that participate in TLGP are subject to FDIC oversight for compliance with the terms of TLGP. By participating, they agree to be subject to the FDIC's authority to request information and conduct on-site reviews to verify such compliance. The FDIC has described this oversight as "normal" and designed to "prevent rapid growth or excessive risk taking."[46] Participation in TLGP did not result in a change in any entity's primary federal banking agency. The FDIC will consult with a participating entity's primary federal banking agency in enforcing the provisions of TLGP.

For entities participating in the Debt Guarantee Program, the FDIC may consider a payment default an unsafe or unsound practice, and such a determination could result in an enforcement action under the Federal Deposit Insurance Act. Furthermore, for insured depository institutions, conditions giving rise to the FDIC's obligation to pay on its guarantee are a sufficient basis for the FDIC to appoint itself as conservator or receiver of such an institution. The Master Agreement clarifies that the FDIC has the ability to take enforcement actions against participating entities for breach of the Master Agreement, false or misleading statements in connection with the entity's participation in the Debt Guarantee Program or statements made in bad faith with the intent to influence the actions of the FDIC. Such actions may include the termination of participation in the Debt Guarantee Program. Any such termination would be prospective only, and therefore any guaranteed debt outstanding at the time of the action would remain guaranteed.

[46] FDIC, Technical Briefing on the Temporary Liquidity Guarantee Program (Oct. 14, 2008), http://www.fdic.gov/regulations/resources/tlgp/101408_am.html.

Outlook

In connection with the Notice of Proposed Rulemaking for the phase-out of the Debt Guarantee Program, on September 9, 2009, FDIC Chairman Sheila Bair said that, "[a]s domestic credit and liquidity markets appear to be normalizing and the number of entities utilizing the Debt Guarantee Program has decreased, now is an important time to make clear our intent to end the program."[47] Similarly, when approving the six-month extension of the Transaction Account Guarantee Program on August 26, 2009, the FDIC expressed the view that the extension would allow for an orderly phase-out of the program.

The decision to close the issuance window under the Debt Guarantee Program on October 31, 2009, with the possible exception of an emergency facility, did not come unexpectedly. The FDIC's decision in March 2009 to raise the cost of participation by imposing additional surcharges, as discussed above, was intended to encourage a gradual phase-out of TLGP. The proposed emergency facility at significantly higher costs to participating entities, as well as the extension of the Transaction Account Guarantee Program at increased and risk-adjusted fees, were equally designed to assist in the phase-out of TLGP.

What may have ultimately facilitated the conclusion of the Debt Guarantee Program as planned is many large participating entities' voluntary pledge to stop issuing FDIC-guaranteed debt in order to lay the foundation for repaying their TARP funds. In fact, as noted above, as of September 10, 2009, there had only been eight issuances of FDIC-guaranteed debt in the third quarter of 2009. With troubled insured depository institutions reaching numbers not seen since the end of the savings and loans crisis, it is currently unclear whether the Transaction Account Guarantee Program will expire on June 30, 2010 as currently scheduled. Comptroller of the Currency John Dugan has already stated that he would like to consider an additional extension of the Transaction Account Guarantee Program beyond June 30, 2010.

Outstanding Debt Maturities

Debt refinancing needs through 2012 are likely to be immense. From June 2009 through year-end, it is estimated that an additional $172 billion in debt in the market will mature. In 2010, it is estimated that $245 billion in debt

[47] *FDIC May Extend Debt Guarantee Program For Banks*, ASSOCIATED PRESS, Sept. 9, 2009, http://www.nytimes.com/aponline/2009/09/09/us/politics/AP-US-FDIC-Bank-Guarantees.html.

will come due.[48] Approximately 72% of debt due by the end of 2009 and 58% of debt maturing in 2010 is floating-rate debt.[49]

The amount of debt which must be repaid or refinanced continues to increase after 2010. In the United States, it is estimated that approximately $1.1 trillion of senior bank bonds will mature by December 2012, a figure that includes $475 billion of FDIC-guaranteed debt coming due largely in 2011 and 2012.[50] Approximately $430 billion in leveraged loans, which were used to finance the wave of leveraged buyouts from 2005 through 2007, are due to mature between 2012 and 2014. This flood of supply in a market with little demand has led some bank executives to question whether the financial system can withstand such large amounts of debt coming due just as liquidity-enhancing government programs expire.[51] Conditions in the market for debt issued by insured depository institutions, their holding companies or their affiliates will have to continue to stabilize in order to support refinancings by such entities in the absence of the Debt Guarantee Program.

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[48] Gretchen Morgenson, *Debts Coming Due at Just the Wrong Time*, N.Y. TIMES, June 14, 2009, at BU1, http://www.nytimes.com/2009/06/14/business/14gret.html.

[49] Gretchen Morgenson, *Debts Coming Due at Just the Wrong Time*, N.Y. TIMES, June 14, 2009, at BU1, http://www.nytimes.com/2009/06/14/business/14gret.html.

[50] Richard Barley, *No Guarantees for Bank-Debt Refinancing*, WALL ST. J., July 6, 2009, http://online.wsj.com/article/SB124683485464097775.html. It should be noted that Europe will also face a similar refinancing crunch, with approximately €1.9 billion in bank debt maturing by December 2012.

[51] Gretchen Morgenson, *Debts Coming Due at Just the Wrong Time*, N.Y. TIMES, June 14, 2009, at BU1, http://www.nytimes.com/2009/06/14/business/14gret.html.

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http://www.fdic.gov/regulations/resources/TLGP/chairman_statement.html

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http://www.fdic.gov/news/board/TLGPreg.pdf

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http://www.fdic.gov/news/board/08BODtlgp.pdf

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http://www.fdic.gov/regulations/laws/federal/2009/09FinalAD37mod.pdf

Final Rule Extending Debt Guarantee Issuance Window to October 31, 2009
http://www.fdic.gov/regulations/laws/federal/2009/09FinalAD37.pdf

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http://www.fdic.gov/news/board/aug26no4.pdf

Notice of Proposed Rulemaking to Establish Emergency Guarantee Facility
http://www.fdic.gov/news/board/NoticeSept9no6.pdf

FDIC FAQ on TLGP
http://www.fdic.gov/regulations/resources/TLGP/faq.html

TLGP Master Agreement
http://www.fdic.gov/regulations/resources/TLGP/master.pdf

FDIC Guidance on FDIC-Guaranteed Debt Claims Payment Process (Non-Commercial Paper)
http://www.fdic.gov/regulations/resources/TLGP/payment_process.html

Memorandum of Understanding: Settlement Procedures on FDIC-Guaranteed Commercial Paper
http://www.fdic.gov/regulations/resources/TLGP/Payment_Timeline.pdf

TLGP Demand and Proof of Claim Form
http://www.fdic.gov/regulations/resources/TLGP/claims.html

CHAPTER 6: THE TERM ASSET-BACKED SECURITIES LOAN FACILITY

James A. Florack, Leor Landa and Danforth Townley

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Introduction

The financial crisis has deeply affected the securitization market. In a period of months, the pendulum swung from a condition in which the financial markets assigned too low a value to the risk of certain securitization asset classes – such as subprime mortgages – to one in which seemingly the only securities that were readily marketable were those with an explicit or implicit government backing. Issuance of securities backed by credit card receivables and auto loans slowed to a trickle, and the sale of new CMBS ceased altogether. The absence of a functioning securitization market in turn severely constrained the practical ability of banks and other financial institutions to extend new loans to consumers and businesses.

In an effort to revive the ABS markets and provide "a critical channel for supply of new credit to households,"[1] the Federal Reserve created TALF, which began operations in March 2009 under the administration of the Federal Reserve Bank of New York. Recently, Secretary Geithner characterized TALF as "[o]ne of the most important" Federal Reserve programs.[2] Through TALF, the Federal Reserve Bank of New York provides non-recourse loans to borrowers, secured by qualifying non-mortgage-backed ABS and, more recently, CMBS. The Federal Reserve Bank of New York is expected to lend up to $200 billion, but TALF may be expanded to allow the Federal Reserve Bank of New York to lend as much as $1 trillion. TALF is scheduled to stop making loans on March 31, 2010

The publication date of this Chapter is September 17, 2009. All acronyms used in this Chapter are defined in the Glossary at the front of this Manual. All terms are defined within this Chapter.

Senior associate Joerg Riegel has played a major role in the writing and research of this Chapter. Research assistance has been provided by Sparkle Alexander, Daysun S. Chang, Jennifer Grant Cooper, Peter E. Devlin, Serge Martyn, Chaoyuan Charles Shi and Kacper A. Walicki.

[1] *See* U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES 3 (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

[2] *Written Testimony of Treasury Secretary Timothy Geithner: Hearing Before the Cong. Oversight Panel,* 111th Cong. (2009) (statement of Timothy Geithner, Secretary, U.S. Dep't of the Treasury), http://cop.senate.gov/documents/testimony-091009-geithner.pdf.

for non-mortgage-backed ABS and legacy CMBS and on June 30, 2010 for newly issued CMBS. The terms "legacy" and "newly issued" are defined below under The Jury is Out: TALF on CMBS.

Initially greeted with tepid interest, the program has since gained momentum. Through September 2009, investors have requested $46.5 billion worth of TALF loans to purchase eligible ABS.[3] In the area of non-mortgage-backed ABS, TALF is considered a success by lawmakers, the Federal Reserve and business circles alike. Representative John Adler (D-NJ) described it as "ingenious,"[4] Federal Reserve Chairman Ben Bernanke said that it "has shown early success"[5] and Standard & Poor's credited it with fostering an increase in ABS issuance both within and outside of the actual usage of the facility.[6]

This Chapter discusses this "ingenious" structure, the expanding circle of participants, the asset classes TALF has impacted or may in the future impact, and speculates on the facility's possible further extension and expansion as well as life for the securitization markets after TALF.

An "Ingenious" Structure: Core Features of TALF

TALF Basics

Under TALF, the Federal Reserve Bank of New York extends to eligible borrowers loans with a term of 3 years, or in certain cases 5 years, that are secured by certain highly-rated asset-backed securities. Any loans secured by collateral with a maturity of less than 3 or 5 years, as applicable, are due upon the maturity of the ABS collateral securing that loan. Borrowers are permitted to borrow an amount equal to the value of their pledged collateral minus a haircut – generally between 5% and 16% – that varies depending on the type and average life of the security pledged. Special rules applicable to CMBS are discussed later in this Chapter. There is no maximum loan amount, but there is a minimum loan amount of $10 million.

Interest rates are set based on the type of ABS securing the loan and have generally been below market rates for comparable secured loans, if any,

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[3] *See* U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES 38 (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

[4] *Humphrey Hawkins Hearing on Monetary Policy: Hearing Before the H. Comm. on Financial Servs.,* 111th Cong. (2009) (statement of Rep. John Adler).

[5] Ben S. Bernanke, Chairman, Bd. of Governors, U.S. Fed. Reserve Sys., Reflection on a Year in Crisis, Speech at the Fed. Reserve Bank of Kansas City Annual Symposium (Aug. 21, 2009), http://www.federalreserve.gov/newsevents/speech/bernanke20090821a.htm.

[6] *See S&P: Gauging TALF amid ABS issuances, tighter spreads*, REUTERS, Aug. 11, 2009, http://www.reuters.com/article/rbssFinancialServicesAndRealEstateNews/idUSWNA118820090811.

offered in the market. The rates are set with the goal of encouraging borrowers to buy eligible ABS at yield spreads above recent historical norms but below those in a poorly functioning market.

Part of the ingenuity of TALF lies in the way it channels market forces to advance its goals. While some traditional securitization investors remained on the sidelines, more risk-tolerant investors, such as hedge funds, were attracted by the leverage provided by TALF and the corresponding potential for enhanced return on equity. In the beginning, TALF, by design, offered attractive returns on equity for several asset classes, so much so that critics warned it might offer rewards primarily to a small group of investors while placing downside risk on taxpayers.[7] As more buyers for those ABS classes emerged, however, spreads on eligible securitizations decreased significantly from their crisis highs. As a result, returns for ABS buyers diminished,[8] and some of the benefits of the program shifted to ABS originators and, potentially, consumer and small business borrowers whose loans were being securitized. In this sense, the Federal Reserve Bank of New York has furthered its goal of providing the "balance sheet capacity necessary to facilitate the continued flow of credit to households and businesses."[9] In fact, TALF has been successful enough in narrowing the spread in certain asset classes that some sophisticated investors have indicated they are curbing their participation in TALF in order to focus on higher yielding asset classes.[10]

TALF loans are non-recourse, except in certain cases of breach of agreement discussed below, meaning that investors can generally surrender the collateral to the Federal Reserve Bank of New York instead of repaying the loan. This put option may be of significant value to investors, especially given the perceived continued downside risk in the asset-backed and commercial-mortgage-backed securities markets. If collateral is surrendered to the Federal Reserve Bank of New York, it may sell the collateral to a special purpose vehicle, TALF LLC, established specifically for the purpose of purchasing and managing surrendered assets.

Through its capital structure, TALF LLC also effects a loss sharing arrangement between Treasury and the Federal Reserve Bank of New York.

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[7] *See TARP Oversight: A Six Month Update: Hearing Before the S. Comm. on Finance*, 111th Cong. 6 (2009) (statement of Prof. Elizabeth Warren, Chair, Cong. Oversight Panel), http://finance.senate.gov/hearings/testimony/2009test/033109ewtest.pdf.

[8] *See* Al Yoon, *Munder May Halt Growth of TALF Fund as Yields Drop*, REUTERS, Aug. 3, 2009, http://uk.reuters.com/article/idUKLNE57202020090803 (by one measure, return on equity available to TALF borrowers in the asset backed space have shrunk from 18% to 6%, causing at least one fund to declare that it would curb its investing in TALF ABS).

[9] William C. Dudley, President and CEO, Fed. Reserve Bank of N.Y., A Preliminary Assessment of the TALF, Remarks at the Securities Industry and Financial Markets Association and Pension Real Estate Association's Public-Private Investment Program Summit (June 4, 2009), http://www.newyorkfed.org/newsevents/speeches/2009/dud090604.html.

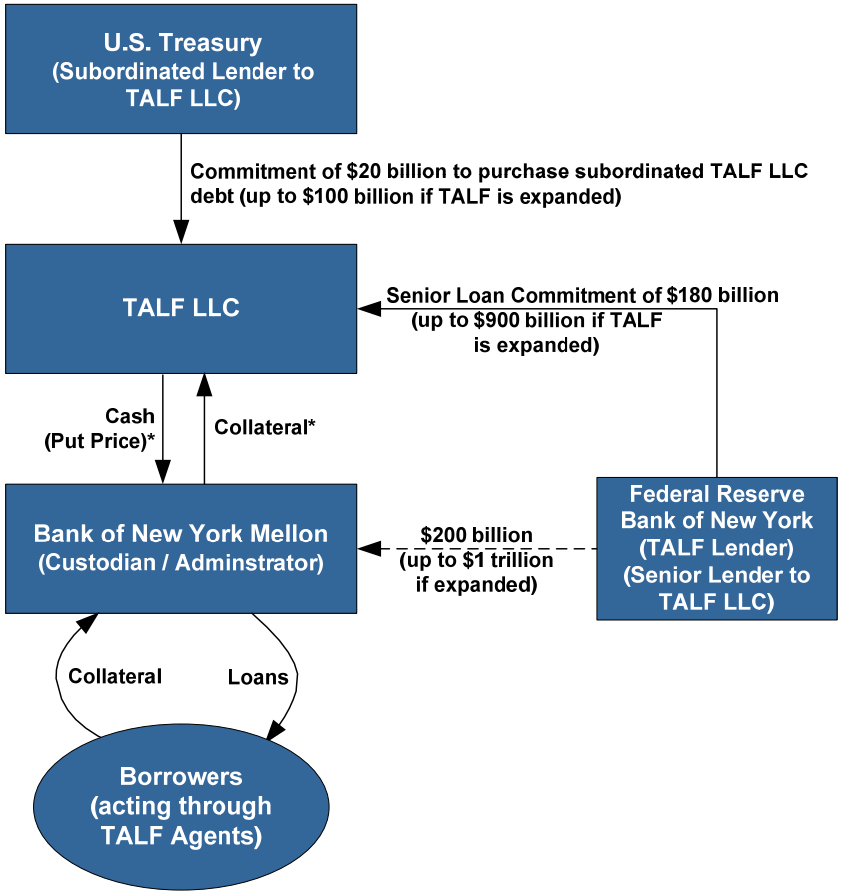
[10] *See* Al Yoon, *Munder May Halt Growth of TALF Fund as Yields Drop*, REUTERS, Aug. 3, 2009, http://uk.reuters.com/article/idUKLNE57202020090803.

Treasury provides the first loss protection in the form of a subordinated loan to TALF LLC, and the Federal Reserve Bank of New York will bear any losses in excess of such first loss protection in the form of a senior loan.

TALF LLC was initially funded by a $100 million loan from TARP. On March 3, 2009, Treasury allocated TARP funds to the purchase of a subordinated debt security by TALF LLC in the amount of $20 billion. To the extent that the program is expanded to $1 trillion, the TARP commitment is also expected to increase to up to $100 billion. As discussed later in this Chapter, the sunset of Treasury's authority to make purchases with TARP funds could impact the possible expansion of TALF.

The Bank of New York Mellon serves as the custodian bank, responsible for disbursing loan proceeds and holding collateral for the Federal Reserve Bank of New York.

TALF Structure



* Upon any collateral surrender or enforcement against collateral, Federal Reserve Bank of New York has the option to sell the collateral to TALF LLC.

Operational Mechanics

The steps required for obtaining a TALF loan are summarized in the sidebar on the following page.

For all transactions under the facility, a borrower must be represented by a "TALF Agent." TALF Agents are primary dealers, as well as dealers specifically designated by the Federal Reserve Bank of New York as TALF Agents. They serve an important screening function within the framework of TALF, which is explained in more detail below under TALF Agents.

Non-mortgage-backed ABS TALF loans are offered in the first half of each month, and CMBS TALF loans are offered in the latter part of each month. Before the subscription date, the borrower must submit a loan package to its TALF Agent containing details of the loan request, including the loan amount requested, applicable interest rate type (*i.e.*, fixed or floating) and information identifying the collateral (*e.g.*, CUSIP numbers). Generally, the borrower cannot pledge more than one security as collateral for a single loan. The TALF Agent then submits a loan package to the Federal Reserve Bank of New York and the Bank of New York Mellon on the subscription date, which includes the loan packages from all borrowers serviced by that TALF Agent and the total requested loan amount.

After the Bank of New York Mellon reviews the loan packages, it notifies each TALF Agent of the approved loan amount, the collateral to be delivered, the administrative fee and the haircut amount. On the loan settlement date, the TALF Agent delivers such funds and securities to the Bank of New York Mellon, who in turn credits the TALF Agent's account with the loan amount. The TALF Agent then disburses the loan amount to the individual borrowers. Although the Federal Reserve Bank of New York expects the collateral to be delivered by the settlement date, a borrower will not incur a penalty for failing to provide a security on the settlement date; however, the Federal Reserve Bank of New York will cancel the portion of the loan that would have been collateralized by the missing collateral without refunding the applicable administrative fee to such borrower. With respect to a loan expected to be secured by newly issued ABS, a borrower is not required to own on the subscription date the ABS it plans to pledge as collateral for such loan, but must deliver the collateral by the settlement date. By contrast, the purchase of a legacy CMBS must settle no later than the relevant TALF loan subscription date.

Under most circumstances, the Federal Reserve Bank of New York will fulfill the loan request of every eligible borrower who posts eligible collateral, and the Federal Reserve Bank of New York also has a pre-certification policy in place for certain classes of borrowers. However, in rare circumstances, the Federal Reserve Bank of New York can refuse a borrower's funding request if it believes that a borrower's ability to independently assess the risk of investment in the pledged ABS is impaired due to such borrower's economic interest in the underlying loans or leases backing the ABS. The Federal Reserve Bank of New York's expanded ability to reject loan requests to fund legacy CMBS is discussed below under Discretion to Reject CMBS.

There is no limit on how many loans a borrower may request at each monthly subscription window, and borrowers may request loans through multiple TALF Agents. A practice has developed whereby borrowers use a

Obtaining a TALF Loan

- Be an eligible borrower;
- Establish an account relationship with a TALF Agent;
- Provide the TALF Agent with required information;
- Execute a customer agreement with the TALF Agent, who thereby becomes the borrower's agent, enabling the borrower to become a party to the loan agreement with the Federal Reserve Bank of New York;
- Notify the TALF Agent of the loan request before the monthly subscription window;
- Deliver to the TALF Agent the collateral, applicable haircut and administrative fee.

dealer participating as an underwriter in an ABS issuance as their TALF Agent for the TALF loan secured by securities from such issuance. This practice has been made possible, in part, by a letter of the Securities and Exchange Commission granting a limited exemption from Section 11(d)(1) of the Securities Exchange Act of 1934 that otherwise prohibits primary dealers that participate as members of selling syndicates or groups from facilitating the extension or maintenance of certain credit.[11]

Interest payments are due monthly, and are payable to the Bank of New York Mellon as custodian. To the extent the interest rate charged by the Federal Reserve Bank of New York is lower than interest earned on the collateral, the borrower will generally not need to make a monthly payment. Instead, the borrower will receive a net interest payment, subject to certain limits on the distribution of net carry that are determined according to a formula set by the Federal Reserve Bank of New York based on the term of the loan. For five-year TALF loans, net carry earned on ABS is remitted to borrowers only up to a per annum threshold, with the rest of net carry applied to the TALF loan principal. The per annum threshold is 25% of the original haircut amount for each of the first three years, 10% for the fourth year and 5% for the fifth year of the TALF loan. For three-year TALF loans secured by legacy CMBS, net carry will be remitted to borrowers in each loan year until it reaches 30% per annum of the haircut, with the rest applied to the loan principal. Net carry is determined at the same frequency that principal and interest is remitted on the pledged collateral (*i.e.*, monthly, quarterly or semi-annually).

Generally, any remittance of principal on the collateral is allocated *pro rata* between the borrower and the Federal Reserve Bank of New York in proportion to the original haircut. Under certain circumstances, all cash flows received from the ABS collateral must be applied to pay accrued interest on and any outstanding principal of the TALF loan. These circumstances include certain early amortization events for any ABS collateral with a revolving or master trust, events of default under the governing agreements for non-mortgage-backed ABS collateral and depletion of credit support for CMBS collateral.

Subject to the non-recourse feature of the TALF, principal losses on the collateral are borne by the borrower. If the borrower wishes to surrender the collateral, it must submit notice and assign its rights in such collateral to the Federal Reserve Bank of New York. Under those circumstances, the borrower will not be required to repay the loan amount. However, if such notice is not submitted and the borrower simply stops making payments, the borrower would be responsible for the entire loan amount.

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[11] *See* Fed. Reserve Bank of N.Y., SEC No-Action Letter (Feb. 17, 2009), http://www.sec.gov/divisions/marketreg/mr-noaction/2009/frbny021709.pdf.

Master Loan and Security Agreement

The Master Loan and Security Agreement is the agreement entered into by the Federal Reserve Bank of New York, the Bank of New York Mellon as custodian bank and the TALF Agents on their own behalf and on behalf of the borrowers. It outlines the terms under which borrowers may request loans and borrow under TALF, contains representations, warranties and obligations of borrowers and TALF Agents, and sets forth certain terms that must be included in customer agreements between borrowers and TALF Agents.

The terms of the Master Loan and Security Agreement are subject to periodic review by the Federal Reserve Bank of New York, which generally retains the right to amend the Master Loan and Security Agreement prospectively at any time, and has done so on several occasions since the program's inception. Moreover, the Master Loan and Security Agreement incorporates by reference other TALF documents that are subject to periodic change, such as the TALF Standing Loan Facility Procedures, which encompass, among other documents, TALF Terms and Conditions and Frequently Asked Questions.[12] Key features of the Master Loan and Security Agreement are outlined below.

Representations and Warranties

The TALF Agents and borrowers make certain key representations and warranties in the Master Loan and Security Agreement. For example, the TALF Agent and each borrower serviced by the TALF Agent represent that the borrower is eligible and that all applicable collateral is eligible, and make certain representations with respect to the borrower's right to grant a security interest to the Federal Reserve Bank of New York. The TALF Agent also represents that each borrower has authorized the dealer to act on its behalf and that a customer agreement has been entered into with the relevant borrower. In addition, as discussed in more detail later in this Chapter, borrowers that wish to use legacy CMBS as collateral for TALF loans must also make certain additional representations and warranties.

A borrower's representation under the Master Loan and Security Agreement with respect to collateral eligibility is limited to the borrower's knowledge based on its review of the applicable offering materials. The standard of diligence applicable to TALF Agents is similar: TALF Agents must exercise reasonable care in confirming the accuracy of their representation as to eligibility of collateral. In meeting the reasonable care standard, the TALF Agent is expected to have reviewed the applicable offering materials,

[12] *See* Fed. Reserve Bank of N.Y., Term Asset-Backed Securities Loan Facility, http://www.newyorkfed.org/markets/talf.html (amendments to the Master Loan and Security Agreement and other program documents are posted on the Fed. Reserve Bank of N.Y.'s TALF website. Interested parties can also sign up for email alerts).

including any certifications made therein, and independently determined that the current collateral ratings conform to the eligibility criteria.

Collateral Surrender Right / Limited Recourse

Generally, the Master Loan and Security Agreement provides for non-recourse loans, in that the right of the lender to proceed against the borrower is limited to the specific collateral used to secure that loan, even if the value of the collateral does not cover the full amount of the unpaid loan. However, the Federal Reserve Bank of New York retains additional recourse against borrowers in certain limited circumstances, including if the borrower fails to satisfy borrower eligibility requirements, knowingly breaches its representations as to the collateral's eligibility or breaches certain other representations, warranties or covenants (including failure to authorize a TALF Agent as agent or lack of rights to pledge the relevant collateral). If a borrower sells the collateral below the principal amount owed on the loan, the borrower is responsible for the difference.

There are no margin calls on the loans, meaning that the Federal Reserve Bank of New York may not demand additional amounts from borrowers if the collateral decreases in value. While borrowers may elect to surrender the collateral to the Federal Reserve Bank of New York in lieu of repayment of their loans, the election cannot be made for specific collateral underlying a particular loan, but must be made for the entire pool of collateral underlying such loan.

Transferability

The Master Loan and Security Agreement permits a borrower to assign its rights and obligations with respect to any loan to another eligible borrower using an assignment and assumption agreement in the form provided on the TALF website. However, the Federal Reserve Bank of New York must consent to any assignment and such consent may be withheld for any reason. Pursuant to the current terms of the Master Loan and Security Agreement, the Federal Reserve Bank of New York will not consent to a loan assignment after March 31, 2010 (or, in the case of a loan secured by newly issued CMBS, June 30, 2010) unless it determines that there are unusual and exigent circumstances in the financial markets.

Prepayment and Substitution

During the term of the loan, a borrower may prepay its TALF loan in full or in part without any penalty on certain repayment dates set forth in the Master Loan and Security Agreement, but under no circumstances may a borrower substitute collateral.

Customer Agreement

- **Required Terms**
  - Borrower must authorize the TALF Agent to execute and deliver the Master Loan and Security Agreement to the Federal Reserve Bank of New York on its behalf;
  - Borrower must authorize the TALF Agent to act as an agent regarding loans, including delivery of all notices and instructions to the lender, custodian and administrator;
  - Borrower must authorize the TALF Agent to receive notices and instructions on its behalf from the lender, custodian and administrator. TALF Agent in turn must agree to provide copies of these documents to the borrower;
  - Borrower must agree to provide the TALF Agent with all information required pursuant to the Know Your Customer Program and anti-money laundering compliance programs; and
  - Borrower must agree that any funds to be disbursed regarding the loan will be disbursed to the TALF Agent's account for further distribution.

Customer Agreement

A customer agreement is entered into between a borrower and TALF Agent authorizing the TALF Agent to act on behalf of the borrower in connection with TALF borrowings. The Federal Reserve Bank of New York has not mandated a form of the customer agreement but the Master Loan and Security Agreement specifies minimum content for such agreements, the terms of which are described in the sidebar. Many dealers' form of customer agreement is based on a template developed by SIFMA. At the time of the launch of TALF in March 2009, industry groups such as the Managed Funds Association and the American Securitization Forum, along with certain fund managers and dealers, participated in discussions regarding the SIFMA form agreement and its terms. In response to investor complaints that the standard customer agreement favored the arrangers,[13] some of the TALF Agents have, to varying degrees, moved away from the SIFMA terms and indicated willingness to negotiate customer agreement terms on a case-by-case basis with TALF borrowers. Some common key features of the customer agreements are described below.

Agency Relationship

A power of attorney contained in the customer agreement authorizes the TALF Agent to enter into the Master Loan and Security Agreement on behalf of the relevant borrower and to grant a security interest in the ABS collateral to the Federal Reserve Bank of New York. To the extent the Master Loan and Security Agreement requires the TALF Agent to deliver documents and funds on the borrower's behalf, and deliver notices to the borrower on behalf of the Federal Reserve Bank of New York, the customer agreement sets out the terms upon which the TALF Agent will act. As the terms of the Master Loan and Security Agreement are subject to change by the Federal Reserve Bank of New York, customer agreements generally provide TALF Agents some measure of flexibility to amend the terms of the borrower/TALF Agent arrangements in order to remain consistent with the Master Loan and Security Agreement.

Certain Rights of the TALF Agent

TALF Agents typically ask in their form of customer agreement that the borrower agree that it will perform its obligations under the Master Loan and Security Agreement, that all representations and warranties made by the borrower in the Master Loan and Security Agreement are true and correct and that each loan covered by the customer agreement satisfies all Master Loan and Security Agreement requirements applicable to such loan (*e.g.*, borrower eligibility and collateral eligibility). In addition, the forms require

[13] *See The Torpor of the TALF*, ECONOMIST, Apr. 30, 2009, http://www.economist.com/businessfinance/displayStory.cfm?story_id=13579218.

borrowers to indemnify TALF Agents to some extent for damages arising out of the transactions contemplated by the customer agreement, subject to certain carve-outs, and may contain more or less broadly construed set-off rights favoring the TALF Agent. For certain borrowers, in particular special purpose vehicles formed for the purpose of holding a TALF-financed investment, TALF Agents may request parent guarantees or cross-indemnification obligations across multiple entities.

Termination Options

Where the TALF Agent retains the right under the customer agreement to terminate a TALF Agent/borrower arrangement, significant negative consequences for TALF borrowers may result. If the TALF Agent terminates a customer agreement, the borrower may be required to take certain actions, for instance: causing the TALF Agent to be replaced, causing the loan to be transferred according to the procedures for permitted transfers under the Master Loan and Security Agreement or surrendering the relevant collateral in accordance with the terms for collateral surrender under the Master Loan and Security Agreement. The circumstances under which TALF Agents may terminate a TALF Agent/borrower relationship vary.

Fraud Prevention

The TALF contains various certification, attestation and due diligence requirements aimed at managing the Federal Reserve Bank of New York's risk and assuring compliance. Several of these requirements are discussed later in this Chapter. In addition, an enforcement initiative has been implemented. The TALF Task Force is a multi-agency task force that was established earlier this year to deter, detect and investigate instances of fraud. The task force aims to proactively identify individuals who attempt to profit criminally from TALF and is comprised of SIGTARP, the Board of Governors of the Federal Reserve System, the Federal Bureau of Investigation, the Financial Crimes Enforcement Network, US Immigration and Customs Enforcement, the Internal Revenue Service Criminal Investigation, the Securities and Exchange Commission and the US Postal Inspection Service. Representatives of each agency meet on a regular basis.

Further compliance measures have been and may in the future be implemented as a result of recommendations formulated by SIGTARP in quarterly reports to Congress. For instance, in an April 2009 report to Congress, SIGTARP, whose oversight extends to TALF due to the fact that TARP funds provide a first loss protection to the Federal Reserve Bank of New York as described earlier in this Chapter, recommended mandating public disclosure of the identity of borrowers who surrender TALF collateral and the development of additional compliance protocols for all TALF transaction participants, some of which have since been implemented. Several fraud prevention features specifically applicable to legacy CMBS were also implemented partly in response to SIGTARP recommendations.

Participants in TALF

Investment Funds and Beyond: Eligible Borrowers

Eligible Borrowers

- Business entities or institutions organized under US law with significant operations in US;
- US branches or agencies of foreign banks that maintain reserves with Federal Reserve;
- US insured depository institutions;
- Investment funds organized under US law and managed by managers with principal places of business in US (including US-organized subsidiaries of foreign entities managed by a US investment manager with a principal place of business in the US); and
- Excludes any entity controlled by a foreign government or managed by an investment manager controlled by a foreign government, with certain exceptions.

Borrowers eligible to participate in TALF include any "US company" that owns eligible collateral and maintains an account relationship with a TALF Agent. The sidebar details the entities who are considered "US companies" eligible to participate. Entities controlled by foreign governments (*i.e.*, where a foreign government holds power to vote 25% or more of a class of voting securities) or managed by investment managers controlled by foreign governments are generally not eligible. However, there are exceptions for foreign government-controlled US insured depository institutions and foreign banks with a branch or agency in the US that maintain reserves with the Federal Reserve. These entities are considered "US companies" and thus eligible to participate in TALF regardless of foreign government control.

The terms and conditions for TALF state which "investment funds" qualify as eligible borrowers. "Investment fund" is broadly defined to include any pooled investment vehicle, including a hedge fund, private equity fund or mutual fund, as well as a special purpose vehicle specifically created to make investments financed through the facility in securities that satisfy the eligibility requirements for TALF collateral. Investment funds that are "organized in the United States" with a "principal place of business in the United States" are eligible borrowers, as long as the funds are managed by a US-based investment manager.[14] Provided they comply with such requirements, US-organized investment fund subsidiaries of a foreign entity and newly established US-organized funds may qualify as eligible borrowers.

In addition to the borrower eligibility guidelines specified in the TALF program terms and conditions, there are additional eligibility requirements relating to due diligence programs to be administered by TALF Agents which are discussed below under Role of TALF Agents later in this Chapter.

Investment Fund Restructuring

Offshore entities are commonly used in investment fund structures managed by US-based investment managers. In particular, offshore entities may serve as entry points for foreign and US tax-exempt investors and may make investments in parallel with onshore entities established for US taxable investors. Alternatively, offshore entities may serve as the "master fund" in a "master/feeder" fund structure. As a result of the eligible borrower restrictions imposed by the Federal Reserve Bank of New York under TALF, offshore investment funds may be required to create subsidiaries or

[14] *See* Fed. Reserve Bank of N.Y., Term Asset-Backed Securities Loan Facility: Frequently Asked Questions, http://www.newyorkfed.org/markets/talf_faq.html.

otherwise modify their structures in order to obtain loans through TALF. The Federal Reserve Bank of New York, in the TALF FAQs, has specifically endorsed one such way investment funds may facilitate offshore fund participation. Under the approved structure, an offshore "master fund" managed by a fund manager with a principal place of business in the US may create a subsidiary special purpose vehicle in the US for which the US manager also serves as investment manager. If such a structure is employed, the special purpose vehicle may qualify as an eligible borrower under the TALF.

The creation of subsidiary special purpose vehicles to serve as TALF borrowers may also provide benefits for onshore funds not otherwise required to employ such structures. Restrictions on the ability of TALF borrowers to transfer TALF loans and collateral securing such loans are likely to be a factor in determining funds' opportunities to exit TALF-financed investments. To the extent ABS securing multiple TALF loans are held by the same entity, the ability of investment funds to sell individual ABS may be limited. However, investment funds may gain additional flexibility to dispose of particular ABS together with the related TALF loan to the extent they are segregated in special purpose vehicles that may themselves be sold, subject to certain conditions imposed by the Federal Reserve Bank of New York and the applicable TALF Agent.

New TALF Investment Funds

Newly formed investment funds are eligible to invest in TALF, and such funds may either invest only in TALF-eligible ABS, or may pursue multiple strategies. Since the initiation of TALF, several fund managers have launched new investment funds to invest primarily in ABS purchased with TALF financing, believing that TALF provides attractive leverage and creates opportunities for investment in the securitization markets. The terms, investment strategies and investment guidelines of these funds vary. TALF standards for eligible borrowers may be reflected in the fund managers' discretion to require mandatory withdrawal of certain classes of investors from the funds (*e.g.*, investors who are controlled by foreign governments) if such funds' participation in TALF would be jeopardized by such investors' continued participation.

Mutual Fund Participation

While mutual funds have technically been included in the definition of eligible borrower under TALF, restrictions with respect to leverage permitted to be used by such funds have raised obstacles to their participation. Generally, registered funds are restricted in their ability to borrow, since they are generally required under the Investment Company Act of 1940 to hold assets with a value of at least 300% of the amount of the fund's debt obligations. This stands in stark contrast to the ability of other types of TALF borrowers to obtain loans based on their ownership of the ABS collateral alone (roughly equivalent to a 100% asset coverage requirement)

without having to meet mark-to-market or collateral liquidity requirements. In addition, registered funds must maintain custody of the fund's assets in a prescribed manner that may conflict with the generally applicable TALF custody arrangements.

On June 19, 2009, the Securities and Exchange Commission granted no-action relief to registered open and closed-end funds that allows slightly more favorable leverage restrictions in respect of TALF loans.[15] However, rather than exempting TALF loans from the borrowing restrictions altogether, the SEC afforded secured loans under TALF the same treatment as is applicable to reverse repurchase agreements; going forward, the funds would be required to maintain a segregated asset pool of liquid assets with a mark-to-market value of 100% of the TALF loan. Thus, the no-action letter effectively reduced the asset coverage test with respect to TALF loans from 300% to closer to 200%.[16] In addition, the SEC has granted relief allowing registered funds to participate in the TALF custody arrangement with Bank of New York Mellon.

Whether the applicability of the 200% asset coverage test will suffice to attract mutual funds as TALF borrowers remains to be seen. The no-action letter clearly falls short of allowing registered funds to participate in TALF on equal terms with other borrowers, as the restrictions on leverage remain onerous. In addition, the requirement to maintain liquid assets to cover the TALF loan obligations requires that a registered fund diversify its investments away from many TALF-eligible investments.

Concerns about Restrictions on Pay and on Hiring of Foreign Workers

Since its inception, enthusiasm for TALF has been dampened by a fear among market participants that involvement in the program has the potential to entangle investors in an uncertain web of government interference.

EAWA places new restrictions on H-1B petitions filed by any recipient of funding under EESA (including all TALF borrowers, but excluding TALF Agents, acting in such capacity) or Section 13 of the Federal Reserve Act. In the case of an investment fund or special purpose vehicle borrower, EAWA's restrictions also apply to any entity owning or "controlling" 25% or more of the total equity of such borrower. An entity is deemed to control an investment fund if, among other things, the entity owns, controls or holds with power to vote 25% or more of a class of voting securities, or total equity of, the borrower. EAWA's restrictions are intended to ensure that a company covered by the restrictions does not displace US workers. The company is prohibited from hiring an H-1B visa holder for any position for

[15] *See* Franklin Templeton Invs., SEC No-Action Letter (June 19, 2009), http://www.sec.gov/divisions/investment/noaction/2009/franklintempleton061909.htm.

[16] *See* Peter Ortiz, *Franklin Paves Way for Funds to Tap Loan Program*, IGNITES, July 6, 2009, http://www.dechert.com/practiceareas/practiceareas.jsp?pg=news_detail&nw_id=10938&pa_id=19&nav.

which it has not made a good faith effort to seek a US worker or if, during the period beginning 90 days prior to the filing of the H-1B petition and ending 90 days after the filing, the company terminated the employment of any US worker employed in a similar position. The company is required to attest to the US Department of Labor that it has complied with these and other specified requirements.[17]

In addition, potential TALF borrowers have expressed concerns about retroactive application of executive compensation restrictions and potential privacy risks posed by requirements to disclose information, such as information relating to beneficial owners, to the government. Particularly in the wake of the backlash regarding payment of bonuses to employees of the American International Group, many potential investors determined that the potential risks were not worth the reward of accepting government financing.[18]

The Federal Reserve Bank of New York has attempted to address such investor concerns, with varying degrees of success. With respect to fears regarding application of TARP executive compensation restrictions to TALF participants, the Federal Reserve Bank of New York has made it clear that such restrictions will not apply to sponsors, underwriters and borrowers under TALF as a result of their participation in the program, noting that the intent of executive compensation restrictions is to guarantee that executives of government-supported companies do not unjustly benefit from such assistance. Indeed, the Treasury Regulations governing compensation applicable to recipients of TARP assistance do not apply to sponsors, underwriters and borrowers under TALF because the entities receiving funding under TALF do not enter into funding or guaranty transactions directly with Treasury. However, the Federal Reserve Bank of New York's guidance regarding the application of EAWA, particularly with respect to investment funds, remains in need of further clarification. In particular, the Federal Reserve Bank of New York's statement that an entity that owns, controls, or holds with power to vote 25% or more of a class of voting securities, or total equity of, an investment fund would be deemed to control such fund has led to confusion and concern among many investment fund managers that they, as managers of investment funds, and especially special purpose vehicles, borrowing under TALF, could become restricted by EAWA in their hiring practices.

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[17] The Federal Reserve, in consultation with U.S. Citizenship and Immigration Services, developed EAWA FAQs to provide guidance on how the EAWA applies to recipients of funding under section 13 of the Federal Reserve Act, but which do not address recipients of TARP funding. *See* Fed. Reserve Bank of N.Y., EAWA Frequently Asked Questions, http://www.federalreserve.gov/monetarypolicy/files/eawafaq.pdf.

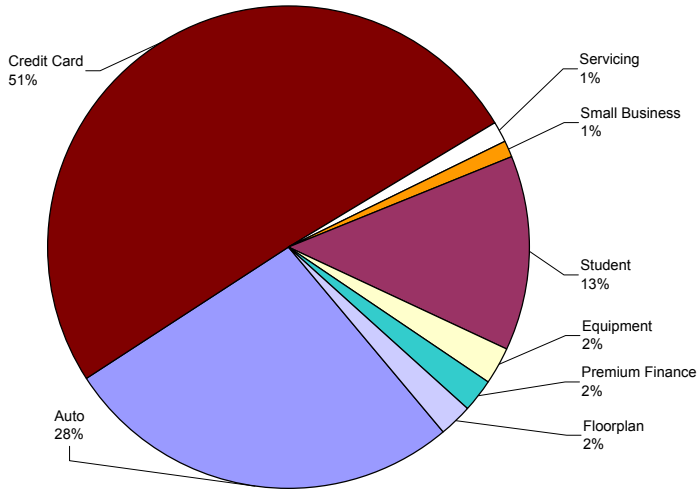
[18] *See* Laura Mandaro, *TALF Struggles to Drum Up Interest in Second Round*, MARKETWATCH, Apr. 7, 2009, http://www.marketwatch.com/story/credit-card-auto-loan-lenders.

Issuers and Sponsors

Various terms of TALF for newly issued ABS are directed primarily at the sponsors of ABS as well as at the legal entities that act as issuers (or, in the case of CMBS, as depositors) of ABS. Those terms serve two main goals: setting standards for acceptable collateral and building in safeguards against abuses of TALF.

Requirements for eligible collateral are discussed later in this Chapter. Sponsors of ABS backed by various asset classes face challenges in assembling qualifying receivable pools and adjusting their issuance practices to conform to TALF requirements. Some categories of sponsors have fared better than others. Because qualifying collateral backed by credit card receivables, car loans and certain student loans is comparatively easy to aggregate, and because of attractive TALF loan pricing and robust demand, these ABS classes have been leading TALF loan subscriptions to date (see chart below, showing non-mortgage-backed TALF loan subscriptions though September 3, 2009).

Non-Mortgage-Backed TALF
Loan Subscriptions by Category



The decision whether to fulfill TALF eligibility requirements in issuing ABS may also be impacted in some cases by structural factors, such as the availability of receivables of sufficiently high quality to achieve the required ratings without the benefit of significant overcollateralization levels or third party guarantees. As discussed below under Collateral Characteristics for Non-Mortgage-Backed ABS — Ratings Requirements, TALF-eligible securities' ratings must be obtained without the benefit of such a guarantee.

Meeting TALF issuance requirements for newly issued CMBS, which, at its height, was as big a market as auto, credit card and student loan

securitizations combined, has been particularly challenging.[19] Detailed criteria for newly issued CMBS were first announced on May 1, 2009, and sponsors have not been able to construct deals for the first four TALF loan subscription dates for this asset class. The delay has been explained by several factors, including the later launch of this part of the program and the "free-fall on fundamentals" in the commercial real estate sector.[20] In addition, a recent New York bankruptcy court decision, in which the judge ruled that special purpose entities for mortgage loans repackaged into CMBS are not bankruptcy proof and can be included in the bankruptcy process of the entities' parent, could erode CMBS holders' protection in bankruptcy proceedings and therefore further chill new CMBS issuance.[21]

First issuances of TALF-eligible CMBS are expected for the end of 2009.[22] They will likely involve single borrower securitizations, as banks are reluctant to take on warehousing risks associated with pooling loans from several borrowers.[23] It is expected that a large number of small developers and commercial property owners may face challenges meeting qualification requirements.[24]

In an attempt to alleviate some of the concerns raised by the lengthy preparation stage for CMBS, the Federal Reserve Bank of New York is considering allowing issuers to reserve prospective funding of TALF loans secured by newly issued CMBS against a reservation fee. No decision has been made whether such a feature will indeed be offered, and what the proceeding will look like. As currently contemplated, the reservation feature would not extend beyond the last subscription date for newly issued CMBS, nor would it exempt from satisfying all borrower and collateral eligibility requirements.

In order for newly issued ABS to qualify as TALF collateral, issuers and sponsors, as well as in certain cases direct and indirect parents of a sponsor, must certify in connection with the prospectus or other offering document that the ABS offered are TALF eligible, and that no untrue statements have been made to the rating agencies in order to obtain the required rating,

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[19] *See* Lingling Wei, *Mall Owner Prepares TALF Deals*, WALL ST. J., July 22, 2009, at C1, http://online.wsj.com/article/SB124821069749669769.html.

[20] Mark Anderson, *Bank notes: TALF help should help CRE debt, eventually,* FIN. AND COM., Aug. 21, 2009 (subscription needed), http://www.finance-commerce.com/article.cfm/2009/08/21/BankNotes-TALF-help-should-help-CRE-debt--eventually.

[21] *See* Aleksandrs Rozens, *Judge's Decision Could Chill the CRE Market*, INVESTMENT DEALERS' DIG., Aug. 21, 2009, at 1, http://www.iddmagazine.com/issues/2009_32/judges-decision-could-chill-cre-196865-1.html.

[22] *See* Aleksandrs Rozens, *Judge's Decision Could Chill the CRE Market*, INVESTMENT DEALERS' DIG., Aug. 21, 2009, at 1, http://www.iddmagazine.com/issues/2009_32/judges-decision-could-chill-cre-196865-1.html.

[23] *See* Lingling Wei, *Mall Owner Prepares TALF Deals*, WALL ST. J., July 22, 2009, at C1, http://online.wsj.com/article/SB124821069749669769.html.

[24] *See* Lingling Wei, *Mall Owner Prepares TALF Deals*, WALL ST. J., July 22, 2009, at C1, http://online.wsj.com/article/SB124821069749669769.html.

which is described below. If collateral is later found to be ineligible, the Federal Reserve Bank of New York and TALF LLC are entitled to indemnification by the issuer and the sponsor (and its parent, where applicable) to the extent of damages suffered, with further remedies available in the event of fraud.

For newly issued CMBS to qualify as TALF collateral, the sponsor's accounting firm must provide to the Federal Reserve Bank of New York a TALF-Specific Agreed-Upon Procedures Report on factual matters related to various eligibility criteria of the CMBS, as well as a copy of such report, including any updates made to it, that it delivers to the sponsor and the underwriter or the initial purchaser with respect to the CMBS issuance. No such report is required to obtain TALF loans secured by legacy CMBS. For non-mortgage-backed ABS, sponsors must obtain auditor attestations, details of which are described on the TALF website.

In addition, the Federal Reserve Bank of New York conducts further due diligence on the major participants in CMBS transactions, including issuers, loan sellers and sponsors of mortgage borrowers, and an onsite inspection program is currently under development.

TALF Agents

- **Screening Function**
  - Assess borrower risk pursuant to Know Your Customer program;
  - Perform due diligence with regard to collateral eligibility;
  - Provide customer risk assessment methodology to Federal Reserve Bank of New York; and
  - Communicate high risk customer information to Federal Reserve Bank of New York.
- **Administrative Function**
  - Collect loan requests, CUSIPs and offering documents of collateral securities;
  - Submit collected information to Federal Reserve Bank of New York for review;
  - Submit aggregate loan requests to Federal Reserve Bank of New York;
  - Deliver collateral securities, fee and margin to Federal Reserve Bank of New York; and
  - Deliver funds disbursed from Federal Reserve Bank of New York to borrowers.

TALF Agents

Role of TALF Agents

TALF Agents play an integral role in TALF. All borrowers must be customers of a TALF Agent, which serves as an agent for the borrower in connection with transactions with the Federal Reserve Bank of New York. Under TALF, the Federal Reserve Bank of New York does not intend to directly interface with borrowers. TALF Agents are banks or securities broker-dealers that have been pre-approved by the Federal Reserve, and as of September 1, 2009, there are 22 institutions on the Federal Reserve Bank of New York's TALF Agent list. As described above, borrowers must execute a customer agreement authorizing the TALF Agent to execute the Master Loan and Security Agreement as agent on the borrower's behalf.

The mandatory intermediation of TALF Agents helps alleviate potential concerns about the inclusion of private unregulated entities in the program by performing a "screening" function with respect to borrowers. The obligation of the TALF Agent is to ensure that every customer who requests a TALF loan is an eligible borrower. TALF Agents must assess borrower risk by applying internal customer identification and due diligence procedures to their customers, as well as communicating information on high risk customers to the Federal Reserve Bank of New York.

TALF Agents must subject each potential borrower to their Know Your Customer Program. It must also send information to the Federal Reserve Bank of New York identifying (i) each "specified borrower" who the TALF Agent has flagged as warranting special scrutiny, and (ii) each entity that the TALF Agent "looks through" pursuant to its program or industry practices,

and the persons and entities to which the TALF Agent looks through. For instance, TALF Agents generally look through captive or semi-captive funds. The extent of the look-through requirements may vary among the dealers, but generally the Federal Reserve Bank of New York expects look-through identification procedures in cases where special purpose vehicles are established for purposes of investing in TALF or if an investment fund has material investors (*i.e.*, owning more than 10% of the fund).

Since the Federal Reserve Bank of New York is permitted to disclose any information it receives to oversight bodies, including Congress, to the extent required by law or subpoenas, investor privacy may be a significant concern for investment funds contemplating TALF investments. Once disclosed to the Federal Reserve Bank of New York, information given by the TALF Agents identifying investors may eventually become publicly available.

As a further safeguard, TALF Agents must provide adequate information about their Know Your Customer Program and customer risk assessment methodology to the Compliance Department at the Federal Reserve Bank of New York. They must also update the Federal Reserve Bank of New York regarding any material changes to their Know Your Customer Program as long as they remain TALF participants. The Federal Reserve Bank of New York relies substantially on the due diligence and customer identification programs administered by the TALF Agents. It expects that each TALF Agent will safeguard its reputation by performing its functions diligently.

In addition to the screening function, TALF Agents are responsible for certain administrative functions outlined in the sidebar on the previous page.

Restrictions on TALF Agents' Involvement in Hedging Activities

A TALF Agent may, and typically will, participate as an underwriter in an ABS issuance in addition to acting as TALF Agent for TALF loans secured by securities from such issuance. Under the terms of the Master Loan and Security Agreement, where a TALF Agent acts in both such capacities, it is restricted from entering into hedging transactions with or on behalf of the borrower for the purpose of protecting against losses on securities purchased with TALF loans. The provision prohibits both direct hedges, including credit default swaps and correlative hedges, and indirect hedges, such as short-selling the ABX index. However, hedges on a borrower's broader portfolio, which may include securities purchased with TALF financing, and interest rate swaps with an ABS trust (but not a CMBS trust), entered into at a fair price and for the sole purpose of creating a floating-rate security based off of fixed-rate receivables, are permitted.

Rekindling Securitization Markets: The Eligible Collateral

Eligible Collateral under the first phase of TALF was limited to newly issued non-mortgage-backed ABS. On May 1, 2009, the Federal Reserve

expanded TALF to include newly issued CMBS as eligible collateral, and on May 19, 2009, further expanded the classes of eligible collateral to include legacy CMBS.

The Poster Child: Non-Mortgage-Backed ABS

Market Impact

Issuance of non-mortgage-backed ABS seems to have stabilized since TALF was introduced, even though issuance levels are still lagging significantly behind the pre-crisis levels[25] and a majority of the newly issued ABS since the launch of TALF have been supported by TALF.[26] As of September, approximately $100 billion in new ABS, backed primarily by credit-card and auto loans, had been sold during the year, with $77 billion of this amount eligible for TALF.[27] The impact of the facility was particularly noticeable in the decrease in the spreads on consumer ABS, which have fallen sharply from their peaks reached during the crisis.[28] For example, the credit spreads for two-year AAA auto and credit card ABS have dropped from almost 700 basis points in the fall of 2008 to about 100 basis points in July 2009.[29] As a further sign of normalization in the non-mortgage-backed securitization market, institutional investors, such as pension funds, appear to be renewing their participation.[30]

Collateral Characteristics for Non-Mortgage-Backed ABS

Collateral eligible under TALF includes ABS in the form of US dollar-denominated cash (*i.e.*, not synthetic) ABS. Eligible ABS must be issued on or after January 1, 2009, except for SBA Pool Certificates or Development Company Participation Certificates, which must be issued on or after

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[25] *See* Anusha Shrivastava, *Extra Credit: TALF Thaws Consumer Loan-Backed Bond Market*, DOW JONES & COMPANY, INC., June 9, 2009.

[26] *See* U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES 15 (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

[27] *See* Anusha Shrivastava, *TALF Helps Revive Securities*, WALL ST. J., Sept. 3, 2009, at C9, http://online.wsj.com/article/SB125189767141579487.html?mod=rss_markets_main.

[28] *See* U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES 7 (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

[29] *See* U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES 7 (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

[30] *See TARP Oversight: Warrant Repurchases and Protecting Taxpayers: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Servs.,* 111th Cong. (2009) (statement of Herbert M. Allison, Jr., Assistant Secretary for Financial Stability, U.S. Dep't of the Treasury), www.ustreas.gov/press/releases/tg226.htm.

January 1, 2008. The ratings requirements for qualifying ABS are discussed below.

Both publicly and privately placed ABS may be TALF-eligible. Generally, the Federal Reserve Bank of New York will not accept newly issued ABS as collateral if the issuer has an option to redeem such ABS before maturity. ABS must not bear interest payments that step up or step down to predetermined levels on specific dates. In addition, all TALF borrowers must agree not to exercise, or refrain from exercising, any voting, consent or waiver rights under a pledged ABS without the consent of the Federal Reserve Bank of New York. The ABS must be cleared through the Depository Trust Company.

TALF borrowers cannot pledge ABS for which the borrower or any affiliate originated or securitized any underlying credit exposure. In addition, if the borrower and/or its affiliates are the manufacturer, producer or seller of any products, or the provider of any services, the sale, provision or lease of which is financed by the loans or leases representing more than 10% of the aggregate principal balance of all receivables backing an ABS as of the date of issuance of the ABS, then such borrower cannot use such ABS as collateral under TALF. Similar restrictions apply for borrowers that are, or the affiliates of which are, obligors under certain commercial and government fleet leases, rental fleet leases or floorplan loans (threshold of 10%) or borrowers under commercial mortgage loans (threshold of 5%).

Ratings Requirements

To be TALF-eligible collateral, ABS must have short-term or long-term ratings in the highest investment-grade category from two or more eligible SEC-registered credit rating agencies known as NRSROs, and not have a rating by any such NRSRO that falls below the highest investment-grade rating. There are two exceptions to these ratings requirements. ABS that obtain credit ratings based on the benefit of a third-party guarantee are not eligible collateral under TALF. ABS that an eligible NRSRO has placed on review or watch for downgrade are also not included in eligible collateral. However, any subsequent downgrade of an ABS that was eligible for TALF at the time TALF financing was provided will have no effect on such existing TALF loan.

For non-mortgage-backed ABS there are currently three TALF-eligible NRSROs: Fitch Ratings, Moody's Investors Service and Standard & Poor's. The Federal Reserve intends to periodically review the list of rating agencies.

Like other programs recently established by the Federal Reserve, TALF relies on private rating agencies to make ratings determinations that impact the eligibility of collateral, thereby raising questions of whether the Federal Reserve is perpetuating the issue of reliance on credit assessments by entities whose weaknesses came to light during the credit crisis. Market participants, including one rating agency, have also expressed concerns that the programs' ratings requirements may prompt a "race to the bottom,"

as rating agencies employing lower standards might be favored by issuers seeking to obtain the required two ratings.[31]

Nonetheless, William C. Dudley, the President and CEO of the Federal Reserve Bank of New York, has defended the Federal Reserve's reliance on rating agencies, asserting that despite the fact that some rating agency models have not held up well in the crisis, consumer ABS models have proven to be reasonably strong. He also expressed a belief that investors will become less reliant on rating agencies and instead conduct their own appropriate due diligence.[32]

Regulatory initiatives are currently under way to improve the integrity of the rating agencies' rating process. These initiatives have focused on enhancing the transparency of the rating process through greater disclosure of rating agencies' procedures and methodologies and strengthening rules addressing conflicts of interest. On July 14, 2009 the SEC's Chairman, Mary Schapiro, announced a plan to create a new entity within the SEC whose sole purpose is to oversee and examine credit-rating agencies.[33] On September 17, 2009, the SEC held an open meeting on measures to strengthen the oversight of credit rating agencies. At the meeting, the SEC voted unanimously to take several rulemaking actions, including the adoption of amendments designed to reduce reliance on credit ratings by eliminating references to NRSRO ratings from certain SEC rules and forms. Also adopted were rules to provide investors with greater information concerning ratings history and to promote unsolicited ratings by providing all NRSROs with equal access to data underlying structured finance products. The SEC also proposed rules that would enhance credit rating agencies' compliance programs, further eliminate references to NRSRO ratings from SEC rules and forms, and require additional disclosure about the meaningfulness of ratings and the potential existence of revenue-related conflicts of interest.[34] In addition, recently proposed legislation introduced by Treasury would require registration of all credit rating agencies as NRSROs, further enhance the SEC's supervision of credit rating agencies,

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[31] OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 185 (July 21, 2009), http://www.sigtarp.gov/reports/congress/2009/July2009_Quarterly_Report_to_Congress.pdf; *See also* Caroline Salas, *Fed's TALF Fuels Rating 'Shopping,' Moody's Says*, BLOOMBERG, June 4, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aWCvq9XF63rY.

[32] *See* William C. Dudley, President and CEO, Fed. Reserve Bank of N.Y., A Preliminary Assessment of the TALF, Remarks at the Securities Industry and Financial Markets Association and Pension Real Estate Association's Public-Private Investment Program Summit (June 4, 2009), http://www.newyorkfed.org/newsevents/speeches/2009/dud090604.html.

[33] *See SEC Oversight: Current State and Agenda: Hearing Before the Subcomm. on Capital Markets, Insurance and Government-Sponsored Enterprises of the H. Comm. on Financial Servs.,* 111th Cong. 10 (2009) (statement of Mary L. Schapiro, Chairman, Securities and Exchange Commission), http://www.house.gov/apps/list/hearing/financialsvcs_dem/sec_testimony.pdf.

[34] SEC Press Release, SEC Votes on Measures to Further Strengthen Oversight of Credit Rating Agencies (Sept. 17, 2009), www.sec.gov/news/press/2009/2009-200.htm. *See also* SEC Fact Sheet: Strengthening Oversight of Credit Rating Agencies (Sept. 17, 2009), http://www.sec.gov/news/press/2009/2009-200-factsheet.htm.

and impose investor protection requirements.[35] However, critics have been vocal in their assertions that current initiatives do not go far enough. Such critics have suggested further-reaching initiatives, such as requiring rating agencies to perform their own due diligence to verify information presented to them by issuers and exposing rating agencies to meaningful legal liability risks.[36] The SEC has actively engaged such critics and recently voted to issue a concept release considering whether to subject NRSROs to liability when their ratings are used in connection with a registered offering.[37]

Pool and Receivable Requirements

In furtherance of the Federal Reserve's objective of increasing credit available to domestic consumers and small businesses, for an ABS to be eligible, 95% or more of the dollar amount of the underlying credit exposures of the security must be exposures to US-domiciled obligors or with respect to US real property, and must originate with US-organized entities or institutions or US branches or agencies of foreign banks.

The categories of non-mortgage-backed ABS that are eligible include securities backed by auto loans and leases, student loans, credit card receivables, equipment loans and leases, floorplan receivables, insurance premium finance loans, small business loans fully guaranteed as to principal and interest by the SBA, and receivables related to residential mortgage servicing advances.

The underlying credit exposures may not contain exposures that are themselves cash ABS or synthetic ABS. For credit card, auto lease, floorplan and equipment lease securitizations, the underlying exposures may contain intermediate securities (*i.e.*, financial assets that represent an interest in or the right to payments or cash flows from another asset pool) created in the normal course of business solely to facilitate the issuance of an ABS. In such cases, for purposes of determining whether the exposures underlying an ABS meet the eligibility requirements for TALF collateral, the credit exposures underlying the intermediate securities are considered to be the underlying exposures of the ABS itself.

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[35] *See* U.S. Dep't of the Treasury Press Release, Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward Credit Rating Agency Reform Legislation Sent to Capitol Hill, (Jul. 21, 2009), http://www.ustreas.gov/press/releases/tg223.htm.

[36] *See* Andrew Ackerman, *Lawmakers Fault Obama's Plan to Regulate Raters*, AM. BANKER, Aug. 6, 2009, http://www.americanbanker.com/issues/174_150/lawmakers_fault_obamas_plan_to_regulate_raters-1000728-1.html.

[37] The concept release was voted upon at the SEC's September 17, 2009 open meeting. At the time of the publication of this Manual, the SEC had not yet posted the text of the release to its website. For a summary of the concept release, see SEC Fact Sheet: Strengthening Oversight of Credit Rating Agencies (Sept. 17, 2009), http://www.sec.gov/news/press/2009/2009-200-factsheet.htm.

The average life for auto loan, credit card, equipment loan, floorplan, insurance premium finance or servicing advance receivable ABS must not be greater than five years. Information related to a newly issued ABS's average life is usually published by the issuer in the relevant prospectus or offering document.

TALF Loan Details for Non-Mortgage-Backed ABS

Interest Rates and Fees

In determining the attractiveness of TALF-eligible ABS deals, investors will look at the cost of funding, including fees, as well as haircuts. The Federal Reserve Bank of New York has stated that both haircuts and interest rates will be periodically reviewed to fulfill the policy objectives of the facility.

Interest rates for TALF loans are based on the type of underlying collateral securing the loan. The rates are set to provide an incentive to borrowers to purchase eligible ABS at yield spreads higher than in normal market conditions, but lower than in recent highly illiquid market conditions. Loans are priced either at a fixed or floating interest rate depending on the nature of the underlying ABS collateral, and as detailed in the sidebar.

An administrative fee of 10 basis points of the loan amount is assessed on the settlement date of each loan transaction.

Haircuts and Loan Amounts

Under TALF, borrowers are permitted to borrow up to an amount equal to the lesser of the par or market value of the pledged collateral, minus a haircut. If the market value of the pledged collateral is greater than its par value, TALF borrowers are alternatively allowed to borrow an amount equal to the market value of the pledged collateral, subject to a cap of 110% of par, minus the applicable haircut. The haircut represents the borrower's stake in the investment or their "skin in the game." Except in certain circumstances described earlier in this Chapter, the amount that the borrower can lose is limited to the haircut amount, and the government is responsible for all losses in excess of such amount.

The Federal Reserve Bank of New York has published a table of collateral haircuts based on asset classes and the expected lives of the ABS, set between 5% and 16% and covering asset classes with expected lives up to seven years. The collateral haircuts have been designed to be risk sensitive across asset class and maturity. Haircuts are based in part on the expected life of the collateral because typically the longer the average life of the asset, the greater the credit risk. Generally, for ABS with average lives of five or more years, haircuts increase by 1% for each additional year of average life at or beyond five years; but for those with a government guarantee (such as SBA and certain student loans), haircuts increase by 1% for every two years

Interest Rates Details as of September 17, 2009

Loans without government guarantee

- Floating:
  1-month LIBOR plus 100 basis points.
- Fixed 3-year loan with weighted average life of less than 1 year:
  1-year LIBOR swap rate plus 100 basis points.
- Fixed 3-year loan with weighted average life of greater than or equal to 1 year and less than 2 years.
  2-year LIBOR swap rate plus 100 basis points;
- Fixed 3-year loan with weighted average life of 2 years or greater:
  3-year LIBOR swap rate plus 100 basis points.

Loans with government guarantee

- 50 basis points (*i.e.*, 50 basis points over (i) the federal funds target rate (or the top of the federal funds target range) plus an additional 25 basis points for SBA 7(a) ABS, (ii) one-month LIBOR for Federal Family Education Loan Program ABS and (iii) three or five year LIBOR swap rate for SBA 504 ABS).

Loan secured by private student loan ABS bearing a prime-based coupon:

- Higher of 1% and the "prime rate" as defined in the Master Loan and Security Agreement, minus 175 basis points.

of average life at or beyond five years. As of August 31, 2009, the average haircut under TALF is approximately 8.2%.[38] Additional detail with respect to haircuts is set forth in the sidebar.

Collateral Haircuts as of September 17, 2009

	ABS Average Life (years)						
Sub-sector	0-<1	1-<2	2-<3	3-<4	4-<5	5-<6	6-<7
Auto Sector							
Prime retail lease	10%	11%	12%	13%	14%		
Prime retail loan	6%	7%	8%	9%	10%		
Subprime retail loan	9%	10%	11%	12%	13%		
RV/ motorcycle	7%	8%	9%	10%	11%		
Commercial & gov't fleets	9%	10%	11%	12%	13%		
Rental fleets	12%	13%	14%	15%	16%		
Floorplan Sector							
Auto	12%	13%	14%	15%	16%		
Non-Auto	11%	12%	13%	14%	15%		
Credit Card Sector							
Prime	5%	5%	6%	7%	8%		
Subprime	6%	7%	8%	9%	10%		
Equipment Sector							
Loans & Leases	5%	6%	7%	8%	9%		
Premium Finance Sector							
Property & casualty	5%	6%	7%	8%	9%		
Servicing Advancing Sector							
Residential Mortgages	12%	13%	14%	15%	16%		
Student Loan Sector							
Private	8%	9%	10%	11%	12%	13%	14%
Gov't guaranteed	5%	5%	5%	5%	5%	6%	6%
Small Business Sector							
SBA loans	5%	5%	5%	5%	5%	6%	6%

The Jury is Out: TALF on CMBS

In May 2009, the Federal Reserve expanded TALF to include both CMBS issued on or after January 1, 2009 (referred to as "newly issued" CMBS) and CMBS issued before January 1, 2009 (referred to as "legacy" CMBS). The TALF expansion to CMBS came at a time when commercial real estate prices had fallen significantly, and default and delinquency rates were rising as property values continued to decline.[39] Such trends have continued in recent months. Valued at approximately $6.7 trillion, or 13% of the US gross domestic product, the commercial real estate market has seen defaults on commercial real estate mortgages more than double from one year ago, to approximately 4.3% in the second quarter of 2009.[40] As of August 11, 2009, delinquencies on loans underlying CMBS were increasing at a rate of over $2 billion per month.[41] Federal Reserve Chairman Bernanke noted in a May 5, 2009 speech that the credit conditions in commercial real estate were so strained that almost no CMBS had been issued in nearly a year.[42] A revival of CMBS issuances is likely to be essential to supply funds needed to refinance commercial mortgage loans that will mature within the next few years. About $700 billion of CMBS are currently outstanding, with an additional $153 billion of loans underlying CMBS to come due by 2012 and $100 billion of that amount projected to encounter refinancing problems.[43] According to Federal Reserve Bank of New York President and CEO William C. Dudley, before the crisis, the CMBS market satisfied about 40% of the credit needs of the commercial

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[38] *See* U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES 39 (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

[39] *See* Hui-yong Yu, *CMBS Defaults, Delinquencies May Top 7% by Year-End, Reis Says*, BLOOMBERG, July 30, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aHOXRaIs05rU; Nicole Bullock, *CMBS Delinquencies Add $2bn per Month*, FIN. TIMES, Aug. 11, 2009, http://www.ft.com/cms/s/0/51218dd6-860e-11de-98de-00144feabdc0.html?nclick_check=1.

[40] *See* Lingling Wei and Maurice Tamman, *Commercial Loans Failing at Rapid Pace*, WALL ST. J., July 21, 2009, at M11, http://online.wsj.com/article/SB124804759792663783.html.

[41] *See* Nicole Bullock, *CMBS Delinquencies Add $2bn per Month*, FIN. TIMES, Aug. 11, 2009, http://www.ft.com/cms/s/0/51218dd6-860e-11de-98de-00144feabdc0.html?nclick_check=1.

[42] *See The Economic Outlook : Hearing Before the U.S. Cong. J. Economic Comm.,* 111th Cong. 2 (2009) (statement of Ben S. Bernanke, Chairman, Board of Governors, Federal Reserve System), http://jec.senate.gov/index.cfm?FuseAction=Files.View&FileStore_id=baa835fe-7bde-43ab-9d4f-7c5f1994ab35.

[43] *See* Lingling Wei and Peter Grant, *Commercial Real Estate Lurks as Next Potential Mortgage Crisis*, WALL ST. J., Aug. 31, 2009, at A2, http://online.wsj.com/article/SB125167422962070925.html.

mortgage market.[44] If the CMBS market remains paralyzed, then the difficulty refinancing maturing mortgages could cause another drop in commercial real estate prices, as well as an increase in loan defaults and added pressure on bank capital.[45] Hence, the success of TALF is believed by some to be critical for averting a catastrophe in commercial real estate, which could cripple the economy.[46]

While the impact of TALF on the non-mortgage-backed segment has been significant, the impact on newly issued and legacy CMBS remains to be seen. For reasons explained above under Issuers and Sponsors, sponsors were not able to assemble deals for the first four TALF loan subscription dates for newly issued CMBS. However, the first three TALF loan subscription dates for legacy CMBS yielded more than $4 billion worth of loans. The importance of TALF for legacy securities will only become fully apparent when PPIP begins to operate alongside the TALF or as a competing financing model.

Collateral Characteristics for CMBS

CMBS Payment Terms

Both legacy and newly issued CMBS must entitle the holders to payments of both principal and interest. CMBS that are interest-only or principal-only are not eligible. In addition, both legacy and newly issued CMBS must also earn interest at a fixed pass-through rate or one that is based on the weighted average of the underlying fixed mortgage rates. The average life of the CMBS must not be greater than ten years. Upon issuance, both legacy and newly issued CMBS must not be junior to other securities with claims on the same pool of loans, but CMBS that receive principal later in time than the most senior CMBS are acceptable so long as they are *pari passu* with other senior CMBS with respect to credit support.

Main CMBS Requirements

- At least two highest ratings and no lower ratings;
- Payment of both principal and interest;
- Interest at a fixed pass-through rate or weighed average;
- Issuer is not an instrumentality of the United States or GSE; and
- Generally no early redemption option for the issuer.

As with other types of ABS, all eligible CMBS must be cleared through the Depository Trust Company, and the Federal Reserve Bank of New York generally will not accept newly issued CMBS as collateral if the issuer of that CMBS has an option to redeem such CMBS before maturity.

CMBS Ratings Requirements

As of the TALF loan closing date for newly issued CMBS, and as of the TALF loan subscription date for legacy CMBS, the pledged CMBS collateral

[44] *See* William C. Dudley, President and CEO, Fed. Reserve Bank of N.Y., A Preliminary Assessment of the TALF, Remarks at the Securities Industry and Financial Markets Association and Pension Real Estate Association's Public-Private Investment Program Summit (June 4, 2009), http://www.newyorkfed.org/newsevents/speeches/2009/dud090604.html.

[45] *See* Karey Wutkowski, *FDIC's Bair Says Commercial Loans "Looming Problem,"* REUTERS, Sept. 1, 2009, http://www.reuters.com/article/GCA-CreditCrisis/idUSTRE5806QO20090901.

[46] *See* Lingling Wei, *Mall Owner Prepares TALF Deals*, WALL ST. J., July 22, 2009, at C1, http://online.wsj.com/article/SB124821069749669769.html.

must have a credit rating in the highest long-term investment-grade category (*i.e.*, AAA) from at least two CMBS-eligible rating organizations (*i.e.*, DBRS, Inc., Fitch Ratings, Moody's Investors Service, Realpoint LLC and Standard & Poor's) and not have a rating by any such rating organization that falls below the highest investment-grade rating. Similar to non-mortgage-backed ABS collateral, any CMBS that obtains a rating based on third-party guarantees, or is placed on review or watch for downgrade, cannot qualify as eligible collateral. In addition, the Federal Reserve Bank of New York does not allow an issuer of legacy or newly issued CMBS to be an agency or an instrumentality of the United States or GSE. The reason for this exclusion lies in the purpose of TALF, which is to support and encourage non-government bond issuance.

The increase of the number of rating agencies from 3 to 5 in the context of CMBS has heightened "race to the bottom" concerns.[47] For instance, SIGTARP has expressed a belief that competition among multiple rating agencies provides an incentive to employ lower standards and issue higher ratings in order to attract more clients in the future.[48]

Of more immediate concern to investors in legacy CMBS is the need for ratings stability. As the commercial mortgage market continues to erode, ratings adjustments on legacy bonds may become necessary. As a result, potential borrowers may wonder whether legacy CMBS such borrowers intend to finance through TALF will have the required ratings by the time such collateral is submitted to the Federal Reserve Bank of New York. In fact, such a scenario unfolded when Standard & Poor's recently decreased the creditworthiness on 19 classes of a $7.6 billion deal which was considered to be a benchmark for pricing CMBS. Standard & Poor's subsequently restored some of those bonds back to AAA rating, citing recently updated criteria for assessing losses on top-ranked CMBS bonds.[49] The Federal Reserve Bank of New York may have mitigated this risk somewhat by requiring that ratings of legacy CMBS satisfy the eligibility requirements as of the TALF loan subscription date, which coincides with the latest date on which the purchase of legacy CMBS for a TALF subscription window must have settled.

Discretion to Reject CMBS

Investor uncertainty may arise not only as a result of rating agencies' actions, but also due to the Federal Reserve Bank of New York's right to

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[47] *See* OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 185 (July 21, 2009), http://www.sigtarp.gov/reports/congress/2009/July2009_Quarterly_Report_to_Congress.pdf.

[48] *See* OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 185 (JULY 21, 2009), http://www.sigtarp.gov/reports/congress/2009/July2009_Quarterly_Report_to_Congress.pdf.

[49] *See* Lingling Wei and Anusha Shrivastava, *S&P Shift on Ratings Unsettles Investors*, WALL ST. J., July 24, 2009, at M11, http://online.wsj.com/article/SB124830588436973941.html.

reject any CMBS due to its own discretionary risk assessment despite compliance of such CMBS with ratings and other eligibility requirements. To assist with such risk assessment, the Federal Reserve Bank of New York selected Trepp, LLC and PIMCO as collateral monitors. It is intended that Trepp will focus on monitoring CMBS collateral while PIMCO will take on the broader role of monitoring both mortgage-backed and non-mortgage-backed ABS collateral. While the collateral monitors will provide input, the final decision on whether to reject a CMBS as collateral or exclude a specific loan from a pool is ultimately made by the Federal Reserve Bank of New York and based upon a number of factors. For instance, if any of the loans are in default, delinquent in payment or in special servicing, they may be rejected. Additionally, interests in pools with unacceptable concentrations (*e.g.*, borrower sponsorship, property type or geographic region) may also be rejected.

With respect to newly issued CMBS, the Federal Reserve Bank of New York has stated that, although the fact that loans underlying a CMBS pool are from a single borrower or limited to a single asset class does not alone render a given pool ineligible, the Federal Reserve Bank of New York will scrutinize such a pool more closely and expect it to have a higher level of creditworthiness and/or credit support to compensate for such increased concentration.

For legacy CMBS, the Federal Reserve Bank of New York will perform stress valuations on each CMBS underlying the requested TALF loan and may reject any request for which the loan amount is greater than the stress valuation.

The Federal Reserve Bank of New York accepted 35 legacy CMBS bonds and rejected one for the July 2009 CMBS subscription. The Federal Reserve Bank of New York did not discuss specific reasons for the bond's rejection, other than making clear that borrower-related reasons, such as defects in the loan application process, borrower ineligibility, or issues with the reasonableness of the secondary market transaction price, would not result in a bond being listed as rejected.

There are two general reasons why a bond may be rejected: rejected bonds either did not meet the requirements of the TALF program or were rejected based on the Federal Reserve Bank of New York's risk assessment. The fact that the Federal Reserve Bank of New York did not provide a clear explanation for the rejection gave rise to speculation from the investor community.[50] According to speculation in the media, the rejected bond was part of a deal structured during the height of subprime real estate lending, had a high loan-to-value ratio and included nearly 50% of loans that were interest only and did not require borrowers to pay any principal until

Main CMBS Pool and Receivable Requirements

- Interest in a trust fund consisting solely of fully funded mortgage loans;
- Mortgage or similar instrument in income generating commercial properties;
- Trust funds cannot consist of other CMBS or other securities, interest rate swap or cap instruments, or other hedging instruments;
- At least 95% of legacy CMBS properties must be located in the United States or its territories;
- All newly issued CMBS properties must be located in the United States or its territories;
- All newly issued CMBS must have been underwritten or re-underwritten recently before the CMBS issuance; and
- All mortgage loans backing newly issued CMBS must have been originated on or after July 1, 2008.

[50] *See* Agnes T. Crane, *A CMBS Feels the Sting of Rejection*, REUTERS, July 23, 2009, www.forbes.com/feeds/afx/2009/07/23/afx6694820.html.

maturity.[51] While Moody's had affirmed the AAA status of the bond in February, conditions in the broader real estate market had deteriorated in the intervening months.[52]

The Federal Reserve Bank of New York accepted, in the August 2009 CMBS subscription, a similar percentage of legacy CMBS bonds compared to the July subscription, accepting 83 bonds and rejecting three bonds, and left speculation for the reasons behind these bonds' rejection to the market.[53] Recently, Barclays Capital has been quoted in the press to have approached the Federal Reserve in an attempt to make details on the decision-making process public.[54] It considers the standards for deciding on a loan request unclear, believing that they may discourage investment in TALF.[55]

Pool and Receivable Requirements for CMBS

Asset Types

Each newly issued or legacy CMBS must evidence an interest in a trust fund consisting of fully-funded mortgage loans that are current in payment at the time of securitization, and not other CMBS, other securities, interest rate swap or cap instruments or other hedging instruments. For newly issued CMBS, the trust fund must consist of mortgage loans that are first-priority in addition to being fully-funded. A participation or other ownership interest in such a loan will be considered a mortgage loan and not a CMBS or other security if, following a loan default, the ownership interest is senior to or *pari passu* with all other interests in the same loan in right of payment of principal and interest. All mortgage loans must be fixed-rate loans. No mortgage loan may provide for interest-only payments during any part of its remaining term.

Property Types

For both legacy and newly issued CMBS, the security for each mortgage loan must include a mortgage or similar instrument on a fee or leasehold interest in one or more income-generating commercial properties. For newly issued CMBS, each property must be located in the United States or

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[51] *See* Agnes T. Crane, *A CMBS Feels the Sting of Rejection*, REUTERS, July 23, 2009, www.forbes.com/feeds/afx/2009/07/23/afx6694820.html.

[52] *See* Agnes T. Crane, *A CMBS Feels the Sting of Rejection*, REUTERS, July 23, 2009, www.forbes.com/feeds/afx/2009/07/23/afx6694820.html.

[53] *See Fed Accepts 83 and Rejects Three for 2nd Round of Legacy CMBS TALF*, STRUCTURED FIN. NEWS, Aug. 27, 2009, http://www.structuredfinancenews.com/news/-197062-1.html.

[54] *See BarCap Calls For TALF Bid Process Details*, FUND DIRECTIONS, Sept. 10, 2009, http://www.emii.com/Articles/2292104/Derivatives/Derivatives-Articles/BarCap-Calls-For-TALF-Bid-Process-Details.aspx.

[55] *See BarCap Calls For TALF Bid Process Details*, FUND DIRECTIONS, Sept. 10, 2009, http://www.emii.com/Articles/2292104/Derivatives/Derivatives-Articles/BarCap-Calls-For-TALF-Bid-Process-Details.aspx.

one of its territories. For legacy CMBS, as of the TALF loan subscription date, at least 95 percent of the properties, by related loan principal balance, must be located in the United States or one of its territories.

In-Place Underwriting

The Federal Reserve Bank of New York requires all mortgage loans backing a newly issued CMBS to have been underwritten or re-underwritten recently before the issuance of that CMBS based on then-current in-place, stable and recurring cash flow and then-current property appraisals. Given the recent decline in the values of many commercial properties, conforming existing mortgages to these requirements may require additional equity injections by mortgage borrowers.

TALF Loan Details for CMBS

Interest Rates and Fees

For both legacy and newly issued CMBS, the interest rate of 3-year TALF loans is at a fixed rate per annum equal to 100 basis points over the 3-year LIBOR swap rate, and that of 5-year TALF loans is at a fixed rate per annum equal to 100 basis points over the 5-year LIBOR swap rate.

The Federal Reserve Bank of New York will assess an administrative fee of 20 basis points of the loan amount on the settlement date for CMBS collateral.

Haircuts and Calculating Newly Issued CMBS Loan Amount

The loan amount for each newly issued CMBS will equal the lesser of the par or market value of the CMBS minus the applicable haircut. Alternatively, if the pledged newly issued CMBS has a market value above par, the loan amount will be the market value, subject to a cap of 110% of par, minus the applicable haircut, and the borrower will periodically prepay a portion of the loan.

Each newly issued CMBS with an average life of five years or less will have a collateral haircut of 15%. For those with average lives beyond five years, haircuts will increase by one percentage point for each additional year (or portion thereof) after the fifth year. No CMBS may have an average life of more than ten years. The average life of a newly issued CMBS will be the remainder of the original weighted average life determined by its issuer based on industry-standard assumptions.

Haircuts and Calculating Legacy CMBS Price and Loan Amount

The loan amount for each legacy CMBS will be calculated by choosing the lesser of the dollar purchase price on the trade date or the market price as of subscription date of the CMBS, less the base dollar haircut (from par). Applying par-based haircuts to the current prices of the securities has the effect of increasing the size of the haircut as the securities price's discount from par increases. This reflects the concern by the Federal Reserve Bank

of New York that larger discounts from par likely signal credit concerns. Legacy CMBS will not be eligible if either its dollar purchase price or market price as of the subscription date is less than its base dollar haircut.

To ensure price veracity of the purchase price submitted by the prospective TALF borrower, legacy CMBS funded by the TALF loan must be acquired in recent secondary market transactions between unaffiliated parties that are executed on an arm's length basis at prevailing market prices. In particular, the borrower's transaction to purchase the CMBS must have settled on or before the current subscription date but after the previous month's subscription date; the Federal Reserve Bank of New York must also receive a copy of the sales confirmation of the borrower's purchase of such CMBS. The Federal Reserve Bank of New York will compare the price reflected on the sales confirmation for the secondary market transaction to data of existing market prices on the date of such transaction (*i.e.* trade date), and will reject any loan request backed by legacy CMBS with purchase prices that are not in line with then-prevailing market prices.

The Federal Reserve Bank of New York will determine the market price of the legacy CMBS as of subscription date by looking at the information provided by pricing services, so long as that information is determined by the Federal Reserve Bank of New York and its agents to be representative of market conditions. However, if the pricing information is not available or is determined not to be representative of market conditions, the Federal Reserve Bank of New York will use reasonable efforts to secure price quotations from at least three broker-dealers and will determine the market price to be the arithmetic average of the broker quotations received. If the Federal Reserve Bank of New York is unable to obtain such quotations or determines that one or more of the quotations are not reflective of the market price of such legacy CMBS, then the Federal Reserve Bank of New York and its agents will determine the market price.[56]

The base dollar haircut for each legacy CMBS with an average life of five years or less will be 15% of par. For legacy CMBS that have an average life over five years, base dollar haircuts increase one percent point of par for each additional year (or portion thereof) of average life beyond five years.[57] The weighted average life of a legacy CMBS will be calculated based on set factors and assumptions devised by the Federal Reserve Bank of New York.

Governing Documents for Newly Issued CMBS

To give itself better monitoring capabilities and control as a secured lender, the Federal Reserve Bank of New York expects pooling and servicing

[56] *See* Fed. Reserve Bank of N.Y., Term Asset-Backed Securities Loan Facility: Frequently Asked Questions, http://www.newyorkfed.org/markets/talf_faq.html.

[57] *See* Fed. Reserve Bank of N.Y., Term Asset-Backed Securities Loan Facility: Frequently Asked Questions, http://www.newyorkfed.org/markets/talf_faq.html.

agreements and other agreements governing the issuance of newly issued CMBS and the servicing of its assets to satisfy certain standards. Each pooling and servicing agreement must contain the following provisions: 1) if the class of newly issued CMBS is one of two or more time-tranched classes of the same distribution priority, distributions of principal must be made on a pro rata basis to all such classes once the credit support is reduced to zero as a result of both actual realized losses and "appraisal reduction amounts"; 2) control over the servicing of the assets, whether through approval, consultation or servicer appointment rights, must not be held by investors in a subordinate class of CMBS once the principal balance of that class is reduced to less than 25% of its initial principal balance as a result of both actual realized losses and "appraisal reduction amounts"; 3) a post-securitization property appraisal may not be recognized for any purpose under such agreements if the appraisal was obtained at the demand or request of any person other than the servicer for the related mortgage loan or the trustee; and 4) the mortgage loan seller must represent that, upon the origination of each mortgage loan, the improvements at each related property were in material compliance with applicable law.

Legacy CMBS Warranties and Representations

- Borrower is not an affiliate of the market intermediary and legacy CMBS not acquired from an affiliate;
- Purchase at arms length;
- No other conditions other than payment;
- Purchase price in cash; and
- No consideration to borrowers in exchange for agreement to purchase CMBS other than delivery of CMBS.

Legacy CMBS Master Loan and Security Agreement Changes

The Federal Reserve Bank of New York revised the original Master Loan and Security Agreement to accommodate changes in respect of legacy CMBS.

The revised Master Loan and Security Agreement now includes a requirement that borrowers proposing legacy CMBS as collateral for TALF loans must make certain additional representations and warranties. These representations and warranties are designed to show that the cash purchase price paid by the borrower for the legacy CMBS was a current market price. A breach of any such representations or warranties will result in the loan becoming full recourse. The revised Master Loan and Security Agreement also stipulates that in the case of a permitted transfer of any legacy CMBS TALF loan and related collateral, the successor borrower will assume the liability for such additional representations and warranties made by the original borrower.

Some of the representations and warranties that the borrower must make are set out in the sidebar.

Legacy CMBS Loan Volume Possibly Limited

The Federal Reserve Bank of New York may, in the future, limit the volume of TALF loans secured by legacy CMBS, and is considering whether to use an auction or some other procedure to allocate such volume if a limit is imposed.

Legacy TALF as a Funding Source for Legacy Securities Public-Private Investment Funds

PPIP was announced by Secretary Geithner on March 23, 2009 as another component of the government's plan to aid the financial sector. For a further discussion, see Chapter 7: *The Public-Private Investment Program*. Treasury, which is responsible for the legacy securities portion of PPIP, and the Federal Reserve intend for PPIP and TALF to work together. To the extent the securities markets targeted by the two programs overlap, TALF financing may be used by PPIFs established pursuant to PPIP to invest in legacy securities, so long as such PPIFs meet certain requirements. In order for PPIFs to maintain eligibility to finance investments using "third party debt" (which includes TALF loans), such PPIFs must elect to limit Treasury financing to a maximum of 50% of such funds' capital commitments, known as the "half-turn election." Such PPIFs wishing to use third party debt must also comply with incurrence-based leverage tests and specified asset coverage tests. Chapter 7: *The Public-Private Investment Program* describes further steps that must be undertaken by PPIFs wishing to use third party debt.

While intended to be used together, TALF and PPIP are not compatible in all respects. Collateral eligible under PPIP includes a broader selection of legacy securities than those that are permitted collateral under TALF. While the only TALF-eligible legacy collateral to date are legacy CMBS with AAA ratings as of the loan subscription date, PPIP-eligible assets will initially include legacy CMBS as well as legacy RMBS with AAA ratings at issuance, regardless of current rating. Therefore, TALF financing will not be available with respect to certain PPIF investments.

When PPIP was first announced, SIGTARP expressed concerns that the use of PPIP and TALF loans together would diminish investors' equity stake in the investment (*i.e.*, the "skin in the game"), an important feature of TALF. SIGTARP perceived such a stake as providing a measure of protection to taxpayers, as it encourages investors to conduct adequate due diligence when making TALF-financed investments. Recognizing these potential problems, the Federal Reserve Bank of New York has since clarified that, when TALF financing is used in conjunction with Treasury debt accessed through PPIP, TALF haircuts will be increased such that aggregate debt from both sources will not exceed the total amount of debt that would be available leveraging the PPIF equity alone. TALF haircuts for PPIF borrowers will, according to the Federal Reserve Bank of New York, be 50% higher than for other TALF borrowers.

Some have speculated that it is unlikely that PPIFs will make use of TALF and will, instead, elect to receive Treasury loans up to 100% of fund equity. In addition, the Federal Reserve Bank of New York's recent announcement that it has shelved plans to expand eligible categories of TALF collateral as described below in Expansion of Eligible Collateral, an announcement which quashed prospects for an expansion of collateral to include legacy RMBS, makes it less likely that the two programs will be used in conjunction.

Whether used by PPIFs or rather only by other investors in legacy CMBS, TALF's impact on the liquidity of legacy securities, the programs' usefulness in aiding price discovery and its success in helping financial institutions move such securities off of their balance sheets remains to be seen.

Program Extension and Expansion and Life after TALF

Extension of TALF

On August 17, 2009, the Federal Reserve and the Treasury announced that they have approved extending issuance of TALF loans secured by non-mortgage-backed ABS and legacy CMBS through March 31, 2010. Citing the longer lead time required to assemble new CMBS deals (and perhaps recognizing a particular need for TALF-assisted issuances in that asset class), the Federal Reserve and the Treasury also approved extending issuance of TALF loans secured by newly issued CMBS through June 30, 2010. The original sunset date for all segments of TALF was December 31, 2009. In announcing this extension, the Federal Reserve also left open the option to extend TALF further in response to "unusual and exigent" circumstances in the future.

Expansion of the Size of TALF

As mentioned above under TALF Basics, TALF has the potential to lend as much as $1 trillion to businesses and households, although in the current phase the Federal Reserve Bank of New York will lend only up to $200 billion. Treasury and the Federal Reserve have indicated that an expansion of TALF would occur in conjunction with an additional commitment by Treasury to purchase TALF LLC debt (as much as an additional $80 billion) to provide a similarly proportioned first loss protection to the Federal Reserve Bank of New York as it currently exists through the $20 billion the Treasury allocated on March 3, 2009 to subordinated debt of TALF LLC.

Treasury's authority to make purchases under EESA using TARP money will end on December 31, 2009 unless extended. While we believe that the sunset would not impact Treasury's ability to purchase TALF LLC debt in the amount of any commitment entered into before the termination date, without an extension, Treasury would lose the ability to commit to purchase additional TALF LLC debt with TARP funds. Absent another source of authority under which to purchase such debt, Treasury would no longer stand ready to finance the first loss portion of an expanded TALF program. In turn, after December 31, 2009, the Federal Reserve would no longer be able to expand the size of TALF. This may be one reason why Treasury would seek an extension of its authority under EESA to continue making TARP-funded purchases, as discussed in Chapter 2: *Emergency Economic Stabilization Act: The Original Vision*- Future Spending. It should be noted that, given the limited volume of loans requested under TALF thus far (as of

September 2009, $46.5 billion), even the $200 billion loan volume could prove large enough to cover all loan requests through the extended TALF issuance window which ends on March 31, 2010 or, for newly issued CMBS, on June 30, 2010.[58] A $200 billion cap on TALF loan issuances could however play a role in the Federal Reserve's decision whether or not to further extend TALF or to expand it to other classes of collateral in the future.

Expansion of Eligible Collateral

The program documents provide that the Federal Reserve Bank of New York may allow for collateral in the form of further asset classes. For several months, observers speculated that private-label residential mortgage-backed securities could be next on the TALF expansion list. The need for additional private label financing in the housing sector is apparent, with many hoping that an expansion of TALF to RMBS would slow bank-owned foreclosures, increase lending and boost prices. However, the recent price gains in non-agency RMBS due to the anticipation of new purchasing power from PPIP led market sources to believe that the Federal Reserve is unlikely to expand TALF to RMBS.[59] Meanwhile, the Federal Reserve Bank of New York expressed concerns regarding the challenging practical problems of such an expansion.[60] On August 17, 2009, the Federal Reserve and Treasury announced that they have temporarily put on hold any further expansion with respect to new classes of TALF-eligible collateral, quashing any remaining hopes that an expansion to RMBS was perhaps around the corner.

Life after TALF

The CMBS market has yet to see the effects of TALF, and speculating as to the future of that segment after TALF sunsets would be premature.

Signs for life in the non-mortgage-backed ABS markets outside of TALF have been mixed. On the one hand, with 55% of total new issuance financed by TALF in the period since the March 2009 TALF launch,[61] there are strong signs for investor demand for consumer-ABS without TALF financing. This may indicate that pension funds, insurance companies and

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[58] *See* CONG. OVERSIGHT PANEL, AUGUST OVERSIGHT REPORT: THE CONTINUED RISK OF TROUBLED ASSETS 112 (Aug. 11, 2009), http://cop.senate.gov/documents/cop-081109-report.pdf (finding, at least prior to the extension of TALF into 2010, that it appears unlikely that the program would exceed its $200 billion initial funding level given the extremely large increase in TALF subscriptions that would be required).

[59] *See* Al Yoon, *Invesco Mortgage Turning to PPIP, Loans for Returns*, REUTERS, Aug. 11, 2009, http://www.reuters.com/article/bondsNews/idUSN1151757720090811.

[60] *See* Jody Shenn, *TALF for Home-Loan Debt Poses Hurdles, Official Says*, BLOOMBERG, May 22, 2009, http://www.bloomberg.com/apps/news?sid=a9dxpUcW2nC0&pid=20601087.

[61] *See* U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES 38 (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

other investors that do not seek leverage have returned to the market.[62] In addition, the oversubscription of some TALF deals may have increased demand for trading non-TALF deals in the secondary market.[63] Further evidencing, perhaps, that TALF has fulfilled its objectives, spreads in segments of the asset-backed market have tightened considerably,[64] and it appears that the non-mortgage-backed ABS side of TALF has begun to lose its attractiveness to leveraged investors such as hedge funds. This, in turn, could indicate that not only TALF itself, but also the built-in exit strategy of the Federal Reserve Bank of New York, is working as designed.[65] On the other hand, ABS issuance volume since March has been dominated by TALF-eligible ABS, indicating perhaps that TALF support, either directly through TALF loans or indirectly through the availability of such loans for potential buyers, is still needed to sustain current issuance levels. Indeed, the recent extension of TALF by the Federal Reserve, in conjunction with Treasury, appears to have been driven in part by the fact that there is little new issuance of ABS that is not supported directly or indirectly by TALF.[66] It remains therefore to be seen whether the non-mortgage-backed ABS markets will be able to operate on their own once the facility sunsets, as currently scheduled for March 31, 2010.

The facility would be considered a success by many even if, as some expect, aggregate ABS issuance levels remain well below pre-crisis levels. The expectation is in part due to the fact that some past buyers of ABS are unlikely to contribute to future demand. For instance, off-balance sheet vehicles sponsored by financial institutions, which had historically comprised some of the purchasers of ABS, may be prohibited from playing that role going forward.[67] In addition, it has been suggested that efforts currently under way internationally to impose a gross leverage ratio on financial

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[62] *See* William C. Dudley, President and CEO, Fed. Reserve Bank of N.Y., A Preliminary Assessment of the TALF, Remarks at the Securities Industry and Financial Markets Association and Pension Real Estate Association's Public-Private Investment Program Summit (June 4, 2009), http://www.newyorkfed.org/newsevents/speeches/2009/dud090604.html.

[63] *See Text - S&P: Gauging TALF amid ABS issuances, tighter sprds*, REUTERS, Aug. 11, 2009, http://www.reuters.com/article/rbssFinancialServicesAndRealEstateNews/idUSWNA118820090811.

[64] *See* Al Yoon, *Munder May Halt Growth of TALF Fund as Yields Drop*, REUTERS, Aug. 3, 2009, http://uk.reuters.com/article/idUKLNE57202020090803.

[65] *See* William C. Dudley, President and CEO, Fed. Reserve Bank of N.Y., The Economic Outlook and the Fed's Balance Sheet: The Issue of "How" versus "When," Remarks at the Association for a Better New York Breakfast Meeting (July 29, 2009), http://newyorkfed.org/newsevents/speeches/2009/dud090729.html. (describing the fact that the attractiveness of the Federal Reserve's facilities decreases as market conditions improve as a key element of the Federal Reserve's exit strategy built into most of the facilities).

[66] *See* U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES 15 (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

[67] *See* William C. Dudley, President and CEO, Fed. Reserve Bank of N.Y., A Preliminary Assessment of the TALF, Remarks at the Securities Industry and Financial Markets Association and Pension Real Estate Association's Public-Private Investment Program Summit (June 4, 2009), http://www.newyorkfed.org/newsevents/speeches/2009/dud090604.html.

institutions previously not subject to such limitations could stifle such institutions' appetite for AAA rated assets.[68]

[68] *See* Richard Barley, *Leverage Cap Threat to Securitization*, WALL ST. J., Sept. 15, 2009.

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CHAPTER 7: THE PUBLIC-PRIVATE INVESTMENT PROGRAM

John L. Douglas, Yukako Kawata, Margaret E. Tahyar and Danforth Townley

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PPIP is the latest US government initiative to address the enduring problem of illiquid and troubled assets on financial institutions' balance sheets. For a discussion of an earlier initiative, see Chapter 2: *Emergency Economic Stabilization Act: The Original Vision*. The program, announced by Secretary Geithner on March 23, 2009, was originally hailed as a vital component of the government's plan to heal the financial sector. It received a warm welcome from Wall Street, with the Dow Jones Industrial Average rising 7 percent on the day of its announcement. Enthusiasm for PPIP waned over the following months, however, falling off particularly sharply after the results of the stress tests were announced on May 7, 2009, during which time it became clear that large financial institutions, at least, were once again able to tap the capital markets and would, therefore, be less likely to use PPIP to sell troubled assets, and as concerns were raised about the intersection of sales and mark-to-market accounting. For a further discussion of the stress tests, see Chapter 3: *The Capital Twist* – Capital Assistance Program and the Stress Tests, and for a further discussion of the accounting issues, see Chapter 2: *Emergency Economic Stabilization Act: The Original Vision* – Annex A: Mark-to-Market Accounting Changes.

As originally contemplated, PPIP had two halves: a Treasury-run securities purchase program, designed to remedy the illiquidity in the secondary markets for certain mortgage-backed securities, and an FDIC-run loans purchase program, designed to create a market for troubled loans weighing down the balance sheets of US banks. Both programs contemplated the formation of investment funds capitalized with equity from Treasury and private investors to be leveraged with potentially attractive government financing in the form of either direct loans or debt guarantees, each fund a public-private investment fund or "PPIF."

The publication date of this Chapter is September 21, 2009. All terms and acronyms used in this Chapter are defined in the Glossary at the front of this Manual.

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A key principle underlying PPIP was a belief that, with the assistance of governmental capital and leverage, the private sector could be induced to purchase these troubled and illiquid assets at prices substantially in excess of the then-current market price. Both the government and the banks believed that such market prices simply reflected speculative "vulture" funds taking advantage of the distress of the banks and the dysfunctional credit markets to purchase assets at fractions of their underlying economic value. With added competition among potential purchasers in the form of PPIFs, each of which would have the advantage of a lower cost of capital and funding, Treasury appears to believe that there would be higher offering prices, and accordingly greater inducement on the part of the banks to sell troubled assets without incurring substantial damage to their balance sheets as a result. It is too soon to state whether PPIP will achieve these objectives.

In June 2009, the FDIC indefinitely postponed its half of the program, although in late summer 2009 it held a pilot sale of receivership assets, discussed later in the Postponement and Pilot Test section of this Chapter, that it hopes will serve as a template for transactions involving banks that have not been closed if and when the program is expanded to them. While Treasury has moved forward with its half of the program, with the first purchases expected in October according to one source,[1] it faces numerous uncertainties. PPIP is now considerably smaller than originally anticipated, involving Treasury commitments of $30 billion, down from the initial announcement of $75-$100 billion, and it is unclear whether the program has the scale to address the underlying problem. For the reasons discussed below, among others, it continues to be uncertain whether financial institutions will be willing to sell at the bids likely to be offered. Finally, it is also uncertain whether private investors will be willing to participate given the "political risk" of doing business with the government, including the risk of retroactive rule changes and confiscatory measures aimed at returns considered, in hindsight, to be excessive. For a further discussion of political risk, see Chapter 2: *Emergency Economic Stabilization Act: The Original Vision* – Political Risk.

Valuation and accounting issues are central to understanding both the need for PPIP and the challenges affecting its success. Accounting rules do not require certain whole loans to be marked-to-market, and many financial institutions have understandably not done so. Should financial institutions sell these assets at a material discount to par, potentially substantial losses would translate into significant depletion of capital. By contrast, accounting rules do require mortgage-backed securities to be marked-to-market if they are classified as either "trading securities" or "available-for-sale securities."

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[1] *See* Edmund L. Andrews, *FDIC Sells Failed Bank's Troubled Mortgages to Private Investor*, N.Y. TIMES, Sept. 17, 2009, http://www.nytimes.com/2009/09/17/business/17loans.html?_r=1.

Because fair value accounting applies to mortgage-backed securities, many such assets have already been marked down to market or near-market levels, potentially making these assets better candidates for sale through PPIP.[2] However, recent changes to fair value accounting and other-than-temporary impairment rules have made it easier for holders to avoid further mark-downs on such securities, with the result that holders may now be less likely to sell these assets through PPIP.[3] For a further discussion of these and other accounting issues, see Chapter 2: *Emergency Economic Stabilization Act: The Original Vision* – Annex A: Mark-to-Market Accounting Changes.

Financial institutions, however, continue to be burdened with billions of dollars of troubled assets. Their values are uncertain and could have a potentially material impact on the solvency of the financial institutions holding them. The COP's August 2009 report, which focuses on troubled loans, estimates that banks face substantial losses on such assets in the near future, as "overall loan quality at American banks is the worst in at least a quarter century, and the quality of loans is deteriorating at the fastest pace ever."[4] The report notes that troubled loans are an especially serious problem for small banks, as they hold a greater concentration of commercial real estate loans, which are at a particularly high risk of default, and have more difficulty accessing the capital markets than larger banks. The report observes that troubled securities are not as serious a problem for small banks because they have relatively small holdings of such assets, meaning that PPIP as it currently stands does not address the primary troubled asset problem of small banks. Moreover, in the event of further deterioration in the economy, many financial institutions may once more find an urgent need for a mechanism to cleanse their balance sheets.

That mechanism could well be a scaled-up variant of PPIP, although TARP funds would have to be committed before December 31, 2009 unless the Treasury Secretary exercises his option to extend to October 3, 2010. For a further discussion of the extension of TARP, see Chapter 2: *Emergency Economic Stabilization Act: The Original Vision* – Future Spending. The COP has called for Treasury to "assure robust legacy securities and legacy

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[2] In addition, the FDIC earlier this year reaffirmed a capital rule that requires banks to hold additional capital against subordinated tranches of certain ABS if the senior tranches of such securities have been downgraded. This increased capital obligation could potentially require "dollar for dollar" capital against the asset, which would potentially make these assets candidates for sale through PPIP.

[3] The accounting analysis on the securities side is still more complicated. Sellers and conceivably even non-participants could, if PPIP creates a sufficiently active market for troubled securities and subject to certain other conditions under fair value accounting rules, be forced to mark unsold securities to price levels established in PPIP transactions.

[4] The COP notes that, as of March 31, 2009, 7.75% of all bank loans and leases were showing signs of distress, a total of approximately $597 billion.

loan programs or consider a different strategy to do whatever can be done to restart the market for those assets."[5]

The remainder of this Chapter will describe the mechanics of PPIP and set forth certain issues with respect to its design and implementation. PPIP revolves around three principles:

- Maximizing the impact of each taxpayer dollar by leveraging approximately $10 billion of TARP funds to generate expected purchasing power of $40 billion.
- Sharing risks and rewards between the taxpayer and the private sector.
- Using private sector price discovery to protect the public from paying too much for the troubled assets.

Many of PPIP's key elements remain unresolved, particularly on the stalled loans side, where the terms announced to date represent only a framework for further regulatory elaboration. The first two sections of this Chapter describe the two halves of PPIP. The third section reviews the recommendations for PPIP announced by SIGTARP as well as legislation enacting a number of these recommendations.

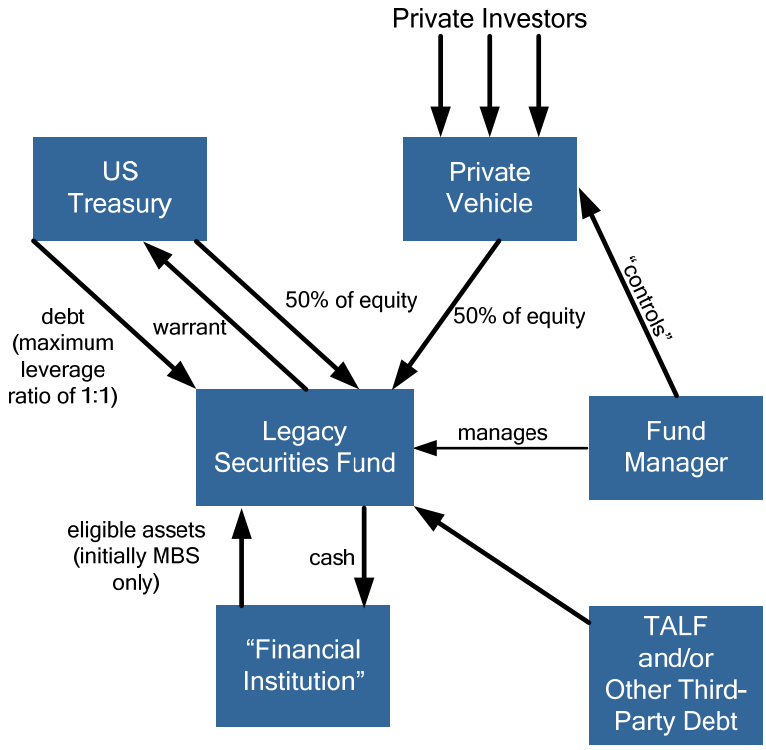
Pre-Qualified Fund Managers:

- AllianceBernstein;
- Angelo, Gordon & Co. and GE Capital Real Estate;
- BlackRock;
- Invesco;
- Marathon Asset Management;
- Oaktree Capital Management;
- RLJ Western Asset Management;
- TCW Group; and
- Wellington Management Company.

Legacy Securities Program

Treasury has selected nine fund managers, as shown in the sidebar, to establish and manage PPIFs to be termed "Legacy Securities Funds." These Legacy Securities Funds will be capitalized with equity contributions from private investors and Treasury, leveraged through direct lending from Treasury and possibly TALF and other private sources. For a further discussion of TALF, see Chapter 6: *The Term Asset-Backed Securities Loan Facility*. The diagram below sets forth the basics of the Legacy Securities Program.

[5] *See* CONG. OVERSIGHT PANEL, AUGUST OVERSIGHT REPORT: THE CONTINUED RISK OF TROUBLED ASSETS 62 (Aug. 11, 2009), http://cop.senate.gov/documents/cop-081109-report.pdf.



Eligible Assets

- Commercial and non-agency residential mortgage-backed securities, although Treasury may later designate other eligible securities;
- Issued before 2009;
- Originally rated AAA or the equivalent;
- Secured directly by mortgage loans, leases or other assets and not by other securities;
- At least 90 percent of underlying assets must be situated in the United States; and
- Purchased solely from "financial institutions" as defined under EESA (or, in limited circumstances, from foreign governments).

Eligible Assets

Securities eligible for purchase by the Legacy Securities Funds are set forth in the sidebar and will initially include only certain commercial and non-agency residential mortgage-backed securities. Such securities will only be eligible for inclusion in PPIP if purchased from "financial institutions" as defined in EESA, subject to an exception noted in the sidebar. As a result of the broad definition of "financial institutions" in EESA, the range of possible sellers in the Legacy Securities Program could be broad. For a further discussion of this definition, see Chapter 2: *Emergency Economic Stabilization Act: The Original Vision* – What is a Financial Institution?. It is not clear whether an eligible seller may buy assets from an ineligible institution and sell them into the program, although there is no prohibition against such resale in the current documentation. Treasury has indicated that it may add additional classes of eligible securities in the future "[d]epending on how financial markets evolve."[6]

Pre-Qualification of Fund Managers

As mentioned above, Treasury has selected or pre-qualified nine fund managers to raise private capital to invest in Legacy Securities Funds

[6] U.S. DEP'T OF THE TREASURY, THE NEXT PHASE OF GOVERNMENT FINANCIAL STABILIZATION AND REHABILITATION POLICIES (Sept. 14, 2009), http://treas.gov/press/releases/docs/Next%20Phase%20of%20Financial%20Policy,%20Final,%202009-09-14.pdf.

alongside Treasury, to invest some capital of their own and to manage the Legacy Securities Funds, as described below. The criteria for selection of fund managers for the Legacy Securities Program, including the criteria set forth in the sidebar, were quite stringent and may have significantly narrowed the pool of potential managers. For example, applicants were required to have $10 billion of eligible assets under management. The requirement that fund managers furnish performance track records with respect to eligible assets may also have limited the pool of eligible managers. Treasury has repeatedly stated, however, that it evaluated fund manager applications "on a holistic basis" such that failure to meet any one criterion did not disqualify an applicant.

Pre-Qualification Criteria for Fund Managers Included:

- Demonstrated capacity to raise at least $500 million of private capital;
- Demonstrated experience investing in eligible assets;
- A minimum of $10 billion in market value of eligible assets under management;
- Demonstrated operational capacity to manage funds so as to achieve attractive returns through a long-term buy-and-hold strategy; and
- Headquartered in the US.

In April 2009, Treasury received 141 applications for the program. After more than two months of deliberation and due diligence, Treasury announced nine fund managers on July 8, 2009.

Treasury has indicated that it may select additional fund managers in the future and that, in so doing, it may relax certain pre-qualification or capital-raising criteria with the objective of facilitating the participation of smaller fund managers.

Treasury encouraged applicants to partner with small and veteran-, minority- and women-owned firms, and has announced that pre-qualified fund managers have entered into relationships with ten such firms.

Eligible Investors

Private investors will invest in each Legacy Securities Fund through one or more private vehicles, which may be publicly or privately offered and controlled by a fund manager. These private vehicles and Treasury will be the sole equity investors in each Legacy Securities Fund. Program terms require fund managers to comply with strict anti-money laundering, know-your-customer and federal securities laws screening requirements with respect to private investors.

Generally. No private investor's capital commitment, when combined with those of its affiliates, may exceed 9.9 percent of any Legacy Securities Fund's aggregate capital commitments, including those of private investors, the fund manager and Treasury. Furthermore, there is no limitation on foreign investor participation in the program.

Retail Investors. Treasury has encouraged fund managers to create structures that enable retail investors to participate in the Legacy Securities Program. As of the date of publication, three fund managers,

AllianceBernstein, Angelo Gordon & Co. and BlackRock, have announced their intention to do so and filed prospectuses with the SEC.[7]

ERISA Investors. Treasury initially indicated that it expected fund managers to structure private vehicles to accommodate ERISA investors, although the issue is not addressed in the term sheet. If fund managers accommodate ERISA investors, this will likely mean that ERISA investors will nevertheless be restricted to less than 25 percent of the equity of a private vehicle (excluding, for the purpose of this calculation, the equity held by the fund manager) to avoid potentially onerous restrictions under ERISA.

Financing

Equity. Each pre-qualified fund manager has up to 12 weeks to raise at least $500 million of private capital. It is not clear from the program materials when this period expires, but the COP has stated that the deadline is in early October 2009. While a small number of fund managers announced early that they had achieved substantial commitments of private capital, many fund managers were still in the early days of fundraising in August 2009.

Treasury will match the equity capital contributed by the fund manager and private investors up to a maximum that may vary from Legacy Securities Fund to Legacy Securities Fund. Although the individual maximums have not been disclosed, Treasury's aggregate equity investment in the Legacy Securities Program is not expected to exceed $10 billion.

Each fund manager will be required to invest at least $20 million of its own capital in its Legacy Securities Fund. Fund managers may choose to exceed this minimum, but are subject to the same 9.9 percent ceiling as the private investors.

Gains and losses on equity capital will be shared *pro rata* among Treasury and private investors, subject to Treasury's right to receive warrants. Treasury and private investors will invest in and divest the eligible assets proportionately, at the same time and on the same terms and conditions. For a further discussion of the warrants requirement, see Chapter 4: *Warrants: Upside for the Taxpayer*.

Treasury Debt Financing. Each fund manager will have the option to subscribe for non-recourse loans from Treasury secured by the Legacy Securities Fund's eligible assets, provided that the fund manager has raised

[7] FourSquare Capital Mgmt., LLC, Preliminary Prospectus (Form S-11/A) (Sept. 8, 2009), http://www.sec.gov/Archives/edgar/data/1466863/000095012309041543/0000950123-09-041543-index.htm; AG Fin. Inv. Trust, Inc., Preliminary Prospectus (Form S-11) (July 13, 2009), http://www.sec.gov/Archives/edgar/data/1467462/000104746909006732/a2193714zs-11.htm; BlackRock Legacy Sec. Public-Private Trust, Preliminary Prospectus (Form N-2) (July 24, 2009), http://www.sec.gov/Archives/edgar/data/1468877/000134100409001634/n2.htm.

Interest on Treasury Loans

- Interest on Treasury loans will initially accrue at an annual rate equal to one-month LIBOR plus a margin based on the fund manager's election—2 percent for a half turn election and 1 percent for a full turn election.
- In the case of a half turn election, this margin will increase upon the incurrence of third-party debt equal to the greater of 2 percent and 100 basis points more than the weighted average margin applicable to all third-party debt outstanding. The increased margin for a half turn election corresponds to the greater total leverage (including TALF and private debt) allowed for a Legacy Securities Fund with such an election.
- Each Legacy Securities Fund will be required to establish and maintain an interest reserve account funded with three months' interest payments.

the minimum amount of private equity and that the private investors do not have voluntary withdrawal rights with respect to their capital commitments.

The amount of Treasury debt financing available to the Legacy Securities Fund will depend on an election by the fund manager. If the fund manager makes a "half turn election," the Legacy Securities Fund may subscribe for Treasury loans equal to 50 percent of the Legacy Securities Fund's aggregate drawn capital commitments and may obtain additional third-party debt, as described further below. If the fund manager makes a "full turn election," the Legacy Securities Fund may subscribe for Treasury loans up to 100 percent of the Legacy Securities Fund's aggregate drawn capital commitments, but may not take on any third-party debt. News reports indicate that Treasury expects fund managers to make full turn elections,[8] although with respect to any retail fund formed as a closed-end registered investment company to invest in a Legacy Securities Fund, such a fund will be required to cap its leverage at 33⅓ percent to satisfy leverage restrictions under the Investment Company Act of 1940.

In each case, the amount of Treasury loans available to the Legacy Securities Fund will be subject to a maximum that may vary from Legacy Securities Fund to Legacy Securities Fund. Although the individual maximums have not been disclosed, Treasury's aggregate debt investment in the Legacy Securities Program is not expected to exceed $20 billion.

Treasury's loans will have a final maturity of the earlier of ten years from the initial closing and the termination or expiration of the underlying Legacy Securities Fund.

TALF or Third-Party Private Debt. If a fund manager makes a half turn election, then it may also finance the purchase of eligible assets with TALF debt or third-party private debt. A Legacy Securities Fund may not incur third-party debt other than TALF debt without Treasury's consent, which may not be unreasonably withheld. In order to use third-party debt, the Legacy Securities Fund must form one or more wholly owned subsidiaries to finance, acquire, and hold the eligible assets. Assets contributed to or acquired by such financing subsidiaries will not constitute collateral securing the Treasury loans. Third-party creditors will have recourse to the applicable financing subsidiaries only and not to the Legacy Securities Funds or other financing subsidiaries, *i.e.* there may be no cross-collateralization of third-party debt with the assets of any other entity.

As discussed in greater detail in Chapter 6: *The Term Asset-Backed Securities Loan Facility*, eligible borrowers under TALF, including Legacy Securities Funds, can obtain non-recourse financing for the purchase of so-called "legacy" CMBS. However, the eligibility criteria for legacy CMBS under TALF exclude all but a subset of the eligible CMBS in the Legacy

[8] *See* Rebecca Christie, *U.S. Treasury Taps 9 Managers for Toxic-Debt Program*, BLOOMBERG, July 8, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aY5sV2ruKWQ4.

Securities Program. TALF haircuts will also be increased such that the combination of Treasury- and TALF-supplied debt will not exceed the total amount of debt that would be available via leveraging the PPIF equity alone. In addition, certain other types of eligible assets in the Legacy Securities Program, including most notably RMBS, are not eligible collateral under TALF. Furthermore, if Legacy Securities Funds make full turn elections, then they will not be able to incur any TALF debt. For a further discussion of issues relating to borrowing by Legacy Securities Funds under TALF, see Chapter 6: *The Term Asset-Backed Securities Loan Facility*.

Leverage Test. If the fund manager makes a half turn election, then the Legacy Securities Fund is subject to a maximum leverage ratio of 5 to 1. If a Legacy Securities Fund falls out of compliance with this leverage test, it may not make additional purchases of eligible assets until it re-establishes compliance. The leverage ratio is based on the outstanding principal of the Legacy Securities Fund's debt and certain accrued but unpaid interest and the market value of the Legacy Securities Fund's assets. The leverage test does not apply if the fund manager makes a full turn election, accepting only Treasury debt financing.

Asset Coverage Test. Each Legacy Securities Fund must satisfy an asset coverage test, regardless of whether the Legacy Securities Fund has any third-party debt. The test requires that the asset value of the Legacy Securities Fund's portfolio, less the principal and any accrued but unpaid interest and other amounts due under any third-party debt, exceed 225 percent of the Legacy Securities Fund's Treasury debt, if the fund has taken a half turn election, or 150 percent of the Legacy Securities Fund's Treasury debt, if the fund has taken a full turn election. As with the leverage test, a Legacy Securities Fund that falls out of compliance with the asset coverage test may not make additional purchases of eligible assets until it re-establishes compliance. In addition, Treasury will require monthly determinations of compliance with the asset coverage test. If the Legacy Securities Fund falls out of compliance with the asset coverage test, it must pay down Treasury debt to re-establish compliance in accordance with the waterfall described below.

Valuation Agent. Treasury will appoint a third-party valuation agent to determine the value of the investments held by Legacy Securities Funds for certain purposes, including to calculate asset coverage and leverage ratios. There will be only one such valuation agent for the Legacy Securities Program.

Treasury Warrant. Treasury will take a warrant in the Legacy Securities Fund as required by EESA. For a further discussion of EESA's warrant requirement, see Chapter 4: *Warrants: Upside for the Taxpayer*. Under the terms of the warrant, after a private vehicle has received distributions of investment proceeds equal to the aggregate amount of capital contributions made by the private vehicle to the Legacy Securities Fund, additional distributions to the private vehicle will be reduced by a certain percentage that will be paid to Treasury. This percentage payment to Treasury will be

1.5 percent if the fund manager makes a half turn election and 2.5 percent if the fund manager makes a full turn election, with such percentages subject to reduction if Treasury contributes less than 50 percent of the Legacy Securities Fund's equity. Treasury will refund to the Legacy Securities Fund any overpayment upon liquidation of the fund.

Mechanics and Governance

Closings. Treasury has indicated that it expects the initial Legacy Securities Funds closings to occur in late September. The fund manager may choose to hold up to two subsequent closings, the last of which will occur not more than six months after the initial closing. Treasury expects the Legacy Securities Funds to be fully funded before the end of 2009.

Investment Period. At the initial closing, a three-year investment period will begin to run. During the investment period, the private vehicle and Treasury must fund their capital commitments. When the investment period expires, the private vehicle and Treasury are released from the obligation to fund any undrawn capital commitments. Treasury will reserve the right in its sole discretion to terminate the investment period after one year.

Drawdowns. Fund managers must draw down committed private and Treasury equity capital into the Legacy Securities Fund at the same time and in the same proportion. The minimum drawdown increment is 10 percent of capital commitments.

Fund managers may draw Treasury loans at any time during the investment period upon 10 days' notice and in any amount per-draw, subject to the applicable maximum aggregate principal amount.

Term and Dissolution. The standard term of a Legacy Securities Fund will be eight years. However, the term of the Legacy Securities Fund may be extended at the fund manager's discretion and with Treasury's written consent for up to two consecutive one-year periods. The maximum term of a Legacy Securities Fund will therefore be ten years.

A Legacy Securities Fund may be dissolved and terminated earlier than eight years after closing on certain conditions, including the liquidation of all investments and the bankruptcy, dissolution or any similar event of withdrawal of the fund manager, unless Treasury agrees to continue the Legacy Securities Fund and appoints another fund manager. Fund managers have also retained the right to dissolve Legacy Securities Funds early to protect themselves and private investors against the risk of adverse changes in law, a significant concern expressed by many potential participants in PPIP. Specifically, a Legacy Securities Fund may be dissolved if any change in law would materially adversely impact the fund manager, a majority in interest of investors in the private vehicle or their affiliates as a result of their management of, or participation in, the Legacy Securities Fund.

Removal of the Fund Manager. Treasury may unilaterally remove a fund manager for cause, defined to include a breach of the fund manager's obligations to make capital contributions or to bear its expenses in accordance with the partnership agreement and judicial findings, or admissions, of malfeasance. Treasury will have the right to remove a fund manager without cause if it obtains the written consent of a majority in interest of private investors. Treasury may also have the right to remove a fund manager with the consent of a certain percentage of the private investors if certain key personnel of the fund manager are not actively involved in the management of the Legacy Securities Fund.

Control and Investment Strategy. Subject to the contractual provisions set forth in the ultimate partnership agreements, fund managers will have full control over asset selection, pricing, asset liquidation, trading and disposition. Treasury will not have control rights over the Legacy Securities Funds. Nonetheless, Treasury has stated that the fund managers are expected to adopt a "buy and hold" strategy for the troubled securities.

Most Favored Nation Clause. Subject to certain exceptions, Treasury will have the right to elect the benefit of any provision of the governing documents of the private vehicles or any side letter that is more favorable to any investor in the private vehicles than the partnership agreement is to Treasury. In addition, any amendment to such governing documents or side letters that would adversely affect Treasury or the Legacy Securities Fund will require Treasury's consent, which it may not unreasonably withhold.

Confidentiality. Treasury is required to keep confidential all information received from the Legacy Securities Funds, subject to applicable law. This requirement does not apply to SIGTARP or the GAO.

Fees. Treasury's early releases on the Legacy Securities Program indicated that fund managers would be allowed to charge private investors fees, and that Treasury would consider such fees when evaluating applications to become fund managers. From publicly available sources, it appears that fund managers are charging private investors fees similar to what they charge for other fund products.

Fund managers will charge Treasury management fees that will be payable solely out of distributable investment proceeds and not from drawdowns of Treasury capital. During the three-year investment period, Treasury will pay a management fee, quarterly in arrears, equal to 0.20 percent per annum of its capital commitment as of the last day of the period to which the management fee relates. After the expiration of the investment period, the fee will be equal to 0.20 percent of the lesser of Treasury's capital commitment and the fair market value of its interest in the Legacy Securities Fund as of the last day of the period to which the management fee relates.

Liquidity

Distributions. Legacy Securities Funds will make distributions following each fiscal quarter in which investment proceeds are received, subject to

the waterfall described below, provided that fund managers may withhold from distribution any amounts necessary to make investments that the fund manager or the Legacy Securities Fund is legally bound to make prior to the expiration or termination of the three-year investment period and to create reasonable reserves for the making of investments, the payment of fund expenses and the repayment of debt. Each of Treasury and the private vehicles will receive a share of distributions proportionate to its interest in the Legacy Securities Fund, subject to the Treasury warrant described above.

Non-Default Waterfall:

- Administrative expenses.
- Payments on permitted interest rate hedges.
- Payments of current interest and (any other non-principal amounts) due to Treasury.
- Interest reserve account.
- Repayment of principal to the extent necessary to satisfy the asset coverage test.
- Early termination payments under permitted interest rate hedges.
- During the investment period, at the option of the fund manager, for investment in eligible assets or temporary investments (or prepayment of principal).
- Beginning in January 2010, up to an 8% per annum distribution to the equity investors in the fund, subject to compliance with certain asset coverage ratios and a cap based on the cumulative net interest for the preceding 12 months.
- Repayment of principal in an amount equal to the applicable prepayment percentage (set forth in the next sidebar on the following page) of the amount remaining for distribution.
- So long as no incipient event of default is then continuing, distributions to the equity investors (or optional prepayment of principal).

Waterfall. Legacy Securities Funds will be required to distribute investment proceeds in accordance with a priority of payments schedule, or "waterfall." The priority of payments will vary based on whether the Legacy Securities Fund is in default on the Treasury debt financing. If the Legacy Securities Fund is not in default, it will be required to distribute investment proceeds in the order set forth in the sidebar on this page. If the Legacy Securities Fund is in default, it will be required to distribute investment proceeds in the order set forth in the sidebar on the following page.

Withdrawal Rights. Neither the private vehicle nor Treasury may withdraw from a Legacy Securities Fund. Private investors may only withdraw from the private vehicle for "legal reasons," which are not specified in the public releases, but may refer to dissolution in the event of a change of law. Nonetheless, as noted below, private investors may transfer their interests in the private vehicles under certain circumstances. As noted above, Treasury debt financing will not be available for any period in which investors in the private vehicle have voluntary withdrawal rights with respect to their capital commitments.

Transfer of Equity Interests. Neither a fund manager nor a private vehicle will be permitted to transfer its interest in a Legacy Securities Fund without the prior written consent of Treasury. However, investors' interests in each private vehicle will be transferable, provided that the fund manager ensures that each transferee meets the screening requirements applicable to the initial investors, described above in the Eligible Investors section of this Chapter.

Investments

Temporary Investments. Funds held by a Legacy Securities Fund pending investment or distribution may be invested temporarily in cash, Treasury securities or certain SEC-registered money market mutual funds that invest exclusively in Treasury securities or obligations unconditionally guaranteed by the US government.

Reinvestment of Proceeds. During the three-year investment period, fund managers are permitted to retain and reinvest proceeds subject to the waterfall described above.

Investment Strategy and Restrictions on Investments. The investment objective of the Legacy Securities Funds will be "to generate attractive

Applicable Prepayment Percentages

Period	Half Turn	Full Turn
Year 1	33.3%	50.0%
Year 2	33.3%	50.0%
Year 3	33.3%	50.0%
Year 4	50.0%	75.0%
Year 5	75.0%	100.0%
Year 6	100.0%	100.0%
Year 7	100.0%	100.0%
Year 8	100.0%	100.0%
Year 9	100.0%	100.0%
Year 10	100.0%	100.0%

Default Waterfall:

- Payment of permitted administrative expenses.
- Payments on permitted interest rate hedges secured by eligible assets or other collateral of the fund.
- Payment of all interest and principal and any other amounts due to Treasury as lender.
- Early termination payments under any permitted interest rate hedges secured by collateral.
- Distributions to the equity investors in the fund or the satisfaction of other obligations of the fund.

returns . . . through long-term opportunistic investments." [9] Legacy Securities Funds may hedge interest rate exposure, but may not enter into derivatives contracts for any other purpose, and in particular may not hedge the credit risk of any investment in eligible assets and may not lend eligible assets or any economic interest therein. In addition, Legacy Securities Funds will not be permitted to invest more than 5 percent of aggregate capital commitments in any particular issuance of eligible assets. Fund managers will be required to adopt and comply with a "fair and equitable" trade allocation policy reasonably satisfactory to Treasury.

Alignment of Interests. To ensure that Legacy Securities Program fund managers have sufficient "skin in the game," not only will each fund manager will be required to invest at least $20 million of its own capital in its Legacy Securities Fund, as noted above, but each fund manager will also be required to allow its employees to invest in its Legacy Securities Fund.

Fund managers will also be required to demonstrate that their compensation structures align the economic interests of employees managing the Legacy Securities Funds with the interests of investors in such funds.

Restrictions on Transactions with Affiliates. Without the written consent of Treasury, no Legacy Securities Fund may purchase assets from or sell assets to:

- its fund manager or any of the fund manager's affiliates, which include all other funds managed by the fund manager as well as any entity in which the fund manager or its affiliates hold 5 percent or more of any class of equity or debt securities;
- any investor who accounts for 9.9 percent or more of the aggregate capital commitments made by private vehicles to the Legacy Securities Fund or any affiliate of any such investor; or
- any other Legacy Securities Fund formed under PPIP.

Making Home Affordable Program. Fund managers will have certain obligations with respect to Legacy Securities Fund investments and the Making Home Affordable Program, the Obama Administration's mortgage modification program. Subject to the fund manager's fiduciary duties and the overall goal of maximizing the Legacy Securities Fund's returns, fund managers will be required to consent to reasonable requests from servicers and trustees for approval to participate in the Making Home Affordable Program or to implement other reasonable loss mitigation measures. Additionally, if a Legacy Securities Fund acquires 100 percent of the residential mortgage-backed securities that are backed by a particular pool

[9] U.S. Dep't of the Treasury Press Release, Legacy Securities Public-Private Investment Funds: Summary of Proposed Terms (Apr. 6, 2009), http://www.treas.gov/press/releases/reports/legacy_securities_terms.pdf.

of loans, the fund manager will be required to instruct the servicer or trustee to include such pool in the Making Home Affordable Program.

Conflicts of Interest, Compliance and Other Restrictions

Conflicts of Interest Policies and Codes of Ethics. Fund managers will be required to adopt conflict of interest mitigation plans and codes of ethics reasonably satisfactory to Treasury. Although these policies and codes have not yet been publicly released, Treasury has summarized certain key provisions, most of which have been described in other sub-sections here. Provisions not described elsewhere include limitations on personal trading by key fund manager employees, the prohibition of the execution of Legacy Securities Fund trades through affiliated broker-dealer affiliates and the prohibition of "pay-to-play" arrangements between fund managers and placement agents, underwriters and other service providers.

Competing Funds. Fund managers will face certain restrictions on establishing funds that compete with Legacy Securities Funds. Without Treasury's consent and subject to certain exceptions, a fund manager may not form another fund with the primary objective of investing in eligible assets before the earlier of one year after the initial closing date of the Legacy Securities Fund it manages and the date on which the Legacy Securities Fund has invested 85 percent of its capital commitments. Excluded from the restrictions are publicly offered funds and funds set up to invest in eligible assets through TALF or other government programs. A fund manager must also notify Treasury if it establishes a competing fund at any time before the expiration of the Legacy Securities Fund's investment period. A fund manager may, however, continue to manage any competing fund established before the Legacy Securities Fund's initial closing date if it observes certain conditions.

Investment Advisers Act. Each fund manager will have to comply with the Investment Advisers Act of 1940 in all material respects, including its antifraud provisions and rules relating to recordkeeping, contracts, advertising, custody of client funds and assets, disclosure and transparency. The nine pre-qualified fund managers are all registered investment advisers.

Executive Compensation and Other TARP Restrictions. As described in Chapter 9: *Executive and Employee Compensation* – Firms and Employees Covered by Compensation Restrictions – Firms covered- PPIP, although not free from doubt, the TARP executive compensation restrictions should not apply to participants in the Legacy Securities Program if Legacy Securities Funds are structured as they are expected to be.

Further, it is uncertain whether, but unlikely that, the restrictions on the hiring of H-1B visa holders under EAWA will apply to participants in the Legacy Securities Program. EAWA places new restrictions on the hiring of H-1B visa holders by any recipient of funding under EESA or Section 13 of the Federal Reserve Act. In the case of a recipient that is an investment fund, EAWA's restrictions also apply to any entity owning or "controlling" 25

percent or more of the total equity of such fund. An entity is deemed to control an investment fund if, among other things, the entity owns, controls or holds with power to vote 25 percent or more of a class of voting securities, or total equity of, the fund.

Legacy Securities Funds will be recipients of EESA funding, so EAWA's restrictions will apply to the funds themselves and any entity that owns or controls 25 percent or more of a class of their voting securities or total equity. However, because of the 9.9 percent cap on the amount of a Legacy Securities Fund's equity that may be held by any one private investor or the fund manager, it is unlikely that any private investor in or fund manager of a Legacy Securities Fund would be subject to the EAWA restrictions. There appears to be no basis for the application of the EAWA restrictions to selling institutions in the Legacy Securities Program by virtue of their participation. For a further discussion of the nature of the EAWA restrictions, see Chapter 6: *The Term Asset-Backed Securities Loan Facility* – Concerns about Restrictions on Pay and on Hiring of Foreign Workers.

Reporting Requirements

- Monthly reports on fund activities showing:
  - Details of securities transactions;
  - Capital activity;
  - Changes in fair market value of fund investments;
  - Performance data;
  - Management discussion and analysis;
  - Analysis of current market conditions; and
  - Additional information as requested by Treasury or SIGTARP.
- Monthly reports on eligible assets;
- Audited annual financial statements;
- Unaudited quarterly financial statements;
- Annual budgets of fund expenses;
- Weekly reports with asset values and applicable ratios for any period during which the fund is not in compliance with the asset coverage test; and
- Certain other information described in the SIGTARP and Subsequent Legislation section of this Chapter.

Reporting and Oversight

Reporting on Fund Investments and Other Activities. As set forth in the sidebar, fund managers will have to submit the reports and other information about Legacy Securities Fund investments and other activities to Treasury and SIGTARP.

Reporting on Eligible Assets Outside of Legacy Securities Funds. Fund managers will also be required to submit monthly reports to Treasury, SIGTARP and the GAO disclosing information about transactions in eligible assets undertaken by the fund manager outside of Legacy Securities Funds. This obligation will extend to any fund or separate account for which a fund manager or any of its affiliates acts as the manager or is the "primary source of investments." Each fund manager must report all holdings of eligible assets and purchases and sales of eligible assets by or for such funds and accounts, as well as certain information about the allocation of investments and disposition opportunities among such funds and accounts. Although fund managers will not be required to name the investors in such funds or clients with respect to such accounts, fund managers will be required to provide Treasury, SIGTARP and the GAO any additional information requested on the subject-matter of these reports.

Access to Books and Records. Fund managers will be obligated to provide Treasury, SIGTARP and the GAO access to fund books and records. They will also be required to provide Treasury access to private vehicles' books and records, including any information in the fund manager's possession regarding the beneficial owners of interests in the private vehicles. Fund managers will also be required to adopt a document retention policy reasonably satisfactory to Treasury.

Audits of Compliance. Both Treasury and SIGTARP will have the right to conduct annual and ad hoc audits of fund managers' compliance with all conflict of interest, ethics, investment and other policies.

Legacy Securities Fund Structures

Many of the investment vehicles established to invest in Legacy Securities Funds will be structured to be exempt from the registration requirements of the Investment Company Act of 1940, meaning that they will be offered solely to sophisticated investors that are qualified purchasers.[10]

There are expected to be a few investment vehicles dedicated to investing in the Legacy Securities Funds that will be available to retail investors in the form of closed-end funds, registered under the Investment Company Act and offered to the public in an underwritten public offering. Such funds will then invest most of their assets in an underlying Legacy Securities Fund managed by the same manager. In order to eliminate any requirement to register the underlying Legacy Securities Fund under the Investment Company Act, the fund manager will likely need an exemptive order granted by the SEC.[11] In order to qualify for an exemption from US federal income tax, in addition to meeting certain asset diversification and qualifying income requirements, retail funds are generally required to distribute all of their income each year. Retail investors have also typically required either a stock exchange listing or assurances from a fund's board that it expects to make a tender offer on a regular basis to provide some liquidity to investors. One of the key benefits of a registered closed-end fund is that it could address tax and regulatory requirements that are essential for raising equity capital from pension plan and tax-exempt investors. Legacy Securities Funds that are registered under the Investment Company Act must restrict the amount of debt incurred by the fund to satisfy a 300 percent asset coverage test.

An alternative structure for raising equity from retail investors is the formation of an investment entity that relies on an exemption under Section 3(c)(5)(C) of the Investment Company Act relating to investments in real estate assets. Several such retail funds are being formed by Legacy Securities Fund managers. However, one of the structural limitations under the Investment Company Act is that not more than 40 percent of the assets of such retail fund can be invested in the underlying Legacy Securities Fund. In addition, compliance with the Section 3(c)(5)(C) exemption is

[10] The most likely exemption is that under Section 3(c)(7) of the Investment Company Act, which requires that each investor in a Legacy Securities Fund and each investor in any private vehicle formed for the purpose of investing in a Legacy Securities Fund be a qualified purchaser. A qualified purchaser is any entity with at least $25 million in its investment portfolio or any individual with at least $5 million of investment securities.

[11] For example, the offering of the registered investment company could be construed to be an offering of the underlying Legacy Securities Fund, which would require registration of the Legacy Securities Fund's securities under the Securities Act and the Investment Company Act in the absence of an exemptive order.

burdensome since it requires a minimum percentage of assets to be invested in mortgage loans or securities that are deemed the functional equivalent of mortgage loans such as agency whole-pool residential mortgage-backed securities. Thus, a large percentage of investments would be in investments other than those targeted by PPIP. However, such an entity would not be restricted by the leverage limitations or other requirements applicable to a registered fund under the Investment Company Act.

Legacy Loans Program

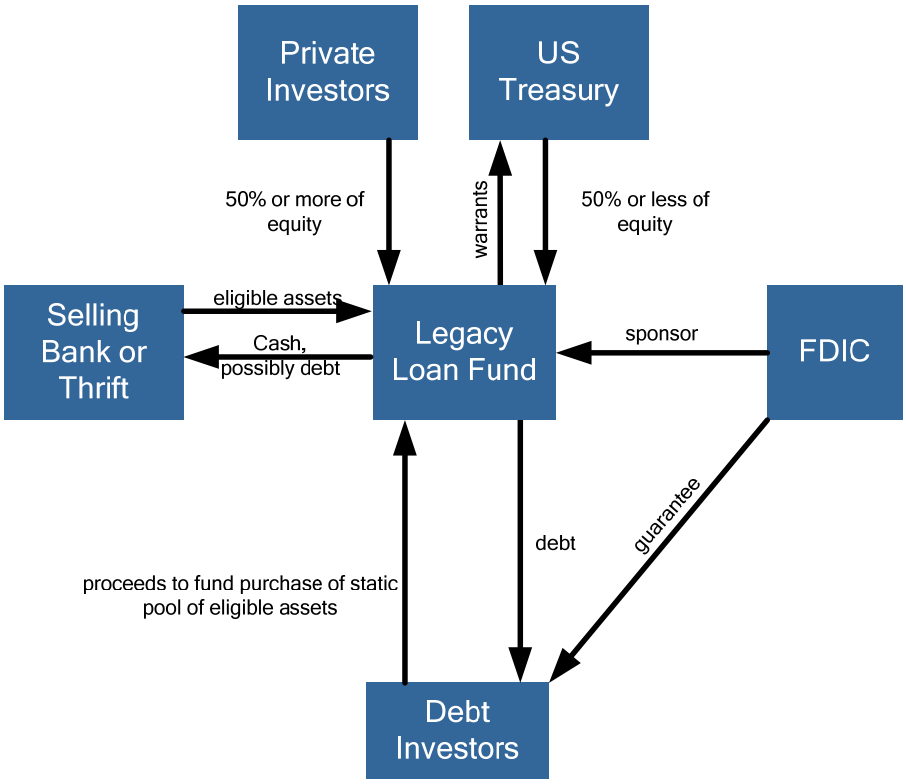
As noted above, the Legacy Loans Program is now suspended. However, if the program proceeds as announced at some point in the future, the FDIC would establish PPIFs, to be termed "Legacy Loans Funds," that would have been capitalized with equity contributions from private investors and Treasury and with FDIC-guaranteed debt to be issued by the Legacy Loans Fund. The diagram below sets forth the basics of the Legacy Loans Program as announced.

Eligible Private Investors

- The list of potentially eligible investors is very broad and may include financial institutions, individuals, insurance companies, mutual funds, publicly managed investment funds, pension funds, foreign investors with a headquarters in the US, private equity funds and hedge funds;
- In order to participate in a troubled asset auction, private investors would have to be pre-qualified by the FDIC; and
- Groups of private investors would not be able to cooperate once the auction process begins.

Eligible Troubled Asset-Selling Banks

- Limited to insured US banks or thrifts;
- Ineligible: banks or thrifts that are owned or controlled by a foreign bank or company.



The scope of private investors who would be eligible under the Legacy Loans Program remains unclear. The definition of "private investor" differs slightly across program materials. The Legacy Loans Program FAQ define private investors to include, among others, "foreign investors with a

headquarters in the United States."[12] None of the other materials suggests a US headquartering limitation. In addition, certain of the materials place a greater emphasis on individual and retail investors.

Identifying Eligible Assets

Troubled assets held by US banks and thrifts, including but not limited to whole loans and pools of loans in the residential and commercial mortgage sectors, would be eligible for sale through the Legacy Loans Program. To be eligible, assets and any collateral supporting them would have to be located predominantly in the US.

A selling bank would have to work with its primary banking regulator, the FDIC and Treasury to identify which troubled assets the bank would try to sell to a Legacy Loans Fund. The term sheet states that eligible assets would have to satisfy undefined "minimum requirements" agreed on by the FDIC and Treasury in order to be eligible. No additional information on these "minimum requirements" has become available since the program was announced.

It is not clear whether an eligible seller could buy assets from an ineligible institution and sell them into the Legacy Loans Program.

Features of FDIC-Guaranteed Debt

- Available guarantee capped per fund according to a leverage ratio established by the FDIC before the auction;
- FDIC would receive a pledge of the Legacy Loans Fund's assets to secure its guarantee;
- Legacy Loans Fund required to maintain a debt service coverage account, initially funded by a holdback of a portion of a selling bank's cash proceeds;
- Other financing terms would be set forth in the FDIC's guaranteed secured debt for PPIFs term sheet, which has not yet been released; and
- FDIC would be reimbursed for auction expenses and paid an administrative fee.

Initial Valuation

Once an asset is deemed eligible, the FDIC would hire a third-party valuation firm to produce an initial valuation. The firm would base this initial valuation on an analysis of expected cash flows based on type of interest rates, risk of underlying assets, expected lifetime losses, geographic exposures, maturity profiles and other unnamed characteristics. The FDIC would use the initial valuation to determine the degree of leverage that the asset pool could support, thereby establishing the ratio of debt to equity that the FDIC would guarantee for a Legacy Loans Fund bidding on the asset pool. It is not clear whether the selling bank would be able to challenge this valuation.

Auction

The auction would be conducted by the FDIC. Selling banks would make information available to the FDIC and potential private investors to facilitate the bidding process according to undefined "pre-established criteria." It is not clear whether the seller would be able to set a reserve price for an auction. The FDIC would review and select the winning bid. Following the announcement of the winning bid, the selling bank would accept or reject the bid within an unspecified time frame. It is not clear how long selling

[12] U.S. Dep't of the Treasury, Frequently Asked Questions: Public-Private, Investment Program for Legacy Loans (2009), http://www.treas.gov/press/releases/reports/legacy_loans_faqs.pdf.

banks would have to accept or reject a winning bid. Nor is it clear whether regulators would seek to influence banks' decisions, although there has been rampant speculation that they would do so.

Structure

The Legacy Loans Program would increase the purchasing power of private investors by two means: equity capital co-investment by Treasury and FDIC guarantees of Legacy Loans Fund-issued debt. Following an auction, the winning bidder and Treasury would each contribute a previously agreed-upon percentage of equity capital, capped at 50 percent for Treasury, to a Legacy Loans Fund created for the purpose of investing in the auctioned assets. The Legacy Loans Fund would then issue FDIC-guaranteed debt in the amount necessary to cover the remainder of the purchase price. This debt would initially be placed at the selling bank, and the selling bank could choose to resell the debt into the market. Alternatively, capital-neutral funding arrangements might be allowed so long as the collateral protection for the FDIC-guaranteed debt is not diminished. Investors could choose to take less Treasury equity subject to an undetermined minimum.

Private investors and Treasury would share profits and losses in proportion to equity invested.

As in the Legacy Securities Program, Treasury would be issued warrants in each Legacy Loans Fund as required by EESA. For a further discussion of EESA's warrant requirement, see Chapter 4: *Warrants: Upside for the Taxpayer* – Statutory Requirements for the Creation of the Warrants.

Role of Asset Manager for Legacy Loans Funds

There is very little information available on the role that asset managers would play under the Legacy Loans Program. A reference to "strict oversight" by the FDIC of the asset managers selected by private investors has raised concerns that the FDIC might dictate goals for asset managers other than using all legitimate means to maximize recoveries.

Management and Governance

Legacy Loans Program materials indicate that asset managers approved by and subject to "strict" FDIC oversight would manage the disposition of the asset pool on an ongoing basis. Unlike the Legacy Securities Program materials, the Legacy Loans Program materials do not indicate the criteria for selecting asset managers or whether asset managers would have any role in raising capital for or structuring the Legacy Loans Funds. Treasury and the FDIC would establish governance procedures relating to management, servicing agreements, financial and operating reporting requirements, exit timing and alternatives for each eligible asset. To the extent practicable, standard documentation would be used.

Although the Legacy Loans Program's documents are not clear, it appears that no Legacy Loans Fund would be permitted to purchase assets from a seller that is an affiliate of any of its private investors or from 10 percent-or-larger private investors in that Legacy Loans Fund.[13]

As described in Chapter 9: *Executive and Employee Compensation*, although not free from doubt, the TARP executive compensation restrictions should not apply to participants in the Legacy Loans Program if Legacy Loans Funds are structured as they are expected to be.

For the reasons described above in the Legacy Securities Fund Structures section of this Chapter, it is uncertain whether, but unlikely that, the EAWA restrictions on the hiring of H-1B visa holders would apply to participants in the Legacy Loans Program.

Postponement and Pilot Test

The implementation of the Legacy Loans Program has proven to be quite difficult. Financial institutions have expressed unwillingness to place assets into the program for fear of the impact on their balance sheets, and investors have shown reluctance to participate with few guarantees of successful execution. On June 3, 2009, the FDIC indefinitely postponed the Legacy Loans Program, but indicated that it would test the funding mechanism underlying the Legacy Loans Program in a pilot sale of receivership assets. The FDIC stated that, in so doing, it would "draw[] upon concepts successfully employed by the Resolution Trust Corporation."[14]

On July 31, 2009, the FDIC announced that it had begun this pilot sale process, which it characterized as the "next step" in the Legacy Loans Program's development that will allow the FDIC "to be ready to offer the [Legacy Loans Program] to open banks as needed."[15] On September 16, 2009, the FDIC announced that final bids were received on August 31, 2009, that 12 consortiums submitted bids and that a winning bidder, Residential Credit Solutions, had been selected. The FDIC indicated that the closing will occur in late September, with additional details of the sale to be published then. What is public about the sale at the publication date of this Chapter is that the transaction will involve the creation of an LLC to which the FDIC receivership of Franklin Bank of Houston, Texas will transfer, on a servicing-released basis, a portfolio of residential mortgage loans with an unpaid principal balance of approximately $1.3 billion in exchange for an

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[13] FDIC, PROPOSED STATEMENT OF POLICY ON QUALIFICATIONS FOR FAILED BANK ACQUISITIONS (July 1, 2009), http://www.fdic.gov/news/board/jul2sop.pdf (these concepts were reprised in a different context in the FDIC's proposed policy statement for private equity).

[14] The Resolution Trust Corporation was the vehicle created to deal with savings and loan troubled assets during the late 1980s.

[15] FDIC Press Release, Legacy Loans Program: Test of Funding Mechanism (July 31, 2009), http://www.fdic.gov/news/news/press/2009/pr09131.html.

equity interest in the LLC. Residential Credit Solutions elected a sale with 6-to-1 leverage, as described further below, and will pay the FDIC $64,215,000 in cash for a 50 percent equity interest in the LLC. The FDIC will take the remaining equity and the LLC will issue to the FDIC as receiver an amortizing note of $727,770,000 guaranteed by the FDIC in its corporate capacity. At a future date, the FDIC anticipates selling the note, which one source reports bears an interest rate of 4.25 percent.[16] After the closing, Residential Credit Solutions will manage the portfolio and service the loans in compliance with the Making Home Affordable Program.

The FDIC estimates that Residential Credit Solutions would be paying about 71 cents on the dollar for the loan portfolio, which FDIC officials said was approximately 20 cents on the dollar more than the investor would have been willing to offer in the absence of the FDIC financing.[17] One of the unsuccessful bidders in the pilot sale suggested that the FDIC had chosen a particularly attractive portfolio, although an FDIC official said that the portfolio was chosen because it is representative of the loans held by many other banks.[18]

Bidders in the pilot sale, which were required to be accredited investors, were offered two options, the details of which were set forth in the July 31 release. The first was a sale on an all-cash basis. Had the winning bidder elected this option, it would have purchased a 20 percent equity stake, the FDIC would have taken the remaining 80 percent and the sale of assets to the LLC would not have been financed with any debt. The FDIC's recent sales of receivership assets have been on an all-cash basis.

The second option was a sale with leverage, which Residential Credit Solutions elected. Under this option, the equity of the LLC had to be split evenly between the bidder and the FDIC and could have been financed with an FDIC-guaranteed note at either 6-to-1 or 4-to-1 leverage. The 6-to-1 election, which Residential Credit Solutions made, will result in the application of certain performance thresholds to the underlying assets, including with respect to delinquency status, loss severities and principal repayments. Failure to meet these thresholds will trigger a redirection of the principal cash flows from the equity investors to pay down the FDIC debt. No such performance thresholds would have applied if the winning bidder had made the 4-to-1 election.

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[16] *See* Edmund L. Andrews, *FDIC Sells Failed Bank's Troubled Mortgages to Private Investor*, N.Y. TIMES, Sept. 17, 2009, http://www.nytimes.com/2009/09/17/business/17loans.html?_r=1.

[17] *See* Edmund L. Andrews, *FDIC Sells Failed Bank's Troubled Mortgages to Private Investor*, N.Y. TIMES, Sept. 17, 2009, http://www.nytimes.com/2009/09/17/business/17loans.html?_r=1.

[18] *See* Binyamin Appelbaum, *FDIC Packages Loans from Failed Banks*, WASH. POST, Sept. 17, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/09/16/AR2009091603055.html.

Under both sale options, bidders had the choice of complying with either the Home Affordable Mortgage Program, as Residential Credit Solutions elected, or the FDIC's loan modification program.

According to one news report, an FDIC official has said that a second sale will occur soon and that others will likely follow before the end of the year.[19]

One benefit of the pilot sale of receivership assets is that it avoids the thorny valuation problems that arise in the context of a sale by an open bank. The receiver, as holder of the assets, is only interested in obtaining the best price for the assets, and a structured sale using the PPIP framework is simply another alternative sales vehicle. There are no concerns on the part of the receivership as to balance sheet or capital impact, as would be present in an open institution.

The FDIC has already used a somewhat similar structure in disposing of hard-to-value assets, where assets are contributed to an LLC. The receiver takes back both the membership interests in the LLC as well as a participation interest giving the FDIC a percentage of cash recoveries on the assets. It then offers the membership interests for sale by auction.

It appears that the FDIC hopes that by demonstrating the effectiveness of the PPIP structure in selling receivership assets, it will demonstrate the viability of the structure and will induce open institutions to participate.

SIGTARP and Subsequent Legislation

The SIGTARP has targeted PPIP in both of his quarterly reports to Congress since PPIP was announced. SIGTARP's April 21, 2009 report concluded that "[m]any aspects of PPIP could make it inherently vulnerable to fraud, waste, and abuse,"[20] highlighting four risks in particular:

- *Conflicts of interest* of fund managers, which could arise if fund managers own or manage eligible assets separately from PPIFs. SIGTARP's concern in such cases is that the fund manager might have an incentive to bid up eligible assets at a loss to the PPIF, and therefore taxpayers, to create a gain on its other holdings of such assets. Problematic conflicts could also arise if fund managers own equity in selling institutions;
- *Collusion* between fund managers and other fund managers, sellers or third parties. SIGTARP's report gives a series of examples of

[19] *See* Binyamin Appelbaum, *FDIC Packages Loans from Failed Banks*, WASH. POST, Sept. 17, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/09/16/AR2009091603055.html.

[20] OFFICE OF THE SPECIAL INVESTIGATOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS (April 2009), http://www.sigtarp.gov/reports/congress/2009/April2009_Quarterly_Report_to_Congress.pdf.

how such collusion could harm taxpayers, generally involving payments to a fund manager for overbidding on eligible assets to create gains on such assets held by others;

- *Money laundering* taking advantage of the imprimatur of a government program; and
- *Excessive leverage* if PPIP and TALF were combined in such a way that private investors have less "skin in the game" than ordinary TALF borrowers. Such dilution could occur if private investors were permitted to fund TALF haircuts with the capital raised by PPIFs, only a portion of which would be investors' own equity. SIGTARP noted that such dilution would magnify the risks listed above and could result in the Federal Reserve Bank of New York's taking on more risk than intended.

The report contained a series of recommendations addressing these risks. Acting with unusual speed, Congress enacted many of them into law as part of the Helping Families Save Their Homes Act of 2009. The requirements of this statutory provision, which applies to both the Legacy Securities and Legacy Loans Programs, are set forth in the sidebar. As described above, Treasury has already implemented several of these provisions, including the conflict of interest rules.

The April 2009 report contained a number of other recommendations, which are set forth in the sidebar on the next page. As described above, some of these have influenced the development of PPIP and TALF, including the recommendations related to the disclosure of all holdings of eligible assets and to the layering of leverage in TALF.

SIGTARP has renewed some of these recommendations and added new ones in his July 21, 2009 quarterly report. SIGTARP calls most forcefully for the imposition of strict information barriers or walls between fund manager employees making investment decisions on behalf of a Legacy Securities Fund and employees managing other funds. The report notes that such walls have already been imposed upon three of the nine pre-qualified fund managers in other bailout programs, and that Treasury itself has required that asset managers erect such walls in other programs. The report also repeats SIGTARP's recommendation that Treasury periodically disclose all trading activity by Legacy Securities Funds, rather than the statutorily required minimum of each PPIF's ten largest positions.

The report contains three additional recommendations. First, SIGTARP recommends that Treasury obtain the right to remove fund managers unilaterally under appropriate circumstances, such as the failure to meet certain performance benchmarks or the violation of compliance or ethics rules. To implement this recommendation, SIGTARP calls for Treasury to identify performance metrics and establish a fund manager evaluation process. Second, SIGTARP recommends that Treasury require fund managers to disclose to Treasury holdings of some or all related assets and liabilities, in addition to the existing requirement to disclose holdings of

Section 402 of the Helping Families Save Their Homes Act of 2009:

- Creates a fiduciary duty running from fund managers to "public and private" investors.
- Requires each fund manager to disclose to Treasury the identity of any investor who holds, directly or indirectly, 10 percent or more of a PPIF's equity.
- Requires each PPIF to file a quarterly report with Treasury disclosing its 10 largest positions, to be made public at such time as Treasury determines disclosure would not harm the PPIF's ongoing operations.
- Imposes "strict" conflict of interest rules on fund managers, to be developed in consultation with SIGTARP.
- Requires each fund manager to retain all books and records related to the PPIF.
- Gives SIGTARP access to all PPIF books and records.
- Requires each fund manager to use strict investor screening procedures.
- Requires each fund manager to develop a robust ethics policy.
- Requires Treasury to consult with SIGTARP and issue regulations on the interaction of PPIP and TALF to "address concerns regarding the potential for excessive leverage."

SIGTARP's Other April Recommendations Would Require:

- Disclosure (not clear to whom) of *all* beneficial owners of equity interests in PPIFs and of *all* transactions entered into by PPIFs.
- Public disclosure of certified reports from all PPIFs showing *all* transactions entered into by the PPIFs and the current valuation of *all* assets.
- Disclosure to Treasury of all holdings and transactions of each fund manager *for its own account or for any of its clients* in the types of assets held by its PPIF.
- SIGTARP to have access to *private investors'* books and records, at least to the extent that they relate to PPIP investments.
- "Most-favored nation clauses" requiring fund managers to treat PPIFs on at least as favorable terms as they extend to other clients.
- Prohibition of Legacy Securities Funds from borrowing under TALF unless measures are put in place to ensure that private investors have enough equity capital at risk.

eligible assets. SIGTARP suggests that "related" should be defined to cover any type of asset or liability the value of which is correlated to the value of eligible assets. Third, SIGTARP recommends that Treasury obtain the unilateral right to prohibit the participation of certain private investors, in furtherance of the government's anti-money laundering efforts. In support of this recommendation, SIGTARP advises imposing an affirmative obligation on fund managers to collect and maintain information about the beneficial ownership of private equity interests, rather than relying on the obligation in the current program terms to share any information in the fund manager's possession on such ownership.

Since the July 2009 report, SIGTARP has indicated that, in response to Treasury's refusal to impose information barriers, it will dedicate additional resources to investigating fund managers' conflicts of interest.

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CHAPTER 8: INVESTIGATIONS AND ENFORCEMENT

William J. Fenrich, Jennifer G. Newstead, Linda Chatman Thomsen and Raul F. Yanes

Table of Contents

What to Expect in the Wake of the Financial Crisis

More, Faster and Tougher Regulation and Enforcement

The financial crisis has resulted in a demand for accountability and retribution at all levels in both the public and private sectors. It is not surprising that, in response, both the federal and state governments have been gearing up to take action against those viewed as having some responsibility for the crisis, and to take measures to prevent future crises. As a result, in the months and years to come, we should expect to see more, faster, and tougher regulation and enforcement.

The Obama Administration seems more willing to increase both government regulation and the intensity of enforcement in the financial sector. It has proposed several pieces of legislation that would do exactly that, including one that would create a new consumer financial protection agency.[1] The Administration also has, through an executive memorandum and through proposed legislation, signaled that it expects the states to play an increased regulatory and enforcement role in the years to come.[2]

In addition, the takeover of Congress by the Democrats may mean more skepticism of the business community in general and, therefore, more regulation and vigorous enforcement. There have already been proposals to increase the budgets for regulators, such as the SEC and the DOJ,

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The publication date of this Chapter is September 21, 2009. All terms and acronyms used in this Chapter are defined in the Glossary at the front of this Manual.

Research Assistance for this Chapter has been provided by associates Daniel S. Kahn, Scott Wilcox, and Rachel S. Zeehandelaar, and summer associates Edith Beerdsen, Eleanor G. Carr, Vesna Cuk, Rebecca Rotem, and Heidi E. Reiner.

[1] For discussion of the CFPA, see the Davis Polk Client Newsflash, *Consumer Financial Protection Agency Act of 2009* (July 1, 2009), http://www.davispolk.com/files/Publication/2c9ef9b3-6871-4eac-9498-49d5fde025c7/Presentation/PublicationAttachment/32be2bc8-4cd3-4673-b1b8-0308ab5100b3/070109_CFPAA.html.

[2] *See* White House Press Release, Memorandum on Preemption for the Heads of Executive Departments and Agencies (May 20, 2009), http://www.whitehouse.gov/the_press_office/Presidential-Memorandum-Regarding-Preemption/.

including a proposal to make the SEC self-funded, and increase its budget 13% from 2009 to 2010.

Enforcement and investigations will follow their own timing rhythm and, based on past experience, can be expected to last for several years after the recession is ended and the rest of the financial sector has moved on to a new business cycle. Moreover, while enforcement actions will almost certainly increase in the very near future to redress the causes of the financial crisis, the effect of the new enforcement tools being enacted in response to the crisis may not be fully realized for several years.

Perhaps two of the most significant proposals that demonstrate the likely increase in regulation and enforcement are the Administration's and Congress's proposals to expand the authority of the SEC and private citizens to seek sanctions against those who aid and abet a securities violation. The proposed Investor Protection Act of 2009, if enacted, would extend the SEC's aiding and abetting enforcement authority to cover all of the securities statutes (it currently covers only the Securities and Exchange Act of 1934 and the Investment Advisers Act of 1940), and would clarify that the SEC's authority includes reckless conduct, thereby resolving a split among the circuit courts of appeal by adopting the more expansive standard of liability.[3] Senator Arlen Specter (D-PA) has proposed a bill that would create a private right of action to pursue claims against those who aid and abet a securities violation, which would significantly increase the number of actions brought against violators.[4] Even while these proposals are still being considered by Congress, the SEC and prosecutors have increased their enforcement efforts. In the second quarter of 2009, securities fraud suits filed by regulators and law enforcement agencies were the most frequent type of securities claim, exceeding even the number of private shareholder suits during this period.[5]

Proposed Legislation

- Investor Protection Act of 2009
  - Would extend the SEC's aiding and abetting enforcement authority to cover all of the securities statutes;
  - Would clarify that the SEC's authority includes reckless conduct, thereby adopting an expansive standard of liability.
- Liability for Aiding and Abetting Securities Violations Act of 2009
  - Would create a private right of action to pursue claims against those who aid and abet a securities violation.

It also appears likely that regulators will begin to work their investigations and enforcement actions more quickly and intensely. For example, in a speech at the New York City Bar on August 5, 2009, SEC Director of Enforcement Robert Khuzami said that he will seek to streamline the SEC's procedures and accelerate the process of identifying, pursuing, and resolving cases.[6] SEC Director of Enforcement Robert Khuzami said that

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[3] See also the Davis Polk Client Newsflash, *Investor Protection Act of 2009* (July 13, 2009), http://www.davispolk.com/files/Publication/248892a6-918c-4063-ba95-0328cb0a2041/Presentation/PublicationAttachment/6393e0f9-ba29-4d4d-a1b1-02e0985d6cdb/071309_IPA_2009.html.

[4] Liability for Aiding and Abetting Securities Violation Act of 2009, S. 1551, 111th Cong. (2009).

[5] Advisen Press Release, Advisen Report Finds That Drop in Q2 Securities Suits May Be a Brief Lull (July 30, 2009), https://www.advisen.com/HTTPBroker?action=jsp_request&id=articleDetailsNotLogged&resource_id=99023246.

[6] *See* Davis Polk Client Newsflash, *SEC Announces Significant Enforcement Initiatives* (Aug. 6, 2009), http://www.davispolk.com/files/Publication/62a11664-06dd-4960-818c-db472e51cd9e/Presentation/PublicationAttachment/f9ed03b2-c8df-4d9a-9e95-db62110432ce/08.06.09.SEC_Enforcement_Initiatives.html.

the Enforcement Division will form specialized units, each led by a Unit Chief and staffed by personnel throughout the country who either have or will develop specific expertise in a relevant subject matter area. The SEC Commissioners recently echoed this call for more expeditious enforcement when they delegated to SEC Director of Enforcement Robert Khuzami the authority to issue formal orders of investigation, with their accompanying subpoena power. In addition, in an effort to speed up investigative actions by eliminating layers of bureaucracy, SEC Director of Enforcement Robert Khuzami stated that he was planning to delegate greater authority to senior officers in local offices, including the subpoena power, and to drastically reduce the number of tolling agreements the SEC would enter into. Finally, the director indicated that he planned to increase incentives for cooperating witnesses, and to create an office to process and respond to tips received by the division.

In this new environment, regulators will wield existing authority more forcefully to impose stricter penalties, and seize upon any expanded authority enacted as a result of the current crisis. Building on existing penalty authority, the Administration has drafted legislation that would permit the SEC to impose a broader range of collateral bars under the Exchange Act and the Advisers Act, prohibiting offenders from associating with a broad range of SEC-regulated entities, rather than only those entities regulated under the particular statutory provisions under which the violation occurred.

Moreover, other proposed legislation would create a Consumer Financial Protection Agency armed with broad investigatory and enforcement powers, including the power to issue subpoenas, demand testimony or written answers to questions, conduct hearings and adjudication proceedings, and bring a civil action against any person who violates the enabling act — or a rule promulgated thereunder — to seek a monetary penalty and/or broadly enumerated equitable relief. Whatever the outcome of the proposed legislation and whether or not a Consumer Financial Protection Agency is created, we expect greater enforcement in the consumer arena.

Despite the high likelihood that there will continue to be more, faster and tougher regulation and enforcement, it is worth noting that the effect of the new enforcement tools being enacted in response to the crisis may not be fully realized for several years. Indeed, enforcement tools enacted in the aftermath of past corporate scandals, notably including those at Enron and WorldCom, are only now being applied by enforcement agencies, in response to the financial crisis. The SEC, for example, for the first time recently asked a court to enforce Section 304 of the Sarbanes-Oxley Act of 2002 — which permits the clawback of certain compensation and profits from chief executive officers and chief financial officers stemming from noncompliance with SEC financial reporting requirements — despite the defendant chief executive officer not being accused of involvement with the underlying accounting fraud.

The financial crisis may afford law enforcement agencies increasing opportunities to use other enforcement tools enacted by the Sarbanes-Oxley

Act, such as harsher criminal penalties for certain fraudulent conduct, expanded authority to seek injunctive relief, new authority to seek an order freezing assets even prior to formally charging a violation of the securities laws, and the authority to set aside certain civil penalties in a disgorgement fund for the benefit of victims of a violation.

The Changing Enforcement Landscape

In response to the increased appetite for regulation, the Administration and Congress are arming enforcement agencies with expanded authority and creating new bodies to investigate and prosecute violations. Even though some of these new investigatory entities do not possess the authority to prosecute violations, their investigations can, and most likely will, lead to an increased number of prosecutions through the information they uncover and turn over to prosecuting authorities.

Enforcement Actors

The government actors that currently possess the authority to enforce laws in the financial arena include the DOJ and SEC, as well as state regulators and enforcement actors that may play an expanding role in part because of the Administration's efforts to encourage them to do so. The proposed Consumer Financial Protection Agency would also be able to institute enforcement actions in this area if it is established in the form envisioned by pending legislation.

Department of Justice

The DOJ intends to play a "crucial role" in the federal financial recovery effort through criminal and civil litigation.[7] The Department has requested a $62.6 million budget increase in FY 2010 to "aggressively pursue mortgage fraud, corporate fraud, and other economic crimes,"[8] including those matters likely to be referred to the DOJ by newly created agencies. The funding would supplement increased resources already provided by the Fraud Enforcement and Recovery Act of 2009, which appropriated $50 million per year to US Attorney's Offices to staff the FBI's fraud strike forces, and $40 million to DOJ's Criminal, Civil, and Tax Divisions to provide litigation and investigative support in fraud cases.[9] Specifically, the FBI plans to augment its current complement of 250 agents devoted to addressing fraud and other

[7] U.S. Dep't of Justice Press Release, Department of Justice FY 2010 Budget Request (May 7, 2009), http://www.usdoj.gov/opa/pr/2009/May/09-ag-451.html.

[8] U.S. DEP'T OF JUSTICE, DEPARTMENT OF JUSTICE FY 2010 BUDGET REQUEST: COMBATING FINANCIAL FRAUD AND PROTECTING THE FEDERAL FISC (2009), http://www.usdoj.gov/jmd/2010factsheets/pdf/cff-fisc.pdf.

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criminal activities related to the financial crisis, by dedicating another 143 new special agents and professional staff to this mission for FY 2010.[10]

Proposed Legislation with Enforcement Elements

- Private Fund Investment Advisers Registration Act of 2009;
- Investor Protection Act of 2009; and
- Consumer Financial Protection Agency Act of 2009.

Increased Enforcement Activity

- From late January to early September 2009, compared to roughly the same period in 2008, the SEC:
  - Opened more investigations (1377 compared to 1290);
  - Issued more than twice as many formal orders of investigation;
  - Filed more than twice as many emergency temporary restraining orders; and
  - Filed nearly 30% more actions.

Securities and Exchange Commission

The Administration and Congress are providing the SEC with increased appropriations and expanded enforcement authority so that it can more aggressively pursue fraud related to the financial crisis. The Senate Appropriations Committee approved $1.13 billion in SEC funding for FY 2010, which would represent an increase of $156 million compared to the previous year, and would support the hiring of more than 200 new full time employees.[11] The bill passed by the House of Representatives would increase the SEC's funding by $76 million compared to FY 2009 levels.[12]

In addition, the Administration has proposed two pieces of legislation that would expand the agency's enforcement authority:

- The proposed Private Fund Investment Advisers Registration Act of 2009, sent to Congress by Treasury on July 15, 2009, would amend the Investment Advisers Act of 1940 to require nearly all advisers to hedge funds and other private pools of capital to register with the SEC.[13]
- The proposed Investor Protection Act of 2009, sent to Congress by Treasury on July 10, 2009, would grant the SEC authority to seek remedies for aiding and abetting violations of the Securities Act of 1933 and the Investment Company Act of 1940, as it currently can for violations of the Securities Exchange Act of 1934 and the Advisers Act.[14] This proposed Act would also extend the SEC's aiding and abetting enforcement authority across all securities laws to include reckless conduct. In addition, the Act would expand the SEC's authority to compensate whistleblowers and would permit the SEC to impose a

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[10] *A Review of the Fiscal Year 2010 Budget Justification for the Fed. Bureau of Investigation: Hearing Before the Subcomm. on Commerce, Justice, Science, and Related Agencies of the S. Comm. on Appropriations*, 111th Cong. (2009) (statement of Robert S. Mueller III, Director, Fed. Bureau of Investigation).

[11] Financial Services and General Government Appropriations Bill, 2010 S. Rep. No. 111-43, 111th Cong. (2009), http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_reports&docid=f:sr043.111.pdf; *Senate panel wants details on use of TARP money*, REUTERS, July 9, 2009, http://www.reuters.com/article/idUSTRE5687PW20090709.

[12] Financial Services and General Government Appropriations Bill, 2010 H.R. Rep. No. 111-202, 111th Cong. (2009), http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_reports&docid=f:hr202.111.pdf.

[13] U.S. Dep't of the Treasury Press Release, Fact Sheet: Administration's Regulatory Reform Agenda Moves Forward: Legislation for the Registration of Hedge Funds Delivered to Capitol Hill (July 15, 2009), http://www.ustreas.gov/press/releases/tg214.htm.

[14] *See* Davis Polk Client Newsflash, *Investor Protection Act of 2009* (July 13, 2009), http://www.davispolk.com/files/Publication/248892a6-918c-4063-ba95-0328cb0a2041/Presentation/PublicationAttachment/6393e0f9-ba29-4d4d-a1b1-02e0985d6cdb/071309_IPA_2009.html.

broader range of collateral bars on violators under the Exchange Act and the Advisers Act.

Even without the proposed expansion of its authority, the SEC brought an increased number of enforcement actions in 2009 to date. See the sidebar on the previous page for data relating to increased enforcement activity.[15]

Consumer Financial Protection Agency

- The proposed legislation would make sweeping changes to the way consumer financial products and services are regulated;
- The Consumer Financial Protection Agency's mission would be "to promote transparency, simplicity, fairness, accountability, and access in the market for consumer financial products or services"; and
- The proposed agency would be headed by a five-member board, which would include the Director of the National Bank Supervisor (the head of a proposed federal agency formed by the merger of the OCC and OTS) and four members appointed by the President with the advice and consent of the Senate.

Consumer Financial Protection Agency

The proposed Consumer Financial Protection Agency Act of 2009 was sent to Congress on June 30, 2009, and was subsequently introduced in the House of Representatives by Financial Services Committee Chairman Representative Barney Frank (D-MA).[16] If enacted, the Consumer Financial Protection Agency would be authorized to regulate "consumer financial products or services," broadly defined as "any financial product or service to be used by a consumer primarily for personal, family or household purposes."[17] The new agency would have the ability to regulate the communications between the consumer and financial entities to ensure that consumers are not being led, intentionally or unintentionally, into unwise financial transactions. The Consumer Financial Protection Agency would be able to regulate disclosures made by financial entities to ensure that the consumer is fully aware of what he or she is entering into. In addition, the Consumer Financial Protection Agency could force financial entities to offer a simple option so that consumers can choose between simple and more complex transactions.

The proposed legislation would grant the Consumer Financial Protection Agency broad authority to collect information, conduct investigations, and bring enforcement proceedings, including the power to issue subpoenas and to require written reports and answers to questions, so long as the information being sought is relevant to the enforcement of the Consumer Financial Protection Agency Act. In addition, the Consumer Financial Protection Agency could bring enforcement actions in federal district courts seeking a wide range of sanctions, including injunctions, penalties, rescission, refunds, restitution, compensation for unjust enrichment, and limitations on activities.

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[15] *Testimony Concerning the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs,* 111th Cong. (2009) (statement of Robert Khuzami, Director, Division of Enforcement, Securities and Exchange Commission), http://www.sec.gov/news/testimony/2009/ts091009rk-jw.htm.

[16] U.S. Dep't of the Treasury Press Release, Administration's Regulatory Reform Agenda Moves Forward: Legislation for Strengthening Consumer Protection Delivered To Capitol Hill (June 30, 2009), http://www.treasury.gov/press/releases/tg189.htm.

[17] *See* Davis Polk Client Newsflash, *Consumer Financial Protection Agency Act of 2009* (July 1, 2009), http://www.davispolk.com/files/Publication/2c9ef9b3-6871-4eac-9498-49d5fde025c7/Presentation/PublicationAttachment/32be2bc8-4cd3-4673-b1b8-0308ab5100b3/070109_CFPAA.html.

It remains unclear whether a Consumer Financial Protection Agency will be created and, if so, how closely it may resemble the agency envisioned by the Obama Administration. Over the past several months, consumer and business interests have worked to shape public opinion about consumer financial protection through advertising campaigns and to influence the legislative debate over the merits of a Consumer Financial Protection Agency through lobbying.[18] Existing regulators, such as the FDIC and Federal Reserve, have argued that existing consumer protection enforcement powers should remain with their respective agencies.[19] Centrist Democrats, among others, have sought to eliminate a provision of the legislation that would permit states to enact tougher rules than those set by the new agency.[20]

Whatever the fate of the proposed Consumer Financial Protection Agency, however, it appears certain that the financial sector will face increasing government scrutiny on consumer protection issues.

The States

Encouraged by the Administration, and emboldened by a recent Supreme Court decision,[21] it is likely that the states will continue, and perhaps increase enforcement activity affecting the financial sector.

States have long been players in the financial regulatory arena, and have sometimes led the way in enforcement efforts. The New York Attorney General, for example, uncovered practices of "late trading" and "market timing" in the mutual fund industry in 2003.[22] That same year, the State of New York brought the first enforcement action concerning these practices, against hedge fund Canary Capital Partners LLC and its affiliates. The states were also instrumental in reforming research practices at investment banks. Beginning in 2002, state and federal agencies cooperated with self-regulatory organizations to investigate ten of the country's largest investment banks.[23] The result was a global settlement that resolved

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[18] Brody Mullins, *Chamber Ad Campaign Targets Consumer Agency*, WALL ST. J., Sept. 8, 2009, http://online.wsj.com/article/SB125236911298191113.html; Peter Stone, *Financial Industry Guns Of August*, NAT'L J., Aug. 1, 2009, http://www.nationaljournal.com/njmagazine/ll_20090801_7076.php.

[19] Associated Press, *FDIC chief says parts of regulatory plan won't fly,* GOOGLE NEWS (Aug. 14, 2009), http://abcnews.go.com/Business/wireStory?id=8329184.

[20] Jessica Holzer, *Centrist Dems To Press Concerns Over New US Consumer Agency*, DOW JONES, Sept. 10, 2009, http://www.nasdaq.com/aspx/stock-market-news-story.aspx?storyid=200909080815dowjonesdjonline000203&title=centrist-dems-to-press-concerns-over-new-us-consumer-agency.

[21] Cuomo v. Clearing House Ass'n, 129 S. Ct. 2710 (2009).

[22] Letter from Karen Tyler, President, N. Am. Sec. Admin. Ass'n, to Jeffrey Stolzfoos, Senior Advisor, Office of the Ass't Sec'y for Fin. Insts., U.S. Dep't of the Treasury, et al. 8 (Nov. 29, 2007), http://www.nasaa.org/content/files/TreasuryResponse112907.pdf.

[23] Letter from Karen Tyler, President, N. Am. Sec. Admin. Ass'n, to Jeffrey Stolzfoos, Senior Advisor, Office of the Ass't Sec'y for Fin. Insts., U.S. Dep't of the Treasury, et al. 9 (Nov. 29, 2007), http://www.nasaa.org/content/files/TreasuryResponse112907.pdf.

various claims for fraud and misconduct relating to analyst reports and required, among other things, that the firms pay over $1.4 billion in restitution, fines, and investor education support and comply with significant requirements to minimize future conflicts of interest.[24] More recently, the states, with the SEC and FINRA, tackled problems in the auction-rate securities market. The North American Securities Administrators Association formed a multi-state Task Force in April 2008 to "investigate whether the nation's prominent Wall Street firms had systematically misled investors when placing them in ARS securities."[25] In testimony before Congress, the Chair of the North American Securities Administrators Association's Enforcement Section stated that in three reporting periods between 2004 and 2007, state securities regulators conducted more than 8,300 enforcement actions, leading to $178 million in monetary fines and penalties and over $1.8 billion ordered returned to investors.[26] He observed that the states' efforts led to prison terms totaling over 2,700 years for individuals accused of fraud.

Although federal preemption of state securities laws has sometimes limited enforcement efforts by state financial regulators, the Obama Administration has signaled its intention to lessen such constraints. On May 20, 2009, the President issued a memorandum announcing Administration policy that state laws should not be preempted by federal departments and agencies unless the preemption is necessary and authorized under the law.[27] In addition, the Administration's proposed Consumer Financial Protection Agency Act of 2009 would permit states to enact consumer protection provisions stricter than those under federal law, and also would permit state attorneys general to bring actions in federal courts to enforce relevant state and federal laws.

A recent Supreme Court decision further enhances opportunities for increased state enforcement. The June, 2009 decision in *Cuomo v. The Clearing House Association, L.L.C.* reaffirmed the states' traditional role in protecting consumers from illegal and improper practices by national banks.[28] The Court held that a regulation promulgated by the OCC did not

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[24] Letter from Karen Tyler, President, N. Am. Sec. Admin. Ass'n, to Jeffrey Stolzfoos, Senior Advisor, Office of the Ass't Sec'y for Fin. Insts., U.S. Dep't of the Treasury, et al. 8 (Nov. 29, 2007), http://www.nasaa.org/content/files/TreasuryResponse112907.pdf; SEC et. al. Joint Press Release, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), http://www.sec.gov/news/press/2003-54.htm.

[25] N. Am. State Sec. Admin. Ass'n Press Release, Regulators Announce Settlement with TD Ameritrade in Auction Rate Securities Investigations (July 20, 2009), http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/11060.cfm.

[26] *Fed. and State Enforcement of Financial Consumer and Investor Protection Laws: Hearing Before H. Comm. on Financial Servs.*, 111th Cong. 5 (2009) (statement of James B. Ropp, Chair, Enforcement Section, N. Am. Sec. Admin'rs Ass'n).

[27] White House Press Release, Memorandum on Preemption for the Heads of Executive Departments and Agencies (May 20, 2009), http://www.whitehouse.gov/the_press_office/Presidential-Memorandum-Regarding-Preemption/.

[28] Cuomo v. Clearing House Ass'n, 129 S. Ct. 2710, 2721-22 (2009).

preempt enforcement of state fair lending laws against national banks.[29] In its decision, the Court emphasized the distinction between supervision, which is solely the domain of the Office of the Comptroller of the Currency, and law enforcement authority, which is a shared responsibility of states and the federal government.[30]

International Enforcement Agencies and Regulators

Enforcement of the Foreign Corrupt Practices Act

- Increasing number of enforcement actions brought by SEC and DOJ:
  - 2008: 37
  - 2007: 38
  - 2006: 15
- More companies under investigation for potential violations:
  - 2009 (through May): 120
  - 2008 (entire year): 100

Individuals and companies increasingly face enforcement actions concerning conduct occurring outside of the United States, particularly through the application of the US anti-bribery statute, the Foreign Corrupt Practices Act.

Over the past several years, the SEC and DOJ have placed greater scrutiny on allegations of foreign bribery by US corporations and by foreign corporations listed on US stock exchanges. As noted in the sidebar, the SEC and DOJ stepped up their enforcement efforts under the Foreign Corrupt Practices Act in 2007 and 2008, when they brought thirty-eight and thirty-seven enforcement actions, respectively, compared to only fifteen such actions in 2006.[31] These efforts seem to be intensifying, with at least 120 companies under investigation for potential Foreign Corrupt Practices Act violations through the first five months of 2009, up from 100 companies in all of 2008.[32]

US enforcement actions against the German company Siemens AG and several of its subsidiaries, which resulted in a plea agreement in December 2008, illustrates two recent trends in the enforcement of the Foreign Corrupt Practices Act. First, fines and penalties for Foreign Corrupt Practices Act violations have been increasing.[33] Siemens AG, for example, agreed to pay a combined total of approximately $800 million to US authorities, which represents the largest monetary sanction imposed under the Foreign Corrupt Practices Act to date.[34] Before that, the highest combined criminal and civil penalties assessed, which related to the prosecution of Baker Hughes, Inc. for bribes paid in connection with oil contracts in Kazakhstan, totaled only $44 million.[35] Second, prosecutors and regulators have

[29] Cuomo v. Clearing House Ass'n, 129 S. Ct. 2710, 2721-22 (2009).

[30] Cuomo v. Clearing House Ass'n, 129 S. Ct. 2710, 2718-19 (2009).

[31] *See* Margaret M. Ayres & Bethany K. Hipp, *Selected Trends in Enforcement of Anti-Corruption Laws Throughout the World*, THE FOREIGN CORRUPT PRACTICES ACT 2009: COPING WITH HEIGHTENED ENFORCEMENT RISKS, B-1737 PLI § 3, 171 (2009).

[32] Dionne Searcey, *U.S. Cracks Down on Corporate Bribes,* WALL ST. J., May 26, 2009, http://online.wsj.com/article/SB124329477230952689.html.

[33] Donald Zarin, *Doing Business Under the FCPA*, THE FOREIGN CORRUPT PRACTICES ACT 2009: COPING WITH HEIGHTENED ENFORCEMENT RISKS, B-1737 PLI § 1-7, 103 (2009).

[34] U.S. Dep't of Justice Press Release, Siemens AG and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations and Agree to Pay $450 Million in Combined Criminal Fines (Dec. 15, 2008), http://www.usdoj.gov/opa/pr/2008/December/08-crm-1105.html.

[35] Donald Zarin, *Doing Business Under the FCPA*, THE FOREIGN CORRUPT PRACTICES ACT 2009: COPING WITH HEIGHTENED ENFORCEMENT RISKS, B-1737 PLI § 1.7, 103 n. 13.1 (2009).

increased their cooperation in anti-corruption enforcement efforts through joint investigations and by sharing information under multilateral or bilateral agreements.[36] In the Siemens case, the DOJ and SEC "closely collaborated" with the Munich Public Prosecutor's Office.[37] The SEC also acknowledged assistance in that case from the UK Financial Services Authority and the Hong Kong Securities and Futures Commission.[38]

In addition to these trends, the SEC recently exhibited its willingness to apply more aggressively control person liability, a theory of joint and several liability—subject only to a good faith defense—for a person who controls another person found liable under the Securities Exchange Act. The SEC has rarely before, if ever, applied control person liability to Foreign Corrupt Practices Act cases. However, in *SEC v. Nature's Sunshine Products, Inc.*, the SEC alleged that Nature Sunshine Products, Inc.'s chief executive officer (at the relevant time, its chief operating officer and corporate director) and former chief financial officer were liable as control persons, directly or indirectly, for books and records and internal accounting controls violations of the securities laws relating to cash payments made by Nature Sunshine Products' Brazilian subsidiary to customs officials.[39] The complaint alleges that the chief operating officer had "supervisory responsibilities for the senior management and policies regarding the worldwide manufacture, inventory and distribution of [Nature Sunshine Products, Inc.'s] products, including the export and sales of those products."[40] The complaint also alleges that the chief financial officer "had supervisory responsibilities for the senior management and policies regarding the making and keeping of books and records at [Nature Sunshine Products, Inc.] that accurately reflected in reasonable detail the state of registration of products sold in Brazil and regarding devising and maintaining a system of internal controls at [Nature Sunshine Products, Inc.] sufficient to provide reasonable assurance that the registration of [Nature Sunshine Products, Inc.'s] products sold in Brazil was adequately monitored."[41] The SEC recently settled its claims against Nature Sunshine Products and its current and former officer, requiring the

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[36] Margaret M. Ayres & Bethany K. Hipp, *Selected Trends in Enforcement of Anti-Corruption Laws Throughout the World*, THE FOREIGN CORRUPT PRACTICES ACT 2009: COPING WITH HEIGHTENED ENFORCEMENT RISKS, B-1737 PLI § 3, 171 (2009).

[37] Margaret M. Ayres & Bethany K. Hipp, *Selected Trends in Enforcement of Anti-Corruption Laws Throughout the World*, THE FOREIGN CORRUPT PRACTICES ACT 2009: COPING WITH HEIGHTENED ENFORCEMENT RISKS, B-1737 PLI § 3, 171 (2009).

[38] U.S. Dep't of Justice Press Release, Siemens AG and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations and Agree to Pay $450 Million in Combined Criminal Fines (Dec. 15, 2008), http://www.usdoj.gov/opa/pr/2008/December/08-crm-1105.html; Margaret M. Ayres & Bethany K. Hipp, Margaret M. Ayres & Bethany K. Hipp, *Selected Trends in Enforcement of Anti-Corruption Laws Throughout the World*, THE FOREIGN CORRUPT PRACTICES ACT 2009: COPING WITH HEIGHTENED ENFORCEMENT RISKS, B-1737 PLI § 3, 167 (2009).

[39] SEC v. Nature's Sunshine Prods., Inc., Lit. Rel. No. 21162 (July 31, 2009), http://www.sec.gov/litigation/litreleases/2009/lr21162.htm.

[40] Complaint, SEC v. Nature's Sunshine Prods., Inc., No. 2:09cv0672 (D. Utah July 31, 2009).

[41] Complaint, SEC v. Nature's Sunshine Prods., Inc., No. 2:09cv0672 (D. Utah July 31, 2009).

payment of civil penalties, but the agency's aggressive use of control person liability may portend broader liability in future Foreign Corrupt Practices Act actions against corporate officers.

Foreign governments also have increased their regulation of financial conduct, and have brought a number of actions alleging insider trading. In the fifth criminal insider-trading case brought by the UK Financial Services Authority this year, two lawyers who worked at the London offices of US law firms were charged with insider trading. One of the lawyers is accused of disclosing inside information — related to the takeover of NeuTec Pharma by Novartis — to the other lawyer, who then passed the information along to a third party who purchased shares of NeuTec.[42]

Inspectors General and Investigative Bodies

In addition to the actors authorized to enforce financial laws and regulations, there are also a number of bodies tasked with investigating and overseeing the financial industry. These include already-established inspectors general, as well as the newer SIGTARP and FCIC. Although these bodies do not have the independent authority to prosecute a violation, they are expected to refer violations to the appropriate authorities for possible prosecution.

Inspectors General

Inspectors General are responsible for investigating and detecting fraud, waste and abuse in government programs and operations. The SEC Office of the Inspector General, for example, is an independent office within the SEC that "conducts audits of programs and operations of the Commission and investigations into allegations of misconduct by staff or contractors."[43] The SEC recently released a 477-page public version of Inspector General David Kotz's report on his investigation into the SEC's failure to uncover Bernard Madoff's Ponzi scheme.[44] The report concludes, among other things, that "the SEC received numerous substantive complaints since 1992 that raised significant red flags concerning Madoff's hedge fund operations and should have . . . led to a thorough examination and/or investigation of the possibility that Madoff was operating a Ponzi scheme. . . . [H]ad [investigative] efforts been made with appropriate follow-up, the SEC could have uncovered the Ponzi scheme well before Madoff confessed."[45] As a

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[42] *Three Accused of Insider Trading in Britain*, N.Y. TIMES, June 16, 2009, at B2, http://www.nytimes.com/2009/06/17/business/global/17insider.html.

[43] SEC Office of Inspector Gen., Introduction, http://www.sec-oig.gov/.

[44] SEC OFFICE OF INVESTIGATIONS, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME: PUBLIC VERSION, REPORT NO. OIG-509 (Aug. 31, 2009), http://www.sec.gov/news/studies/2009/oig-509.pdf.

[45] SEC OFFICE OF INVESTIGATIONS, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME: PUBLIC VERSION, REPORT NO. OIG-509, at 457 (Aug. 31, 2009), http://www.sec.gov/news/studies/2009/oig-509.pdf.

result of his investigation, Inspector General Kotz is considering more than three dozen possible recommendations to the SEC's Enforcement Division and Office of Compliance Inspections and Examinations.[46] He plans to issue reports containing his recommendations by October 2009.[47]

The Treasury Department's Office of Inspector General keeps both the Secretary of Treasury and the Congress informed about "the problems and deficiencies relating to the administration of department programs and operations and the necessity for corrective action."[48] The Federal Reserve System Inspector General "conducts independent and objective audits, inspections, evaluations, investigations, and other reviews related to programs and operations of the Board of Governors of the Federal Reserve System."[49]

SIGTARP

- Neil M. Barofsky, a former federal prosecutor, was sworn into office as SIGTARP on December 15, 2008.
- Thirty-five ongoing criminal and civil investigations as of July 21, 2009.
- Announced plans to increase full-time staff from approximately 70 as of July 2009 to approximately 160—including approximately 70 investigators—by March 2010.

SIGTARP was created by EESA with an initial budget of $50 million, and has been given the mandate to "conduct, supervise, and coordinate audits and investigations of the purchase, management, and sale of assets" under TARP.[50] Like other inspectors general, SIGTARP has the authority to obtain documents from federal departments and agencies and to subpoena reports, documents, and other information from private citizens.[51]

Unlike other inspectors general, however, SIGTARP may undertake law enforcement functions, including carrying a firearm, making an arrest without a warrant, and seeking and executing warrants for arrest, search, or seizure of evidence.[52] The SIGTARP Act, which became law on April 24, 2009, expanded SIGTARP's authority, with only limited exceptions, to conduct, supervise, and coordinate an audit or investigation of any action taken under TARP as SIGTARP determines appropriate. SIGTARP agents have already exercised the office's authorities when executing search warrants at two financial institutions in Florida on August 3, 2009, in

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[46] Jesse Westbrook and Joshua Gallu, *SEC's Kotz Offers Steps to Help Prevent Next Madoff*, BLOOMBERG, Sept. 10, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aaRSNe9wlies.

[47] *Testimony Concerning the SEC's Failure to Identify the Bernard L. Madoff Ponzi Scheme and How to Improve SEC Performance: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. (2009) (statement of H. David Kotz, Inspector General, Securities and Exchange Commission), http://www.sec.gov/news/testimony/2009/ts091009hdk.htm.

[48] U.S. Dep't of the Treasury, About the Office of Inspector General, http://www.ustreas.gov/inspector-general/about.shtml

[49] Bd. of Governors of the Fed. Reserve Sys., Office of the Inspector General, http://www.federalreserve.gov/oig/.

[50] Emergency Economic Stabilization Act of 2008 § 121(c), codified at 12 U.S.C.A. § 5231(c) (2008).

[51] Emergency Economic Stabilization Act of 2008 § 121(d), codified at 12 U.S.C.A. § 5231(d) (2008).

[52] Emergency Economic Stabilization Act of 2008 § 121(d)(1) codified at 12 U.S.C.A. § 5231(d)(1) (2008).

connection with an investigation into a failed deal for capital infusion into Colonial Bank that reportedly would have included TARP funds.[53]

SIGTARP is required to issue quarterly reports summarizing its activities to Congress, the COP, and the public.[54] On July 21, 2009, SIGTARP reported to Congress that the office has thirty-five ongoing criminal and civil investigations, including possible accounting fraud, securities fraud, insider trading, mortgage servicer misconduct, mortgage fraud, public corruption, false statements, and tax investigations.[55]

SIGTARP has already publicly reported on the first few audits it has concluded. On July 20, 2009, SIGTARP issued an audit report detailing findings from survey letters sent in February 2009 to approximately 360 financial institutions participating in CPP that describe the uses of the institutions' TARP funds.[56] The report observes that most financial institutions were able to "provide insights" into their uses of the funds. For example, financial institutions have reported that their lending activities would have been lower or would have come to a standstill without TARP funds, or that they used the funds to invest in securities, to acquire other institutions, or to pay off debts. In light of these findings, SIGTARP has recommended that Treasury require all TARP recipients to report periodically to Treasury on the uses of their TARP funds. SIGTARP has also examined controls on decision-making relating to CPP, recommending in its August 6, 2009 report that Treasury record the votes for Investment Committee decisions, and that Treasury and participating federal banking agencies improve documentation of their verbal communications with actual and potential TARP funding recipients.[57] More recently, without any accompanying recommendation, SIGTARP released an audit of TARP recipients' efforts to adhere to executive compensation restrictions in place at the time of SIGTARP's February 2009 survey and their plans to comply with subsequent changes in the requirements.[58] This reportedly represents the first in a series of audits relating to executive compensation.

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[53] Jane Sutton, *U.S. raids Colonial Bank office in Florida*, REUTERS, Aug. 3, 2009, http://www.reuters.com/article/mergersNews/idUSN0352465120090803.

[54] Emergency Stabilization Act of 2008 § 121(f), codified at 12 U.S.C.A. § 5231(f) (2008).

[55] OFFICE OF THE SPECIAL INVESTIGATOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 20 (July 2009), http://www.sigtarp.gov/reports/congress/2009/July2009_Quarterly_Report_to_Congress.pdf.

[56] OFFICE OF THE SPECIAL INVESTIGATOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, SURVEY DEMONSTRATES THAT BANKS CAN PROVIDE MEANINGFUL INFORMATION ON THEIR USE OF TARP FUNDS (July 20, 2009), http://www.sigtarp.gov/reports/audit/2009/SIGTARP_Survey_Demonstrates_That_Banks_Can_Provide_Meaningfu_%20Information_On_Their_Use_Of_TARP_Funds.pdf.

[57] OFFICE OF THE SPECIAL INVESTIGATOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, OPPORTUNITIES TO STRENGTHEN CONTROLS TO AVOID UNDUE EXTERNAL INFLUENCE OVER CAPITAL PURCHASE PROGRAM DECISION-MAKING (Aug. 6, 2009), http://www.sigtarp.gov/reports/audit/2009/Opportunities_to_Strengthen_Controls.pdf.

[58] OFFICE OF THE SPECIAL INVESTIGATOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, DESPITE EVOLVING RULES ON EXECUTIVE COMPENSATION, SIGTARP SURVEY PROVIDES INSIGHTS

SIGTARP's pending audits include examinations of the use of funds by recipients receiving extraordinary assistance under the Systemically Significant Failing Institutions Program (AIG) and the Automotive Industry Financing Program (GM and Chrysler), as well as insurance companies receiving assistance under CPP; decision-making surrounding the valuation and disposition of warrants held by the federal government; governance issues in institutions in which the federal government holds a large ownership interest.[59]

SIGTARP has encountered mixed success in its efforts to influence Treasury's design and management of TARP programs through its periodic reports to Congress and its audit reports. Treasury has rejected, for example, SIGTARP's recommendation that trading activity, holdings, and valuations of assets of PPIFs be disclosed on a timely basis.[60] For a further discussion of PPIP, see Chapter 7: *The Public-Private Investment Program*. Despite a SIGTARP recommendation, Treasury also has not committed to releasing the values of its TARP portfolio more frequently than required by statute. As noted above, Treasury has instituted contractual reporting requirements concerning TARP investments, but only in limited instances. Treasury also has declined to adopt what SIGTARP calls one of its "most fundamental recommendations"—that Treasury require an informational barrier, or "wall," between fund managers making investment decisions for PPIF and employees of the same firms who manage non-PPIF funds. SIGTARP additionally has recommended that Treasury and the Federal Reserve "disclose the identity of any TALF borrowers that fail to repay the TALF loan and must surrender the ABS collateral" and "develop mechanisms to ensure that acceptance of collateral in TALF is not unduly influenced by the improver incentives to overrate that existing among the rating agencies."[61] For a further discussion of TALF, see Chapter 6: *The Term-Asset Backed Securities Loan Facility*.

SIGTARP's influence has perhaps had the greatest impact on PPIP, fueled by ongoing consultations and the exchange of information between Treasury and SIGTARP, including drafts of the PPIP term sheets and ethical standards and conflicts-of-interest rules provided by Treasury to SIGTARP. Treasury has adopted recommendations from SIGTARP concerning requirements that PPIF managers register as investment advisors with the

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ON COMPLIANCE (Aug. 19, 2009), http://www.sigtarp.gov/reports/audit/2009/Despite Evolving Rules on Exec Comp... 8_19_09.pdf.

[59] OFFICE OF THE SPECIAL INVESTIGATOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS (July 2009), http://www.sigtarp.gov/reports/congress/2009/July2009_Quarterly_Report_to_Congress.pdf .

[60] OFFICE OF THE SPECIAL INVESTIGATOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS (July 2009), http://www.sigtarp.gov/reports/congress/2009/July2009_Quarterly_Report_to_Congress.pdf.

[61] OFFICE OF THE SPECIAL INVESTIGATOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS (July 2009), http://www.sigtarp.gov/reports/congress/2009/July2009_Quarterly_Report_to_Congress.pdf.

SEC, implement a range of policies and procedures on ethics and conflicts of interest, and report to Treasury "a list of all eligible assets held or under consideration for purchase by a manger in both PPIF and non-PPIF funds, including positions and valuations in all eligible assets across the manager firm."[62] Treasury has also agreed to proportionally increase haircuts for TALF in order to "effectively ameliorate[] the leverage-on-leverage and 'skin-in-the-game' issues" that SIGTARP had flagged as concerns.[63]

Financial Crisis Inquiry Commission

- The FCIC's ten members were announced by the congressional leadership on July 15, 2009.
- The members are:
  - Phil Angelides, *Chairman*
  - Bill Thomas, *Vice Chairman*
  - Brooksley Born
  - Byron Georgiou
  - Bob Graham
  - Keith Hennessey
  - Doug Holtz-Eakin
  - Heather Murren
  - John W. Thompson
  - Peter Wallison

The FCIC, whose members are listed in the sidebar, was created by the Fraud Enforcement and Recovery Act of 2009, enacted on May 20, 2009,[64] "to examine the causes, domestic and global, of the current financial and economic crisis in the United States."[65] The FCIC's mandate is to study fraud and abuse in the financial sector, the availability and terms of credit, capital requirements and regulations on leverage and liquidity, lending practices and securitization, compensation structures, derivatives and unregulated financial products and practices, and the quality of diligence undertaken by financial institutions.[66] The FCIC will also "examine the causes of the collapse of each major financial institution that failed (including institutions that were acquired to prevent their failure) or was likely to have failed if not for the receipt of exceptional Government assistance."[67] The FCIC must report its findings to the President and Congress on December 15, 2010.[68]

To carry out its mandate, the FCIC has the authority to hold hearings, take testimony, and, with the affirmative vote of at least one member appointed by the Republicans, subpoena witnesses and documents.[69] If the FCIC comes across any potential violations of law, it must refer the violation to the

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[62] OFFICE OF THE SPECIAL INVESTIGATOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS (July 2009), http://www.sigtarp.gov/reports/congress/2009/July2009_Quarterly_Report_to_Congress.pdf.

[63] OFFICE OF THE SPECIAL INVESTIGATOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS (July 2009), http://www.sigtarp.gov/reports/congress/2009/July2009_Quarterly_Report_to_Congress.pdf.

[64] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, 123 Stat. 1617 (2009).

[65] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 5(a),123 Stat. 1617 (2009).

[66] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 5(c)(1)(A), (D), (G), (I), (M), (P), (V), 123 Stat. 1617 (2009).

[67] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 5(c)(2),123 Stat. 1617 (2009).

[68] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, 1§ 5(h)(1), 23 Stat. 1617 (2009).

[69] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, §§ 5(d)(1)(A)-(B), 123 Stat. 1617 (2009); Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, §§ 5(d)(2)(B)(iii)(I)-(II), 123 Stat. 1617 (2009).

appropriate federal or state enforcement authorities.[70] It is possible that some testimony given before the FCIC or its staff will be used — by the government or private litigants — in future criminal or civil actions against those testifying.

Recovery Accountability and Transparency Board

The Recovery Accountability and Transparency Board, which was established by ARRA, is intended to oversee the use of ARRA funds in order to "prevent fraud, waste, and abuse" and to provide the public with "accurate, user-friendly information" concerning ARRA spending.[71] The Recovery Accountability and Transparency Board is empowered to issue subpoenas and to conduct audits and reviews, and is required to submit quarterly reports and consolidated annual reports to the President and Congress summarizing its findings.[72]

Enforcement Priorities and Tools

The revamped regulatory scheme has resulted in new enforcement priorities and tools and the emergence of new theories of enforcement.

Enforcement Actions Against Primary and Secondary Actors

It is likely that the Administration will attempt to expand both primary and secondary liability under the securities laws, making it easier for enforcement entities to prove a violation. On June 17, 2009, the Obama Administration released a white paper outlining the various financial regulatory reforms the President planned to pursue. Among them is an amendment of "the federal securities laws to provide a single, explicit standard for primary liability to replace various circuits' formulations of different 'tests' for primary liability."[73] While the standard was not specified, it is likely that the more expansive standard would be adopted.

Relatedly, perhaps one of the most significant proposed changes to the enforcement landscape would be the expansion of aider and abettor liability. The Administration has proposed legislation that would both clarify the threshold necessary for the SEC to hold individuals liable for aiding and abetting a securities violation, and expand such authority to cover all

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[70] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 5(c)(4), 123 Stat. 1617 (2009).

[71] Recovery Accountability and Transparency Bd., Mission Statement, http://www.recovery.gov/?q=content/recovery-board.

[72] American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §§ 1524(b)(1)-(3), (c)(1) (2009), 123 Stat. 115,.

[73] U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 72 (June 17, 2009), http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

statutes. The Investor Protection Act of 2009, if enacted, would extend the SEC's aiding and abetting enforcement authority across all of the securities laws, including the Securities Act of 1933 and the Investment Company Act of 1940. Currently, the SEC can only pursue such claims against violators of the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. The proposed Act would also clarify that the threshold for bringing such claims is reckless conduct, broadening potential liability beyond the current standard in some judicial circuits under which the violator must have acted knowingly. This likely would result in a dramatic increase in enforcement actions brought against secondary actors and, at the very least, would ease the SEC's burden in proving such a violation.

In addition, Senator Arlen Specter (D-PA) has introduced a bill to create a private right of action against aiders and abettors under the Exchange Act,[74] which would overturn the Supreme Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver,* 511 US 164, 191 (1994), and undoubtedly would increase significantly the number of lawsuits against those accused of aiding and abetting.

Enforcement Actions Related to the Subprime Mortgage Crisis

Both the SEC and DOJ have focused enforcement resources on violations related to the subprime mortgage crisis. In connection with a June 2008 operation by the FBI and cooperating agencies to target mortgage fraud schemes ("Operation Malicious Mortgage"), more than 400 defendants across the country have been charged, and 164 have been convicted to date.[75]

The SEC has continued to bring securities fraud charges against companies for misleading investors about credit risks and the riskiness of their mortgage holdings, including:

- A June 2008 action against two former Bear Stearns Asset Management portfolio managers for fraudulently misleading investors about the financial state of the firm's two largest hedge funds and their exposure to subprime mortgage-backed securities;[76]
- An April 2009 action against two former executives at American Home Mortgage Investment Corporation for engaging in accounting

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[74] Liability for Aiding and Abetting Securities Violations Act of 2009, S. 1551, 111th Cong. (2009).

[75] FBI Press Release, More Than 400 Defendants Charged for Roles in Mortgage Fraud Schemes as Part of Operation "Malicious Mortgage" (June 19, 2008), http://fdicoig.gov/press/pr061908.html. *FBI Priorities, Changes and Challenges: Hearing Before the H. Comm. on the Judiciary,* 111th Cong. (2009) (statement of Robert S. Mueller III, Director, Fed. Bureau of Investigation), http://www.fbi.gov/congress/congress09/mueller052009.htm.

[76] SEC Press Release, SEC Charges Two Former Bear Stearns Hedge Fund Managers With Fraud (June 19, 2008), http://www.sec.gov/news/press/2008/2008-115.htm.

fraud and making false and misleading disclosures relating to the riskiness of mortgages originated and held by the company in order to conceal the company's worsening financial condition during the subprime crisis;[77] and

- A June 2009 securities fraud action against Countrywide Financial CEO Angelo Mozilo and two other former executives for "deliberately misleading investors about the significant credit risks being taken in efforts to build and maintain the company's market share," including the alleged failure to disclose "an unprecedented expansion of its underwriting guidelines" and writing increasingly riskier loans.[78] The complaint alleges that the three executives "actually knew, and acknowledged internally, that Countrywide was writing increasingly risky loans and that defaults and delinquencies would rise as a result."[79]

Insider Trading Actions

The SEC has signaled that it will employ new, and broader, enforcement theories as it pursues insider-trading violations. In May 2009, for the first time, the SEC brought an insider trading case involving credit-default swaps. The SEC complaint alleges that a credit-default swaps salesperson with inside information about an upcoming bond offering improperly shared information with a portfolio manager for a hedge fund.[80] According to the complaint, the portfolio manager then used that information to trade in credit-default swaps that referenced bonds of the same issuer.[81] After the bond restructuring was publicly announced, the price of credit-default swaps referencing those bonds rose, leading to a substantial profit.[82] Before this case, the SEC had not focused on insider-trading enforcement on the credit-default swaps market because participants in that market are usually sophisticated institutional players.[83] The SEC argues that the credit-default swaps "involved in this case qualified as security-based swap agreements under the Gramm-Leach-Bliley Act and [were therefore] subject to the anti-

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[77] SEC v. Strauss, Lit. Rel. No. 21014 (Apr. 28, 2009), http://www.sec.gov/litigation/litreleases/2009/lr21014.htm.

[78] SEC Press Release, SEC Charges Former Countrywide Executives With Fraud (June 4, 2009), http://www.sec.gov/news/press/2009/2009-129.htm.

[79] SEC Press Release, SEC Charges Former Countrywide Executives With Fraud (June 4, 2009), http://www.sec.gov/news/press/2009/2009-129.htm.

[80] Complaint at ¶ 2, SEC v. Rorech and Negrin, (S.D.N.Y. 2009) (No. 09 Civ. 4329) http://www.sec.gov/litigation/litreleases/2009/lr21023.htm.

[81] Complaint at ¶ 2, SEC v. Rorech and Negrin, (S.D.N.Y. 2009) (No. 09 Civ. 4329) http://www.sec.gov/litigation/litreleases/2009/lr21023.htm.

[82] Complaint at ¶ 2, SEC v. Rorech and Negrin, (S.D.N.Y. 2009) (No. 09 Civ. 4329) http://www.sec.gov/litigation/litreleases/2009/lr21023.htm.

[83] Wachtell, Lipton, Rosen & Katz, *SEC Brings First Insider Trading Case Regarding Credit Default Swaps* (May 6, 2009).

fraud provisions" of the federal securities laws.[84] In seeking judgment on the pleadings, the two defendants have each challenged the SEC's jurisdiction, arguing that the credit-default swaps at issue are not "security-based swap agreements," because no material term of the agreement was based on certain enumerated characteristics of a security or a group or index of securities.

Prosecution of Ponzi Schemes

Ponzi schemes were thrust to the forefront of public and regulatory attention in 2008 with the discovery of the Bernard Madoff scandal. In response, the SEC and DOJ have increased efforts to prosecute those primarily responsible for overseeing, enabling and abetting Ponzi schemes.

In December 2008, Bernard Madoff was arrested and charged with securities fraud for allegedly running a $50 billion Ponzi scheme. The SEC brought a securities fraud action,[85] and the DOJ alleged that Madoff defrauded clients by soliciting billions of dollars of funds, failing to invest those funds as promised, and instead paying certain investors purported returns on investment with the principal received from other investors.[86] The scheme fell apart when clients requested $7 billion in redemptions and Madoff did not have sufficient liquidity to meet those obligations. In March 2009, Madoff pleaded guilty to eleven felony counts, and in June he was sentenced to the maximum term of 150 years in prison.[87]

Soon after the Madoff scandal came to light, the SEC accelerated its investigation of the Houston-based Stanford Financial Group for misappropriating and misusing its clients' assets in connection with investment in Antiguan certificates of deposit. In February 2009, the SEC brought a civil suit against Stanford International Bank, Ltd., and related entities and individuals, alleging a massive Ponzi scheme involving the sale of approximately $8 billion of high-yielding certificates of deposit.[88] In June 2009, the FBI indicted R. Allen Stanford, three Stanford Financial Group executives, and Leroy King, the former chief executive officer of the Antiguan bank regulatory agency, for their scheme to prevent the truth about

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[84] Complaint at ¶ 49, SEC v. Rorech and Negrin, (S.D.N.Y. 2009) (No. 09 Civ. 4329) http://www.sec.gov/litigation/litreleases/2009/lr21023.htm.

[85] Amir Efrati, Tom Lauricella, and Dionne Searcey, *Top Broker Accused of $50 Billion Fraud,* WALL ST. J., Dec. 12, 2008, http://online.wsj.com/article/SB122903010173099377.html.

[86] Complaint at ¶¶ 1, 4(b), United States v. Madoff, (S.D.N.Y. 2008) (No. 08 Mag. 2735).

[87] Diana B. Henriques, *Madoff Is Sentenced to 150 Years for Ponzi Scheme*, N.Y. TIMES, June 29, 2009, http://www.nytimes.com/2009/06/30/business/30madoff.html.

[88] FBI Press Release, Stanford Financial Group Executives and Former Chairman of Antiguan Bank Regulator Indicted for Fraud and Obstruction Charges Related to $7 Billion Dollar Scheme to Defraud Investors (June 19, 2009), http://houston.fbi.gov/dojpressrel/pressrel09/ho061909.htm.

Stanford Financial Group's financial statements from coming to light.[89] The prosecutions are ongoing.

Between January and early May 2009, the SEC filed twenty-three cases involving Ponzi schemes or Ponzi-like payments, alleging that perpetrators fraudulently raised funds from new investors to pay "returns" to existing investors. In nineteen of these actions, the SEC sought emergency relief in the form of an asset freeze to prevent the possible dissipation of investor assets and, in some instances, a temporary restraining order to halt ongoing conduct.[90]

In addition, various enforcement actors are pursuing new forms of third-party liability. In particular, "feeder funds" for fraudulent schemes such as Bernard Madoff's are at risk for liability. A failure to exercise due diligence when transferring money to another money manager, for example, may result in liability. New York Attorney General Cuomo brought a civil action against J. Ezra Merkin and alleged Madoff feeder fund Gabriel Capital Corporation. The complaint alleges that from the 1990s through December 2008, Merkin earned $470 million in management and incentive fees for representing to investors and to non-profit organizations that he was managing their money, when in fact he transferred much of the money to be managed by Bernard Madoff, whom Merkin "failed to adequately oversee, audit or investigate."[91]

Regulation of Misuse of Stimulus Funds

Executive Compensation

Enforcement agencies are increasing their focus on executive compensation. The SEC, for example, is moving to implement enforcement tools enacted early in the decade that concern executive compensation. Section 304 of Sarbanes-Oxley Act of 2002 provides for the recouping or "clawing back" incentive-based executive compensation, such as bonuses, in the event that a company commits accounting fraud in violation of federal securities laws. The provision, which targets a company's failure to comply with financial reporting requirements, is triggered when a company is forced to issue a restatement "as a result of misconduct."[92]

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[89] FBI Press Release, Stanford Financial Group Executives and Former Chairman of Antiguan Bank Regulator Indicted for Fraud and Obstruction Charges Related to $7 Billion Dollar Scheme to Defraud Investors (June 19, 2009), http://houston.fbi.gov/dojpressrel/pressrel09/ho061909.htm.

[90] *Strengthening the SEC's Vital Enforcement Responsibilities: Hearing Before the Subcomm, on Securities, Insurance, and Investment of the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (2009) (statement of Robert Khuzami, Director, Division of Enforcement, Securities and Exchange Commission).

[91] Complaint at ¶ 6, New York v. J. Ezra Merkin (N.Y. Sup. Ct. 2009), http://www.oag.state.ny.us/media_center/2009/apr/pdfs/merkin%20summons%20complaint.pdf%20-%20Adobe%20Acrobat%20Professional.pdf.

[92] Sarbanes-Oxley Act of 2002, 107 Pub. L. No. 204 § 304, 116 Stat. 745 (2006).

In an action against the former chief executive officer of CSK Auto Corporation in July 2009, the SEC for the first time asked a court to enforce the clawback provision against an individual it had not accused of being involved with the underlying fraud.[93] The order asks for the return of more than $4 million in bonuses and stock sale profits earned by ex-CEO Maynard Jenkins while the company was allegedly defrauding investors. It had been an open question whether Section 304 could be enforced against an individual not personally engaged in misconduct. The SEC's current view appears to be that Section 304 allows for the forfeiture of all money earned by an executive whose company allegedly commits accounting fraud, even if the executive was not responsible for the fraud. It is unclear whether the SEC's claim will be successful, but the threat of the clawback provision alone may have an impact.[94]

The SEC and DOJ moved to hold individual executives accountable for alleged fraud of CSK Auto Corp. In March 2009, the SEC alleged that four senior executives at CSK Auto Corp. overstated the company's pre-tax income by fraudulently concealing tens of millions of dollars in uncollectible receivables in violation of securities laws. The DOJ also brought criminal charges against the executives, including conspiracy, securities fraud and obstruction of justice.[95]

In New York, Attorney General Cuomo has focused on executive compensation issues. In March 2009, he sought to recover bonuses paid to employees of AIG.[96] The Attorney General's office also recently concluded a nine-month investigation of compensation practices in the American financial system, during which it found that financial institutions' compensation and bonus plans did not reflect the stated goal of tying pay to performance.[97] The Attorney General's July 2009 report finds that even as banks' financial performance fell during the financial crisis, employees continued to be rewarded with high overall compensation and bonuses. The report rejects several rationales for the discrepancy, such as a need to compensate individual departments that continued to perform well while overall financial performance fell, and a need to keep up with industry-wide

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[93] Christine Caufield, *SEC Seeks $4M Clawback from CSK Auto Ex-CEO*, LAW 360, July 22, 2009, http://securities.law360.com/articles/112717.

[94] In addition, currently pending before Judge Rakoff in the Southern District of New York is an action brought by the SEC against Bank of America in which the Commission charges the bank with misleading investors at the time of its acquisition of Merrill Lynch & Co. about bonuses being paid to Merrill Lynch executives. Judge Rakoff recently rejected a proposed settlement between the parties, and although the consequences of the court's order remain to be seen, it may result in heightened judicial scrutiny of settlements as a general matter.

[95] Christine Caufield, *SEC Seeks $4M Clawback from CSK Auto Ex-CEO*, LAW 360, July 22, 2009, http://securities.law360.com/articles/112717.

[96] Letter from Andrew Cuomo, Attorney Gen., State of N.Y., to Edward M. Liddy, Chairman & CEO, Am. Int'l Group (Mar. 16, 2009).

[97] ANDREW M. CUOMO, ATTORNEY GEN., STATE OF N.Y, NO RHYME OR REASON: THE 'HEADS I WIN, TAILS YOU LOSE' BANK BONUS CULTURE 1 (July 2009) http://www.oag.state.ny.us/media_center/2009/july/pdfs/Bonus%20Report%20Final%207.30.09.pdf.

bonus practices to protect the long-term health of the firm. The Attorney General's Office notes that it expects compensation programs to be more closely tailored to financial institution performance, even when individual departmental success is taken into consideration.

In Connecticut, Attorney General Richard Blumenthal is also aggressively pursuing enforcement actions designed to limit executive compensation. Blumenthal denounced AIG executives' claims that they had to pay certain bonuses to avoid violating a Connecticut law that could require double payment for failure to pay wages.[98] In February 2009, Blumenthal intervened in the Journal Register Co.'s Chapter 11 bankruptcy case to block $1.7 million in bonuses planned for executives in return for shutting down newspapers and laying off more employees. The bonuses were tied to a proposed bankruptcy reorganization plan that sought to compensate executives for meeting certain goals to shut down newspapers and let go of employees. The company claimed that the bonuses would save money because it would cost more to hire outside consultants to engage in the shutdown process. Blumenthal criticized the plan for rewarding the financial failure of the company. In July 2009, a bankruptcy court upheld the award of bonuses to Journal Register Company executives.[99]

Fraud Related to Stimulus Programs

The government is also ratcheting up its oversight of stimulus funding intended to be used for specific programs. FERA carries implications for both criminal and civil enforcement.

On the criminal side, FERA amends several statutes to reach previously unregulated entities, financial products, and fraudulent conduct that, according to Congress, contributed significantly to the economic collapse. FERA broadens the scope of the major statute prohibiting fraud against the United States, which previously was limited to government contractors and subcontractors who fraudulently obtained government funds through a prime contract of over $1 million.[100] The statute now applies broadly to fraud in connection with any form of federal assistance, including through TARP, economic stimulus or rescue plans, and the government's purchase of troubled assets.[101] The limits of the broader language are currently unknown, such as whether a violation would require knowledge that the

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[98] David Savage, *AIG Bonuses Total More than the Reported $165 Million*, L.A. TIMES, Mar. 22, 2009, http://articles.latimes.com/2009/mar/22/nation/na-aig-more-bonuses22.

[99] Connecticut Attorney General Press Release, Attorney General's Statement On Bankruptcy Court Ruling that Allows $1.3 Million In Bonuses To Journal Register Company Executives (July 8, 2009), http://www.ct.gov/ag/cwp/view.asp?A=3673&Q=443082; Paul Bass, *AG Targets Register 'Shutdown' Bonuses*, NEW HAVEN INDEP., Feb. 23, 2009, http://www.newhavenindependent.org/archives/2009/02/register_goes_b_1.php.

[100] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 2(d)(2), 123 Stat. 1617 (2009).

[101] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 2(d)(2), 123 Stat. 1617 (2009).

funds came from the stimulus package or rescue plan.[102] Nevertheless, the statute could engender a variety of new criminal cases.

On the civil side, FERA amends the False Claims Act to broaden third-party civil liability for false claims or false statements that defraud the US government in connection with funds disbursed under TARP, ARRA, and other stimulus programs.[103]

These amendments to the False Claims Act abrogate earlier Supreme Court decisions that had narrowly interpreted the statute to apply only to claims made directly to the US government, not to government grantees; and only when the defendant had intended that the government itself would pay the claim, not when the defendant intended to be paid by a contractor using public funds.[104] Under the new statutory language, companies can be held liable for false claims made to:

- general contractors or grantees who will be reimbursed, in full or part, by the federal government for a company's request or demand;
- quasi-governmental entities, such as Amtrak;
- US administered programs, such as the Coalition Provisional Authority in Iraq, even if the funds are not technically federal; and
- state-administered programs, such as Medicaid, that receive federal funds.[105]

The amendments also broaden liability for "reverse" false claims, such as knowingly retaining overpayments from the government.[106]

As a result, there is new risk of civil liability for companies that indirectly receive funds from financial recovery initiatives, and for companies that make false statements that are material to a false claim.[107] The amendments to the False Claims Act redefine the term "claim" to include any request or demand for money or property that "is to be spent or used on the Government's behalf or to advance a Government program or interest" if the Government "provides or has provided any portion of the money or property" or will provide reimbursement for the requested money or

Fraud Enforcement and Recovery Act

- Under FERA, companies can be held liable for false claims made to:
  - General contractors or grantees who pay the claims using public funds;
  - Quasi-governmental entities;
  - US-administered programs; and
  - State-administered programs, such as Medicaid, that receive federal funds.

[102] Am. Conference Inst. Webinar, Enforcement and Financial Recovery Measures (July 15, 2009).

[103] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 4(a)(1), (b)(2), 123 Stat. 1617 (2009).

[104] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 4(a)(1), (b)(2), 123 Stat. 1617 (2009).

[105] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21,§ 4(a)(1), (b)(2), 123 Stat. 1617 (2009).

[106] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 4(a)(1)(D), 123 Stat. 1617 (2009).

[107] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 4(a)(1)(a)(1)(B), 123 Stat. 1617 (2009).

property.[108] The scope of these amendments is still unclear, but it is possible that indirect recipients of government funds — such as investors in public-private auctions of troubled assets and investors or subcontractors for entities receiving stimulus funds — could be held liable under the False Claims Act. Prosecution of Misrepresentations and Failures to Disclose

There has been an increase in the number of traditional enforcement actions by the SEC relating to misrepresentations and failures to disclose material information to investors. For example, the SEC has:

- Filed suit against the Reserve Primary Fund in May 2009, within three months of initiating its investigation, for failing to provide key material facts to investors and trustees about the fund's vulnerability as Lehman Brothers Holdings, Inc. sought bankruptcy protection. The Reserve Primary Fund held $785 million in Lehman-issued securities, and became illiquid on September 15, 2008 when it was unable to meet investor requests for redemptions. The SEC alleges that the Reserve Primary Fund made misrepresentations and omissions by failing to provide accurate information concerning the value of Lehman securities, which led to the fund being unable to strike a meaningful hourly net asset value as required by the fund's prospectus;[109]
- Obtained an emergency court order to freeze the assets of a Connecticut-based money manager, and the hedge funds he controls, for allegedly forging documents, promising false returns, and misrepresenting assets managed by the funds to illicitly raise more than $30 million from investors;[110]
- Obtained an asset freeze against a Florida-based adviser for allegedly misrepresenting the nature of $550 million in investments;[111] and
- Obtained emergency relief against a Texas businessman and his company — both subjects of a previous SEC enforcement action in 2001 — for the purported fraudulent raising of approximately $40

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[108] Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21,§ 4(a)(1)(b)(2), 123 Stat. 1617 (2009).

[109] SEC Press Release, SEC Charges Operators of Reserve Primary Fund With Fraud (May 5, 2009), http://www.sec.gov/news/press/2009/2009-104.htm.

[110] *Strengthening the SEC's Vital Enforcement Responsibilities: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the S. Comm. on Banking, Housing, and Urban Affairs*; 111th Cong. (2009) (statement of Robert Khuzami, Director, Division of Enforcement, Securities and Exchange Commision); SEC v. Ponta Negra Fund I, LLC et al., Lit. Rel. No. 21012 (Apr. 2009), http://www.sec.gov/litigation/litreleases/2009/lr21012.htm.

[111] *Strengthening the SEC's Vital Enforcement Responsibilities: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the S. Comm. on Banking, Housing, and Urban Affairs*; 111th Cong. (2009) (statement of Robert Khuzami, Director, Division of Enforcement, Securities and Exchange Commision); SEC v. Founding Partners Capital Mgmt. Co., et al., Lit. Rel. No. 21010 (Apr. 2009), http://www.sec.gov/litigation/litreleases/2009/lr21010.htm.

million from hundreds of investors through a high-yield debenture offering.[112]

As the enforcement landscape continues to evolve, new regulatory and enforcement agencies, and new theories and enforcement tools continue to emerge. The public outcry for action has not diminished, and the government appears ready and willing to respond. It is unclear exactly how long it will take for these new enforcement agencies and tools to take hold, but as they do, financial institutions are likely to find themselves the subject of more, faster and tougher regulation and enforcement.

[112] *Strengthening the SEC's Vital Enforcement Responsibilities: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the S. Comm. on Banking, Housing, and Urban Affairs*; 111th Cong. (2009) (statement of Robert Khuzami, Director, Division of Enforcement, Securities and Exchange Commision); SEC v. Benny L. Judah, et al., Lit. Rel. No. 21009 (April 22, 2009), http://www.sec.gov/litigation/litreleases/2009/lr21009.htm.

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CHAPTER 9: EXECUTIVE AND EMPLOYEE COMPENSATION

Beverly Chase, Edmond T. FitzGerald, Kyoko Takahashi Lin, Jean M. McLoughlin and Barbara Nims

Table of Contents

Overview

Since the onset of the financial crisis, there has been a series of legislative and regulatory efforts to address concerns regarding executive compensation, and executive compensation has become a hot button issue both in the US and in Europe. In light of the changing landscape, this Chapter focuses on US regulation regarding compensation as it currently applies to TARP recipients. These recent regulations applicable to TARP recipients include the following:

- Review of previous compensation by a Special Master.
- Restrictions on paying or accruing bonuses, retention awards or incentive compensation (collectively referred to in the regulations and in this Chapter as "bonus payments") for certain employees.
- Regular review of all employee compensation arrangements by the compensation committee to ensure that the arrangements do not encourage unnecessary and excessive risk-taking or manipulation of earnings reports.
- Recoupment of bonus payments based on materially inaccurate information.
- Prohibition on severance or change in control payments for certain employees.
- Adoption of policies and procedures to avoid excessive luxury expenses.
- Mandatory say on pay in effect since February 2009.
- Special Master review of ongoing compensation provided by certain

The publication date of this Chapter is September 21, 2009. All terms and acronyms used in this Chapter are defined in the Glossary at the front of this Manual.

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TARP recipients.

- Prohibition on tax gross-ups for certain employees.
- Disclosure of perquisites.
- Disclosure regarding compensation consultants.

Brief History of TARP Compensation Requirements

EESA, enacted on October 3, 2008, included compensation requirements applicable to participants in the TARP program; these requirements were modified by ARRA, enacted on February 17, 2009. On June 10, 2009, the Treasury Department issued regulations implementing ARRA and providing additional guidance regarding compensation requirements for TARP recipients. The regulations were published in the Federal Register on June 15, 2009 and were effective upon publication. To the extent there are any inconsistencies, the regulations supersede any previous guidance applicable to a TARP recipient, including contractual provisions, as of June 15, 2009. TARP participants receiving exceptional assistance have entered into contractual arrangements with Treasury which imposed additional obligations. A timeline of efforts to regulate the compensation of TARP participants is available at http://www.davispolk.com/files/uploads/FCM/Compensation.Legislative.and.Regulatory.Timeline.for.TARP.Participants.pdf.[1]

Companies not participating in TARP are not subject to EESA, ARRA and the Treasury's implementing regulations, although some members of Congress have indicated a desire to regulate compensation paid by all companies by increasing ties to performance, improving risk management and mandating non-binding shareholder advisory votes on executive pay, among other measures.

Firms and Employees Covered by Compensation Restrictions

Firms covered. The regulations, which apply to current and future TARP recipients, currently recognize five potential categories of firms receiving government funds.

- **TARP recipients with outstanding obligations to Treasury**. This category includes all banks and bank holding companies participating in CPP and TARP recipients receiving exceptional assistance under

[1] For a timeline of efforts to regulate the compensation of companies generally, see http://www.davispolk.com/files/uploads/FCM/Comprehensive.Compensation.Legislative.and.Regulatory.Timeline.pdf.

TARP.[2] This category might also include companies that incur obligations under future programs by accepting funding from Treasury or causing Treasury to pay on a credit insured by Treasury under a TARP program. These TARP recipients will be subject to the full breadth of the regulations' requirements, which will apply until the TARP recipient fully repays its obligation, the so-called "TARP period." The TARP period generally ends upon repayment of the applicable financial assistance, even if Treasury continues to hold warrants.

TARP recipients incurring an obligation to Treasury have typically been required to enter into agreements with Treasury that impose contractual compensation requirements. To the extent that these contractual requirements are not inconsistent with the requirements of the regulations, the contractual requirements will continue to apply. This means that, for TARP recipients that have received funding solely under CPP, most of the contractual requirements previously agreed to in the securities purchase agreements will be superseded by the regulations' more stringent requirements. However, the $500,000 annual deduction limit for the compensation of senior executive officers to which CPP participants have contractually agreed will continue to apply, as this requirement is not affected by the regulations. TARP recipients that have received exceptional assistance beyond CPP have agreed to a variety of contractual requirements that must be coordinated with the requirements of the regulations.

- **TARP recipients that previously had obligations to Treasury but have fully repaid those obligations**. This category includes participants in CPP and exceptional assistance programs that repurchased all their preferred stock and repaid any other obligations to Treasury. The regulations' requirements will generally cease after a TARP recipient has fully repaid its obligation to Treasury, even if Treasury continues to hold warrants with respect to equity securities of the TARP recipient. That said, the TARP recipient will remain subject to any continuing contractual obligations that are not inconsistent with ARRA and the regulations.

- **TARP recipients that have never had an obligation to Treasury**. This category includes TARP recipients that have engaged in transactions with Treasury but have not incurred an obligation to Treasury. This category could include a TARP recipient under a future program under which, for example, Treasury directly insures obligations of a company but the company has not triggered an obligation to Treasury by defaulting on the insured obligations. TARP recipients in this category are subject only to the luxury expense policy requirement

[2] *Participants in Government Investment Plan*, WALL ST. J., Apr. 22, 2009, http://online.wsj.com/public/resources/documents/st_BANKMONEY_20081027.html.

and certain aspects of the risk assessment rules, which apply until the expiration of Treasury's statutory authority under TARP.

- **Participants in government programs that do not involve transactions with Treasury**. This category includes participants in the TALF, under which a special purpose vehicle of the Federal Reserve has guaranteed certain privately-issued asset-backed securities and Treasury has provided backing to the special purpose vehicle. The compensation restrictions of ARRA and the regulations will not apply to participants in these programs because the entities receiving backing from the special purpose vehicles do not enter into funding or guaranty transactions directly with Treasury. The Federal Reserve Bank of New York has also made clear that such restrictions are not applicable to certain TALF participants. For a further discussion, see Chapter 6: *The Term Asset-Backed Securities Loan Facility*.

- **PPIP**. Although not free from doubt, the TARP executive compensation restrictions should not apply to participants in PPIP if the Legacy Securities and Legacy Loans Fund are structured as expected.[3] In general, the compensation restrictions apply to the entities that issue securities to Treasury under EESA, which in the case of PPIP will be the Legacy Securities and Legacy Loans Funds. In addition, with respect to the Legacy Securities Program, Treasury has provided in FAQs that "executive compensation restrictions will not apply to asset managers or private investors provided the [funds] are structured such that the [fund] managers themselves and their employees are not employees of or controlling investors in the [funds], and other investors are purely passive." This is also borne out by the regulations, which apply the compensation requirements on a controlled group basis, which excludes entities that do not hold an interest of at least 50% in a TARP recipient. It is not clear whether, and if so how, Treasury will define "passive." For a further discussion, see Chapter 7: *The Public-Private Investment Program.*

Employees covered. The regulations impose compensation limitations on payments to a TARP recipient's senior executive officers and, in many cases, a broader group of the TARP recipient's most highly compensated employees (referred to as "most highly compensated employees"). Each of these groups is identified by a look-back to the TARP recipient's previous fiscal year, with certain limited exceptions.

- **Senior executive officers**. For a TARP recipient subject to SEC reporting requirements, the regulations and related Treasury guidance provide that its senior executive officers in any given year include any person serving as a principal executive officer (*i.e.* CEO) or principal financial officer (*i.e.* CFO) during the year as well as the named

Covered Employees

- Financial assistance of:
  - **$500 million or more** - Senior executive officers and 20 most highly compensated employees are covered.
  - **$250 million or more, but less than $500 million** - Senior executive officers and 10 most highly compensated employees are covered.
  - **$25 million or more, but less than $250 million** - Five most highly compensated employees are covered.
  - **Less than $25 million** - Single most highly compensated employee is covered.

[3] For a further discussion of PPIP, see Chapter 7: *Public-Private Investment Program*.

executive officers identified in its annual report on Form 10-K or annual proxy statement filed in that year who continue to be employed by the TARP recipient, which includes: all CEOs and all CFOs from the previous year, the next three most highly compensated executive officers in the previous year and up to two additional individuals who would have been among the three most highly compensated executive officers had they been executive officers at the end of the relevant reporting year. This last category would include, for example, an executive officer who steps down from an executive role but continues as an employee into the following year, although ARRA itself had limited the definition to the top five most highly compensated executives whose compensation is required to be disclosed under the securities laws. The identification of the three most highly compensated executive officers and, if applicable, the two former officers, is based on annual compensation for the last completed fiscal year as determined pursuant to SEC compensation disclosure rules (*i.e.*, total compensation minus any reported change in pension value and above-market earnings on deferred compensation). Private company TARP recipients that do not publicly report compensation must identify their senior executive officers in accordance with the SEC compensation disclosure rules as if they were public reporting companies.

- **Most highly compensated employees**. To determine the most highly compensated employees, the regulations require each TARP recipient to calculate previous fiscal year compensation in accordance with the SEC compensation disclosure rules for employees, other than senior executive officers, who were employed as of the first day of the current fiscal year. This requires calculation of accounting expenses for equity compensation awards, the incremental cost of perquisites and other components of "total compensation" that financial institutions have not been previously required to track for their non-executive officers. Under the regulations, different restrictions apply to different groups of most highly compensated employees. For example, the prohibition on golden parachutes applies to the senior executive officers and the next five most highly compensated employees, whereas the prohibition on the accrual or payment of bonus payments may apply to the senior executive officers and up to 20 of the next most highly compensated employees, depending on the amount of the TARP recipient's outstanding obligation to Treasury. The most highly compensated employees are determined on a controlled group basis taking into account all of the employees of the TARP recipient and all entities directly or indirectly controlling, controlled by or under common control with the TARP recipient based on a 50% voting power or value ownership test.

  - *Executive status not relevant*. In contrast to the SEC compensation disclosure rules, a most highly compensated employee may be an employee who is not an executive officer. As a result, revenue-producing personnel, such as investment bankers, investment

managers, traders and others may be subject to compensation restrictions.

- *Calculation of compensation to determine senior executive officers and most highly compensated employees*. Commission compensation is included as part of "total compensation" in determining whether an employee is among the senior executive officer or the most highly compensated employee group, although the regulations exempt qualified commission compensation from the restriction placed on bonus payments.

  It may be difficult to determine the contribution that certain financial arrangements make to total compensation. Where items such as partnership interests (*e.g.*, profits interests) in investment partnerships or other participation rights in asset or revenue pools are shared with service providers of a TARP recipient, there are questions as to whether these arrangements are part of an employment relationship and, if so, how to value the compensatory element involved. The regulations state that although a member of a partnership, LLC or other similar entity will not generally be treated as an employee of the entity, such an entity cannot be used to avoid or evade the regulations.

- *Senior executive officers and most highly compensated employees may not be determined until well into a given year*. Because the calculation of various components of total compensation for employees may not be completed until well after the end of a fiscal year, a TARP recipient may not be able to identify its senior executive officers and most highly compensated employees, other than its principal executive officer and principal financial officer, until some time into the following year. Nonetheless, the regulations make clear that they will apply to the relevant group as of the start of the year. As a result, bonus payment awards in respect of a prior year may need to be qualified pending the determination of the individuals who are subject to the bonus payment limitation in the current year.

  A newly hired employee, other than a newly hired principal executive officer or principal financial officer, should not be considered a senior executive officer or most highly compensated employee prior to December 31 of the year of hire. A newly hired or promoted principal executive officer or principal financial officer, however, should immediately be treated as a senior executive officer. Even when a newly hired employee is not treated immediately as a senior executive officer, any compensation paid to the new hire in the year of hire may cause the employee to be a senior executive officer or most highly compensated employee in the following year. An individual who is not considered a highly compensated employee and is later promoted to a senior executive officer position other than

principal executive officer or principal financial officer should not be a senior executive officer or most highly compensated employee in the year of promotion. As with a newly hired employee, however, any payments made to a promoted employee may cause the employee to be a senior executive officer or most highly compensated employee in the following year.

- *Most highly compensated employees who terminate employment*. It appears that the departure of an employee during a year in which the employee was among the most highly compensated employee group will decrease the size of the group. For example, if the senior executive officers and the next 20 most highly compensated employees of a TARP recipient are subject to the bonus payment restriction under the regulations during a particular year, but one of the most highly compensated employees terminates employment during that year, it appears that the most highly compensated employee group thereafter includes only the remaining 19 most highly compensated employees, with no new members required to be added.

- *New entities*. For an entity created or organized in the year in which it receives TARP assistance, its most highly compensated employees are determined based upon a reasonable, good faith determination of projected annual compensation for the next year. The regulations do not specify, but it is likely that a similar standard would be used to identify senior executive officers as well.

- **Potential for cycling**. Treasury has acknowledged the vagaries inherent in an annual test for identifying the most highly compensated employees. The suppression of most highly compensated employee compensation under the regulations will likely result in certain employees ceasing to qualify as most highly compensated employees for the following year, whereupon the resulting increase in their compensation will likely return them to most highly compensated employee status in the subsequent year. Treasury also recognizes the potential for a TARP recipient to intentionally cycle employees in and out of most highly compensated employee status in alternate years in order to maximize employee compensation in the intervening years. Treasury invited comment on this issue.

- **Determination of senior executive officers and most highly compensated employees looking forward**. On July 10, 2009, the SEC issued a proposed rule that would amend the compensation disclosure requirements in Regulation S-K and that is anticipated to become effective for the 2010 proxy season for all US public companies. The proposed rule would change the current methodology for calculating equity awards for proxy statement reporting purposes, which could change the identities of a company's named executive officers in the 2010 proxy statement. For companies that have received TARP assistance, it could also change the identities of the individuals subject

to the TARP compensation restrictions that apply to their named executive officers (*e.g.*, bonus restrictions, prohibition on golden parachute payments).[4]

TARP Recipients That Have Fully Repaid Their Obligations

The regulations' restrictions generally cease to apply to a TARP recipient after it has fully repaid its obligations to Treasury. The rules in this regard are not, however, entirely clear. For example, although ARRA and the regulations make clear that the restrictions will not apply if Treasury continues to hold only warrants of the TARP recipient, the regulations state at least once that restrictions will apply if Treasury holds common stock of the TARP recipient. This is presumably meant to continue the restrictions in situations where Treasury holds an initial common stock investment or has agreed to convert or exchange preferred stock or debt obligations of a TARP recipient for common stock and not where Treasury has acquired common stock by exercising warrants after a TARP recipient has repaid its obligations.

The summary below attempts to interpret the rules as to the sunset of the compensation requirements for TARP recipients that have completed repayment of their outstanding TARP obligations. TARP recipients exiting TARP may want to consider whether, going forward, and to what extent as a matter of good governance, to adopt measures of their own design reflective of certain of the principles embedded in the regulations.

As discussed earlier, in the parlance of the regulations, when a TARP recipient has fully repaid its TARP obligations, even if Treasury continues to hold warrants of the TARP recipient, the TARP recipient will be deemed to have ended its "TARP period."

- **Special Master approval of compensation for TARP recipients that are awarded exceptional assistance**. The requirement of Special Master review and approval of the compensation arrangements of TARP recipients receiving exceptional assistance will cease immediately at the end of the TARP period.[5]

- **Bonus payment prohibition**. Bonus payments relating solely to periods following a TARP recipient's TARP period are not subject to any restrictions under the regulations. However, as described in the Bonus Payment Restrictions section below, bonus payments relating to service for periods before the end of the TARP period will be subject to

[4] The proposed rule is discussed in further detail in Davis Polk, *Additional Compensation and Corporate Governance Disclosure Requirements for 2010 Proxy Season* (July 17, 2009), http://www.davispolk.com/files/Publication/c6b7b140-313d-4176-b739-00642e59b5a2/Presentation/PublicationAttachment/7f52a73d-7306-42f6-ab5f-05090a67e33c/071709_sec_proposed_rule.pdf.

[5] Some have suggested that this requirement should cease to apply following the repayment of the exceptional assistance, regardless of whether the TARP period has ended.

proration, to avoid the accrual of bonus amounts relating to the TARP period.

- **Risk assessment and avoidance of manipulation**. Requirements relating to periodic assessment of risk and avoidance of manipulation cease to apply after the end of the TARP period, but the TARP recipient will still be required to certify at year-end that these requirements were met for the portion of the last fiscal year before the end of the TARP period. The SEC has promulgated a similar risk analysis requirement, which is discussed in the Risk Assessment and Avoidance of Manipulation section below.

- **Recoupment**. The recoupment provisions generally apply to any bonus payment granted or promised during the TARP period, even if the bonus payment is not paid or settled until after the TARP period has ended.

- **Golden parachutes**. A golden parachute is treated as paid at the time of an employee's termination of employment with a TARP recipient. Therefore, if a covered employee departs before the TARP period has ended, the employee may not become entitled to any golden parachute amounts even if amounts are not payable or paid until after the TARP period has ended.

- **Perquisite and compensation consultant disclosure**. After repayment of its TARP obligations, a TARP recipient or its compensation committee, as applicable, will still be required to make the perquisite and compensation consultant disclosures under the regulations with respect to the portion of the last fiscal year before the end of the TARP period.

- **Gross-up prohibition**. The regulations' prohibition on tax gross-ups to employees in the covered group includes a prohibition against providing a right to a gross-up after the TARP period has ended in respect of taxable income during the TARP period.

- **Luxury policy**. The requirement to maintain a luxury expense policy and to follow procedures for expense reviews ceases to apply as of the end of the TARP period.

Special Master for TARP Executive Compensation

Office of the Special Master. The ARRA regulations create within Treasury an Office of the Special Master for TARP Executive Compensation. The Obama Administration has appointed Kenneth Feinberg to lead this office and serve as the Special Master. Mr. Feinberg agreed to serve as the Special Master without compensation.

Role of the Special Master. The Special Master has three central roles:

- **Mandatory review and approval of the compensation arrangements of TARP recipients receiving exceptional financial assistance from**

Treasury. The Special Master must review the compensation arrangements of TARP recipients receiving exceptional financial assistance from Treasury to determine whether these arrangements are inconsistent with TARP or the regulations or are otherwise contrary to the public interest.[6]

- *Compensation of senior executive officers and most highly compensated employees subject to the bonus payment limitation*. The Special Master must approve the compensation structures and payments for each senior executive officer and most highly compensated employee subject to the bonus payment limitation. TARP recipients were required to submit their initial requests for approval by August 14, 2009. The Special Master was required to issue his determinations within 60 days after the submissions were substantially complete.[7] Thereafter, the TARP recipient must submit a request for redetermination if its compensation structures or payments to any senior executive officer or most highly compensated employee subject to the bonus payment limitation are materially modified.

- *Compensation of employees among the 100 most highly compensated employees not subject to the bonus payment limitation*. The Special Master must approve only the compensation structure, and not amounts payable under the structure, for the executive officers and employees among the 100 most highly compensated employees who are not subject to the bonus payment limitation. The TARP recipient, however, may request advisory opinions for amounts payable under its structure for these employees. The TARP recipient must submit its initial request for 2009 approval for these employees no later than October 13, 2009 and, again, the Special Master is required to issue his determinations within 60 days after the submission is substantially complete. The TARP recipient must submit a request for redetermination if its compensation structure for the covered group is materially modified.

  Under a safe harbor provision, the compensation structure for an employee among the group of 100 most highly compensated employees not subject to the bonus payment limitation will be deemed to meet the requirements, and approval or reapproval will not be required, if the total compensation to the employee (including, for this purpose, any change in pension value and above-market earnings on deferred compensation) does not exceed $500,000, excluding long-term restricted stock.

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[6] As of September 21, 2009, the exceptional assistance companies include AIG, Bank of America, Chrysler, Chrysler Financial, Citigroup, General Motors and GMAC.

[7] All exceptional assistance companies were notified by letter dated September 4, 2009 that their submissions for this group of employees were substantially complete.

- *Review outcomes*. Based on the information submitted, the Special Master has the authority to require alteration of compensation structures or payments. In his review, the Special Master can take into account compensation not otherwise subject to mandatory review, such as the grandfathered arrangements described below. The regulations include a procedure for an appeal for reconsideration by the Special Master of an adverse determination. Final decisions by the Special Master have the status of determinations of the Secretary of Treasury.

- *Confidentiality*. Determinations of the Special Master will be publicly available. Materials submitted to the Special Master are subject to FOIA requests. The regulations require the Special Master to develop procedures, however, to ensure that disclosed materials have been subject to appropriate redaction to protect personal privacy, privileged or confidential commercial or financial information or other appropriate redactions permissible under FOIA. The procedures may include methods for those submitting materials to request redactions and review and request reconsideration of any proposed redactions before such redacted materials are released. FOIA limitations do not apply to Congressional requests for information.

- *Compensation paid during Special Master review*. Compensation paid between June 15, 2009 and the final determination by the Special Master will generally not be overturned by the Special Master if the compensation is paid under a system in place as of June 14, 2009 and complies with the requirements of the regulations generally applicable to companies having obligations to Treasury under TARP.

- **Interpretation and issuance of advisory opinions on the compensation provisions of ARRA and the regulations as well as any compensation-related contractual requirements of a TARP recipient**. Upon the request of any TARP recipient or any affected employee of a TARP recipient, or upon the Special Master's own initiative, the Special Master may issue advisory opinions relating to the compensation of any TARP recipient. If the Special Master issues, or is inclined to issue, a negative advisory opinion, he may pursue negotiations with the affected TARP recipient and its employees to change the relevant compensation arrangement or seek reimbursement of compensation when appropriate. The Special Master has announced that it will issue advisory guidelines on appropriate compensation for executives at certain TARP recipients (other than the exceptional assistance companies).

- **Review of the pre-ARRA compensation of TARP recipients where the Special Master deems it necessary and appropriate**. As prescribed by ARRA, the Special Master has the authority to review bonus payments and other compensation paid before February 17,

2009 to determine if the compensation was inconsistent with the rules or purposes of TARP or contrary to the public interest and, if so, to seek the return of appropriate amounts to the TARP recipient.

Interpretation and application of contractual provisions. The Special Master also has the authority to interpret or apply contractual provisions between Treasury and TARP recipients related to compensation.

Compensation principles. In exercising his authority, the Special Master will consider the following principles:

- **Avoidance of unnecessary or excessive risks**. Compensation structures should avoid incentivizing employees to take unnecessary or excessive risks that could threaten the value of the TARP recipient.
- **Facilitation of competitiveness and repayment**. Compensation structures should be designed to allow the TARP recipient to remain competitive, retain and recruit talented employees and eventually repay TARP obligations.
- **Appropriate allocation**. Compensation should be allocated among different forms based on the role of the employee and other relevant circumstances. An emphasis should be placed on long-term compensation for executives or other senior employees.
- **Performance-based compensation**. Generally, a significant portion of total compensation should be performance based, especially for employees with a high level of responsibility.
- **Comparable compensation to similar entities**. Compensation structures and amounts should be similar to those provided to employees of similar entities that are similarly situated, including, as applicable, entities competing in the same markets and similarly situated entities that are financially distressed or that are contemplating or undergoing reorganization.
- **Value to the employer**. Compensation should reflect an employee's value to the employer, taking into account factors such as revenue production, compliance with company policy and the employee's role in changing the TARP recipient's financial health or competitive position.

Obama Administration Compensation Principles. The Obama Administration's White Paper on Financial Regulatory Reform[8] released on June 17, 2009 proposes that "Federal regulators should issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value and to prevent compensation

[8] U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 29 (June 17, 2009), http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

practices from providing incentives that could threaten the safety and soundness of supervised institutions." These principles, which would apply to all financial firms and not just those participating in TARP, are as follows:

- Compensation plans should properly measure and reward performance;
- Compensation should be structured to account for the time horizon of risks;
- Compensation should be aligned with sound risk management;
- Golden parachutes and supplemental retirement packages should be reexamined to determine whether they align with the interests of executives and shareholders; and
- Transparency and accountability in setting compensation should be encouraged.

These principles are identical to those articulated by Secretary Geithner on June 10, 2009.[9]

Bonus Payment Restrictions

Prohibition. Subject to the exceptions described below for long-term restricted stock and grandfathered bonus payments, ARRA prohibits a TARP recipient from paying or accruing any bonus payments with respect to specified employees.

Covered employees. The prohibition on paying or accruing bonus payments applies with respect to a TARP recipient's senior executive officers and a specified number of most highly compensated employees determined based on the amount of aggregate TARP assistance received by the TARP recipient.

Although ARRA permitted the regulations to extend the bonus payment restriction to a larger number of most highly compensated employees, Treasury did not adopt that approach, deciding instead to require the Special Master to review the compensation arrangements and structures of TARP recipients that receive exceptional assistance, as described in the Special Master for TARP Executive Compensation section above.

The regulations provide that if a TARP recipient increases its financial assistance from Treasury during its fiscal year, it need not cover additional employees until the start of the next fiscal year. Even if a TARP recipient decreases its outstanding financial assistance during a year (unless the

[9] *See* U.S. Dep't of the Treasury Press Release, Statement by Treasury Secretary Tim Geithner on Compensation (June 10, 2009), http://www.ustreas.gov/press/releases/tg163.htm.

What Qualifies as a Bonus:

- Any payment in addition to any amount payable to an employee for services performed by the employee at a regular periodic rate (*e.g.*, hourly, monthly).
- **Includes:** contributions to, or other increases in benefits under, a nonqualified deferred compensation plan and loan forgiveness.
- **Does not include:** salary; contributions to a qualified retirement plan; benefits under a broad-based benefit plan; overtime pay; expense reimbursements; and qualified commission compensation.

What Qualifies as a Retention Award:

- Any payment to an employee that:
  - Is not payable periodically for services performed at a regular periodic rate;
  - Is contingent on the completion of a period of future service or a specified project or transaction; and
  - Is not based on the performance of the employee or the activities or value of the TARP recipient.
- **Includes:** signing bonuses or "make whole" payments subject to service vesting or repayment upon departure before a specified date.
- **Does not include:** salary; contributions to a qualified retirement plan; benefits under a benefit plan; payment of a fringe benefit; overtime pay; expense reimbursements; qualified commission compensation; and deferred compensation plan benefits under a plan that has not been materially enhanced for a significant period of time before the employee becoming a senior executive officer or most highly compensated employee.

decrease is to zero), the number of covered employees will remain the same for that year.

Effectiveness. The prohibition on paying or accruing bonus payments does not apply to payments made or accrued before June 15, 2009. To the extent that a bonus payment relates to a service period that straddles that date, the payment will not be treated as having accrued on or after June 15, 2009 if the payment is reduced at least to reflect the relative length of the period that occurs after such date. For example, if an employee is granted the right to a $200,000 bonus paid with respect to service performed during the one-year period commencing on December 15, 2008, the employee may accrue a bonus of $100,000 without the bonus being treated as having accrued during the period in which the prohibition was in effect. If the employee is a senior executive officer or most highly compensated employee at the time that the $100,000 reduced bonus would otherwise have been paid, the bonus may not be paid until the prohibition is no longer in effect.

Commissions. Commissions may constitute bonus payments, unless they satisfy a number of requirements. To avoid being characterized as a bonus, a commission earned by an employee must be consistent with a program in existence for that type of employee as of February 17, 2009 and must be derived by reference to the purchase price or the volume of sales. Commissions related to a specified transaction, such as an initial public offering or M&A transaction, and fees earned from sales to affiliates, are not qualified commission compensation and are considered to be bonus payments.

Definitions. As summarized in the sidebars and below, the regulations define the terms "bonus," "retention award," "incentive compensation" and "accrue." Neither ARRA nor EESA had defined these terms.

Accrued. In determining whether a bonus payment has accrued, the following principles will apply:

- **The determination entails a facts and circumstances analysis**. The regulations note that an accrual may include the granting of service credit or credit for compensation received. Presumably, therefore, if a TARP recipient that is unable to pay an employee a bonus in one year because of the prohibition pays the employee in the following year a bonus equal to twice the amount of the bonus that it otherwise would have paid the employee, the bonus would be considered to have impermissibly accrued in the first year.

- **Delaying a bonus payment until after an employee is no longer subject to the prohibition will not cleanse the payment**. For example, if after an employee is no longer a senior executive officer or most highly compensated employee, the employee is paid an amount based on services performed during the prohibition period, the amount would be considered to have accrued during the prohibition period.

What Qualifies as Incentive Compensation:

- Any payment to an employee that is intended to serve as an incentive for performance over a specified period, regardless of how the performance is measured.
- **Includes:** equity-based compensation or long-term restricted stock (other than salary).
- **Does not include:** salary in the form of equity-based compensation and qualified commission compensation.

- **Multi-year service periods**. If an employee is covered by the prohibition during a portion of a multi-year service period applicable to a bonus payment, the employee will not be treated as having accrued the compensation during the prohibition period if the compensation is reduced at least to reflect the relative length of the prohibition period. It appears that this multi-year service period also applies where a company is a TARP recipient during a portion of the service period and out of TARP during the remainder of the service period.

Exception for long-term restricted stock. ARRA permits a TARP recipient to grant "long-term restricted stock" without violating the prohibition on paying or accruing a bonus payment if it satisfies certain requirements: (i) the value of the grant may not exceed one-third of the amount of the employee's annual compensation, (ii) no portion of the grant may vest before two years after the grant date and (iii) the grant must be subject to a further restriction on transfer or payment as described below.

- **Restricted stock or restricted stock units**. The regulations define "long-term restricted stock" broadly to include both restricted stock and restricted stock units. Units may be settled in common stock or cash and may track a specific unit or division within the TARP recipient to which the employee provides services.

- **Value limitation**. The value of restricted stock or units may not exceed one-third of an employee's annual compensation for the fiscal year of grant. Note that, although financial institutions typically award bonus payments at the beginning of a fiscal year based on performance in the previous fiscal year, under the regulations, the maximum grant of restricted stock or units is based on total compensation in the year of grant, not total compensation in the year of performance related to the award.

  In calculating annual compensation, the total fair market value of equity-based compensation is included in the fiscal year in which the compensation is granted, rather than being amortized over any vesting schedule.[10] For example, if in 2008 an employee receives restricted stock vesting over three years and having a total fair market value of $900,000, the $300,000 attributable to the portion of the stock that vests in 2009 is not taken into account in calculating the employee's annual compensation for 2009. Similarly, in calculating the maximum value of stock or units that may be granted in a fiscal year, the total fair market value of the stock or units is included in the fiscal year of grant. For example, if in 2009 an employee receives $1 million in salary, the employee may in 2009 receive restricted stock or units having a total fair

[10] As discussed above, on July 10, 2009, the SEC issued a proposed rule that would require reporting the aggregate grant date fair value of equity awards for the year of grant, rather than the amount recognized each year for financial statement reporting purposes, which generally allocates the value of equity awards over several years according to their vesting schedules.

market value of up to $500,000 (*i.e.*, $1 million + $500,000 ÷ 3 = $500,000).

- **Vesting, transfer and payment**. None of the restricted stock or units may vest before the second anniversary of the grant date of the stock or units. Accordingly, an employee must forfeit the stock or units if the employee does not perform substantial services for the TARP recipient for at least two years after grant, unless the cessation of services is due to the employee's death or disability or a change in control of the TARP recipient. The regulations do not restrict the rate of vesting after two years. However, the regulations do impose an added restriction requiring that the stock may not become transferable (or, in the case of units, may not be paid) any more quickly than in accordance with the sidebar (except that transferability and payment may accelerate on an M&A transaction, but not for death or disability):
  - The regulations do not provide details as to how the repayment calculation is to be made, for example, where Treasury holds different obligations of a TARP recipient (e.g., debt, preferred stock, common stock) acquired in different transactions (e.g., exchanges).
  - The regulations provide an exception that allows senior executive officers and most highly compensated employees to transfer shares of restricted stock to the extent necessary to pay the taxes due as a result of the vesting of the shares according to its normal vesting schedule.

Exception for bonus payments under employment contracts. ARRA permits a TARP recipient to pay or accrue a bonus payment if an employee had a legally binding right to the bonus payment under a "valid employment contract" as of February 11, 2009. A valid employment contract is a written contract that is a "material contract" required to be filed under securities law or that would have been required to be filed as a material contract but for the fact that the contract relates to an employee who is not an executive officer or that the TARP recipient is private. For purposes of the regulations, the term "legally binding right" is given the meaning established in the regulations under Section 409A of the Internal Revenue Code. The examples in the regulations make clear that "employment contract" may be broadly interpreted to include not only employment agreements, but also equity-based compensation plans, awards and bonus programs documented in a written plan.

If the contract is amended to increase the amount payable, accelerate any vesting conditions or otherwise materially enhance the benefit, payments under the contract will not be eligible for the grandfather exception. However, the regulations indicate that if the contract is amended in a manner adverse to the employee or if the employee waives any aspect of the contract, then payments will not be disqualified from this exception.

Contractual restrictions on bonus payments for TARP recipients receiving exceptional financial assistance. The bonus restrictions

Transfer and Payment Restrictions

Percentage of Aggregate Assistance Repaid by TARP Recipient	Percentage of Shares or Units That May Become Transferable or Be Paid
25%	up to 25%
50%	up to 50%
75%	up to 75%
100%	up to 100%

included in contracts between TARP recipients and Treasury signed before the regulations are in some cases less restrictive than the prohibition in the regulations. Some of these contracts require that TARP recipients receiving exceptional assistance limit bonus payments, in aggregate, to an amount equal to, or in some cases significantly less than, aggregate bonus payments in previous years. One contract has a prohibition similar to that contained in the regulations but still allows bonuses to be paid with the approval of an individual designated by the President. Some form of bonus restriction is contained in every contract Treasury entered into with a recipient of exceptional assistance.

Recoupment of Bonus Payments

TARP recipients must ensure that any bonus payment made during the TARP period to a senior executive officer or one of the next 20 most highly compensated employees is subject to recovery or "clawback" by the TARP recipient if the bonus payment was based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria.

For purposes of the TARP regulations, a bonus payment is considered to be made to an employee when the employee obtains a legally binding right to the payment, meaning that the bonus payment must be subject to potential recoupment as of the time that the bonus payment opportunity is awarded. In addition, if the material inaccuracy is discovered after the TARP period ends, the bonus payment is still subject to clawback. The clawback is mandatory, and a TARP recipient is required to exercise its clawback rights unless it demonstrates that it is unreasonable to do so (*e.g.*, the enforcement costs would exceed recovered amounts).

The regulations direct TARP recipients to look at the facts and circumstances to determine whether financial statements or performance metric criteria are materially inaccurate. However, financial statements or performance metric criteria are per se materially inaccurate for any employee who knowingly engages in providing inaccurate information relating to the financial statements or performance metrics or knowingly fails to timely correct inaccurate information.

Contractual restrictions on "clawbacks" for TARP recipients receiving exceptional financial assistance. The clawback requirements contained in agreements between Treasury and recipients of exceptional assistance may differ significantly from those in the regulations. Whereas the regulations cover senior executive officers and the next 20 most highly compensated employees, some agreements cover fewer employees (*e.g.*, senior executive officers only). The trigger for requiring a clawback also differs. The regulations require clawback only for payments made on the basis of materially inaccurate financial statements or other materially inaccurate performance metric criteria, whereas some agreements with clawback provisions require clawback of any payment made in violation of

any of the agreement's compensation-related provisions, including payments that would not be covered by the regulations.

SEC enforcement of clawbacks. For a discussion of the SEC's recent efforts to enforce the clawback provision of the Sarbanes-Oxley Act of 2002, Section 304, see Chapter 8: *Investigations and Enforcement*.

	Sarbanes-Oxley (SOX)	ARRA
Subject Companies	Public companies	TARP recipients
Subject Individuals	CEO and CFO	Senior executive officers and next 20 most highly compensated employees
Trigger	Accounting restatement due to material noncompliance by the issuer, as a result of misconduct, with any financial reporting requirement under US securities laws	Payment based on materially inaccurate financial statements or other materially inaccurate performance metric criteria (earnings, revenues, gains or other criteria); no restatement required
Fault by Subject Individuals	No fault required by subject individuals, but requires issuer misconduct	No fault required
Awards Affected	Bonus, incentive-based or equity-based compensation and profits realized from the sale of stock	Bonus, incentive compensation or retention awards
Look-Back Period	During 12-month period following first public issuance or filing with the SEC containing financial reporting triggering clawback	During TARP period
Enforcement Agent	SEC, in its discretion — no private right of action	Mandatory enforcement by TARP recipient unless unreasonable to do so; not explicitly stated in the regulations, but question as to whether also enforceable by Treasury/Special Master

Other bonus-related enforcement actions. In addition to the SEC's recent efforts to enforce the clawback provision of the Sarbanes-Oxley Act of 2002 noted above, the attorneys general of New York and Connecticut have sought to recover or block executive bonuses. In addition, the SEC has charged Bank of America with misleading investors about bonus payments paid to executives in connection with its acquisition of Merrill Lynch. For further discussion, see Chapter 8: *Investigations and Enforcement.*

Golden Parachute Payment Restriction

Prohibition. ARRA prohibits a TARP recipient from making any "golden parachute payment," which is defined as any payment (other than for services performed or benefits accrued) to any of its senior executive officers or the next five most highly compensated employees upon any termination of employment. The regulations expand the prohibition to

preclude golden parachute payments upon a change in control (even of the employing entity), regardless of whether the employee's employment terminates. The regulations eliminate the safe harbor for golden parachute payments equal to three times the senior executive officer's base amount of compensation, which were previously permitted under the contractual limits agreed to between Treasury and TARP recipients under CPP.

Timing. A golden parachute payment is treated as paid at the time of the departure or change in control, if triggered by the departure or change in control, even if paid later. Thus, severance arrangements cannot be structured so that a covered employee of a TARP recipient would receive payments after the TARP period ends that are in connection with the employee's departure or a change in control during the TARP period. Conversely, payments to an employee who terminated employment before the beginning of the TARP period are not prohibited, even if payments continue to be made.

What is not a covered golden parachute. The following payments are not prohibited golden parachute payments:

- Payments for services performed or benefits accrued:
  - Whether a payment is for services performed or benefits accrued is determined based on a facts and circumstances analysis. If a TARP recipient would make the payment or accrue the benefit regardless of whether the employee departed or a change in control occurred, the payment or benefit would not be a golden parachute payment.
  - The fact that a payment or award is subject to holdback, forfeiture or clawback for enforcement of restrictive covenants imposed on the employee (*e.g.*, a non-compete) should not affect the conclusion as to whether the payment or award has been accrued and earned. This conclusion is evidenced by the regulations' statement that potential forfeiture for termination for cause does not void the exemption. Further, this reading is consistent with Treasury's position under Section 409A of the Internal Revenue Code.
  - A payment under a benefit or deferred compensation plan is treated as a payment for services performed or benefits accrued if, among other requirements:
    - The plan was in effect for at least one year before the employee's departure;
    - The employee has a vested right to the benefit at the time of the departure or change in control; and
    - Benefits under the plan are accrued only for current or prior service rendered.
  - Payments under a qualified pension or retirement plan.
  - Payments upon death or disability.

- Severance or similar payments required by state or foreign law.
- Bonus payments under pre-February 11, 2009 contracts.

Risk Assessment and Avoidance of Manipulation

During any period in which a TARP recipient has an outstanding obligation to Treasury, the TARP recipient must establish and maintain a compensation committee of independent directors to review not only executive officer compensation plans, but all employee compensation plans, with the directive to evaluate any risks that they may pose for the TARP recipient and ensure that they do not encourage manipulation of earnings. For companies that do not have securities registered with the SEC and have received $25 million or less in TARP financial assistance, the full board rather than an independent committee may carry out these duties. This mandate, as it pertains to all employee plans, is a departure from the traditional role of the compensation committee, which historically has limited its review to senior executive compensation programs; it is also a departure from what is required of public company compensation committees under the NYSE and Nasdaq listing standards.[11]

Semi-annual review. At least every six months, the compensation committee must discuss, evaluate and review with the TARP recipient's senior risk officers any risks, including long-term and short-term risks, that the TARP recipient faces that could threaten the value of the TARP recipient. In addition, the compensation committee must take the following steps:

- **Senior executive officer compensation plans**. With the TARP recipient's senior risk officers, identify and limit features of senior executive officer compensation plans that could lead senior executive officers to take unnecessary and excessive risks that "threaten the value" of the TARP recipient.
- **All employee compensation plans – risks**. With the TARP recipient's senior risk officers, identify and limit features in all employee compensation plans that unnecessarily pose risks to the TARP recipient.

[11] According to recent news reports, the Federal Reserve plans to vote in the next few weeks on a proposal that would require the compensation policies of the financial institutions that it oversees to ensure that they do not encourage employees to take excessive risks. This new policy would apparently apply to all financial institutions under its supervision, including those that are not or are no longer TARP recipients. The media is reporting that the proposal would not be subject to Congressional approval, but would be subject to a public comment period. Approval of the proposal may trigger a review of the nation's largest financial institutions, numbering approximately 25. *See* Damian Paletta and Jon Hilsenrath, *Bankers Face Sweeping Curbs on Pay*, WALL ST. J., Sept. 18, 2009, http://online.wsj.com/article/SB125324292666522101.html#mod=mod=WSJ_hps_LEADNewsCollection; Edmund L. Andrews and Louise Story, *Fed Considers Sweeping Rules on Bank Pay*, N.Y. TIMES, Sept. 18, 2009, http://www.nytimes.com/2009/09/19/business/economy/19pay.html?_r=l&hp.

- **All employee compensation plans – manipulation of earnings**. Identify and eliminate features of all employee compensation plans that could encourage the manipulation of reported earnings to ensure that the plans do not encourage such manipulation that would enhance the compensation of employees.

Unacceptable plan features include those that would encourage behavior focused on short-term results as opposed to long-term value creation.

Disclosure and certification. A TARP recipient, whether public or private, is subject to annual disclosure and certification requirements if the TARP recipient had any outstanding obligation to Treasury during any part of the previous fiscal year. For details on the location of this disclosure and certification, please see the sidebar.

Location of Disclosure and Certification

- TARP recipient has SEC-registered securities:
  - Include disclosure and certification in the compensation committee report furnished with the annual report on Form 10-K, annual proxy statement or information statement on Schedule 14C.
- TARP recipient does not have SEC-registered securities:
  - Regulations are silent on location of disclosure;
  - Provide certification to Treasury and to the TARP recipient's primary regulatory agency.

- **Disclosure**. The compensation committee must provide a narrative description identifying each senior executive officer compensation plan and each employee compensation plan reviewed and explaining how the risks described above have been limited or eliminated, as required.

- **Certification**. The compensation committee must certify that it has reviewed with senior risk officers: (i) the senior executive officer compensation plans to ensure that such plans do not encourage senior executive officers to take unnecessary and excessive risks; (ii) the employee compensation plans to limit any unnecessary risks that such plans pose to the TARP recipient; and (iii) the employee compensation plans to eliminate any features of such plans that would encourage the manipulation of reported earnings to enhance the compensation of any employee. The regulations provide a model certification, which is discussed further in the CEO and CFO Certification section below.

TARP recipients that have never had an obligation to Treasury. TARP recipients that have never had an outstanding obligation are not required to conduct the comprehensive review described above but instead must undertake a more general review of employee compensation plans to evaluate the risks posed to the TARP recipient by such plans and to identify and limit these risks. For these companies, required disclosure and certification need only reflect such review. This requirement ceases for these TARP recipients as of the sunset date of Treasury's statutory authority under TARP.

Disclosure under SEC Proposed Rule. On July 10, 2009, the SEC issued a proposed rule that would amend the compensation disclosure requirements applicable to public companies under Regulation S-K. One of these amendments is a new section in the CD&A discussing and analyzing whether risks arising from a company's employee compensation programs

may have a material effect on the company. The SEC anticipates that these changes would become effective for the 2010 proxy season.[12]

Tax Gross-Up Prohibition

The regulations prohibit a TARP recipient from paying to any of its senior executive officers or next 20 most highly compensated employees gross-ups or other reimbursements for the payment of taxes, including rights to future gross-up payments for periods that extend beyond the TARP period. This prohibition does not cover payments under tax equalization arrangements, which provide payments to compensate an employee for taxes imposed by a foreign jurisdiction on the employee's compensation in excess of the taxes that would be paid domestically.

Luxury Expense Policy

ARRA contains a provision that amends section 111 of EESA to limit luxury expenses that can be made by TARP recipients. The boards of directors of TARP recipients must establish written policies prohibiting, or requiring prior approval of, excessive and luxury expenditures by the later of September 14, 2009 or the closing of an agreement with Treasury. As of this date, the board of a TARP recipient must adopt a luxury expenditure policy, provide it to Treasury and the TARP recipient's primary regulatory agency, and post the text on the TARP recipient's website.[13] The TARP recipient must maintain the policy through the TARP period, and any amendments to the policy must be provided to Treasury and the TARP recipient's primary regulatory agency within 90 days after adoption and must be posted on the TARP recipient's website.

Expenses covered by the excessive and luxury expenditure policies include entertainment or events, office and facility renovations and aviation or other transportation services, among others. Expenses not covered include reasonable expenditures for staff development, reasonable performance incentives and other similar reasonable measures conducted in the normal course of the TARP recipient's business.

The policy must accomplish the following:

Policy on Luxury Expenditures under ARRA

The company policy may address excessive expenditures on:

- Entertainment or events;
- Office and facility renovations;
- Aviation or other transportation services; or
- Other activities or events that are not reasonable expenditures for staff development, reasonable performance incentives, or other similar measures conducted in the normal course of the TARP recipient's business operations.

[12] *See* Letter from Davis Polk to the Sec. and Exchange Comm., Regarding Comments on Proposed Amendments to the Compensation and Corporate Governance Disclosure Rules and Proxy Rules under the Securities Exchange Act of 1934 (Sept. 14, 2009), http://www.sec.gov/comments/s7-13-09/s71309-50.pdf

[13] For examples of the luxury expense policies that Bank of America and Wells Fargo posted on their websites in response to this requirement, see Bank of America, Excessive or Luxury Expenditures Policy (Sept. 2009), http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MTUxNjN8Q2hpbGRJRD0tMXxUeXBlPTM=&t=1; Wells Fargo & Company, Luxury Expenditures Policy, https://www.wellsfargo.com/pdf/about/corporate/luxury_expenditures.pdf.

Policy on Luxury Expenditures by Agreement

The expense policy, which also applies to the institutions' subsidiaries, must govern:

- The hosting, sponsorship or other payment for conferences and events;
- The use of corporate aircraft;
- Travel accommodations and expenditures;
- Consulting arrangements with outside service providers;
- Any new lease or acquisition of real estate;
- Expenses relating to office or facility renovations or relocations; and
- Expenses relating to entertainment or holiday parties.

- Identify types of prohibited expenditures, possibly including a threshold amount per item, activity, or employee;
- Identify types of expenditures that require prior approval, including possibly threshold expenditure amounts;
- Provide reasonable approval procedures for expenditures requiring prior approval;
- Require CEO and CFO certification of approval for expenditures requiring prior approval from any senior executive officer, similar executive officer or the board;
- Require prompt internal reporting of violations; and
- Mandate accountability for adherence to the policy.

Lobbying Policy

No statutory lobbying restrictions have been placed on recipients of TARP funds or in connection with TARP programs or projects. An article from the Washington Post explained that "[f]inancial firms have successfully quashed proposed legislation that would explicitly ban the use of TARP money for lobbying or campaign contributions."[14]

Treasury issued a press release on January 27, 2009, announcing that it was establishing reforms to restrict lobbying. The press release announced voluntary actions by Treasury to ensure that TARP investment decisions were not influenced by lobbyists. It stated that Treasury would certify monthly to Congress that each TARP investment decision was made solely on the basis of objective investment criteria. Treasury has not, however, incorporated such reforms directly into its capital infusion programs.

Policy on Lobbying by Agreement

The lobbying policy, which applies to each institution and its subsidiaries, must govern:

- The provision of items of value to government officials;
- Lobbying of government officials; and
- Political activities and contributions.

Restrictions Imposed by Agreement

In TARP programs created after CPP, Treasury started imposing restrictions on TARP fund recipients' luxury expenses and lobbying efforts by setting forth such restrictions in purchase agreements. For example, both Citigroup and Bank of America's securities purchase agreements in connection with the Targeted Investment Program include such restrictions, as does Treasury's agreement with AIG under the Systemically Significant Failing Institutions Program.

Each securities purchase agreement requires that the institution maintain and implement a comprehensive written policy governing corporate

[14] Dan Eggen, *Firms Infused with Rescue Cash Find Money to Fund Lobbying*, WASH. POST, Apr. 22, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/04/21/AR2009042101788.html.

expenses and lobbying until it redeems its preferred shares or Treasury transfers the shares to unaffiliated third parties. The institution must maintain a system of reporting and oversight and a mechanism to address non-compliance with the expense and lobbying policies. If it wishes to materially amend either policy, the agreement requires that the financial institution first obtain written consent from Treasury.

Perquisite Disclosure

TARP recipients are subject to more stringent perquisite disclosure requirements than are other companies. The regulations require TARP recipients to annually disclose to Treasury and its primary regulator perquisites or other personal benefits with a total value greater than $25,000 for each senior executive officer and most highly compensated employee subject to the bonus payment limitation. The disclosure must include a discussion of the amount, nature, recipients of and justifications for the perquisites. In comparison, under the SEC rules other public companies must identify each perquisite if the total value of perquisites exceeds $10,000 but need only provide the incremental cost of each perquisite if the individual perquisite exceeds the greater of $25,000 or 10% of the total value of all perquisites provided to the executive.

Say on Pay

Although the regulations made clear that the other compensation requirements of ARRA were effective only for periods after the regulations became effective on June 15, 2009, the ARRA say on pay requirement was deemed effective as of the enactment of ARRA on February 17, 2009.

The regulations require a company that has TARP assistance outstanding to provide for, in any proxy statement relating to an annual meeting (or special meeting in lieu of an annual meeting), a separate shareholder non-binding vote to approve the executive officer compensation that the company has disclosed as required under the SEC's compensation disclosure rules.[15] On July 10, 2009, the SEC issued proposed rules relating to the TARP say on pay requirement.[16]

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[15] For additional information on the SEC's guidance on say on pay, see Davis Polk, *"Say on Pay" Now a Reality for TARP Participants* (Feb. 25, 2009), http://www.davispolk.com/files/Publication/716acff6-4dbf-480d-92a4-15325c88567b/Presentation/PublicationAttachment/c930f31f-250c-4d4d-b48a-1bb4a14eb77e/02.25.09.say.on.pay.pdf.

[16] *See* Letter from Davis Polk to the Sec. and Exchange Comm., Regarding Comments on Proposed Amendments to the Compensation and Corporate Governance Disclosure Rules and Proxy Rules under the Securities Exchange Act of 1934 (Sept. 14, 2009), http://www.sec.gov/comments/s7-12-09/s71209-34.pdf.

There are several pending legislation initiatives that would require all US public companies to provide for a say on pay vote.[17]

CEO and CFO Certification

Within 90 days after completion of the TARP recipient's fiscal year, any portion of which was a TARP period, the CEO and CFO of the TARP recipient must provide certifications of compliance with the Treasury regulations. The regulations provide a sample form for the initial fiscal year[18] of TARP participation and one for later years.[19] SEC-registered TARP recipients must provide their certifications as exhibits to their Forms 10-K. Private TARP recipients must provide their certifications to Treasury and their primary regulatory agency.

In all years, the CEO or CFO must certify that the following are true:

- The compensation committee met at least every six months with senior risk officers to evaluate senior executive officer and employee compensation plans and potential risks, identified and limited plan features that might encourage unnecessary and excessive risk taking and reviewed each employee compensation plan to identify and eliminate features that might encourage manipulation of reported earnings.
- The compensation committee will certify to the reviews and provide a narrative description of how it limited or eliminated the features in the senior executive officer and employee compensation plans that might expose the TARP recipient to risks or encourage manipulation of reported earnings.
- The TARP recipient has complied with all regulations regarding bonus payment limitations, clawback provisions, golden parachute payments, tax gross-ups, luxury expenditure policies, perquisite disclosure, disclosure of compensation consultants, and any additional compensation requirements set forth in any agreement between the TARP recipient and Treasury.

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[17] For more information on the Administration's plans, see Davis Polk, *Treasury Seeks Legislation to Enact Say on Pay and Compensation Committees Changes for All U.S. Public Companies* (July 20, 2009), http://www.davispolk.com/files/Publication/dccc1c9e-91c7-40db-b2ed-05ba2330b43b/Presentation/PublicationAttachment/35d6b2c5-4403-4c9c-a342-0a19c04549c6/072009_SayonPay.html. For an example of such pending legislation, see The Corporate and Financial Institution Fairness Act of 2009, H.R. 3269, 111th Cong. (2009), http://www.house.gov/apps/list/press/financialsvcs_dem/hr3269.pdf.

[18] For the Model Certification for First Fiscal Year Certification, see http://www.davispolk.com/files/uploads/FCM/Model.Certification.First.Fiscal.Year.pdf.

[19] For the Model Certification for Years Following First Fiscal Year Certification, see http://www.davispolk.com/files/uploads/FCM/Model.Certification.Years.Following.First.Fiscal.Year.pdf

- If the TARP recipient has securities registered with the SEC, it will permit a non-binding say on pay vote in accordance with guidance, rules or regulations promulgated by the SEC.
- The employees named in the certification are senior executive officers or most highly compensated employees for the current fiscal year ranked in order of compensation amount based on their compensation in the previous fiscal year.
- If the TARP recipient received exceptional financial assistance and is subject to approval by the Special Master of its compensation structures or amounts, it has received or is in the process of receiving that approval.

If a TARP recipient does not satisfy a requirement under the regulations because it repays its obligations to Treasury prior to the date by which it would have been required to satisfy the requirement, the CEO and CFO must certify only that the TARP recipient was not required to meet the requirement. For example, if a TARP recipient repaid its obligations prior to the September 14, 2009 date by which it otherwise would have been required to establish a luxury expense policy, the CEO and CFO certification simply would be required to state that the TARP recipient was not required to establish such a policy.

Although most TARP recipients must provide certification on an annual basis, certain of the companies receiving exceptional assistance are required to certify compliance at the end of each fiscal quarter rather than annually.

Compensation Consultant Disclosure

The regulations impose broader disclosure obligations for TARP participants regarding compensation consultants than those under existing federal securities laws. Each TARP recipient's compensation committee must disclose to Treasury and its primary regulator annually whether the TARP recipient, its board or its compensation committee has engaged a compensation consultant. The compensation committee must disclose all services provided by the consultant or any of its affiliates for the past three years, including the use of any benchmarking or comparisons employed by the consultant to analyze comparative compensation schemes. If the TARP recipient is not required to maintain a compensation committee, the board must provide the disclosure.

The July 10, 2009 SEC-issued proposed rule would require proxy disclosure by all US companies of services provided to them by compensation consultants and their affiliates that are unrelated to executive or director compensation and the fees paid for such services.

Compliance Timeline

The compliance timeline, available at http://www.davispolk.com/files/uploads/FCM/Compliance.Timeline.pdf, outlines key obligations under the regulations with fixed deadlines. The timeline does not reflect any contractual obligations that TARP recipients may have.

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ABOUT THE AUTHORS

John M. Brandow

Mr. Brandow heads Davis Polk's Equity Derivatives Group, which includes over 35 securities and tax lawyers. He advises a wide variety of market participants—commercial and investment banks, issuers, hedge funds and institutional and individual holders of equity positions— on a complex array of equity-related transactions.

Mr. Brandow has been actively involved in the design of exchangeable securities containing imbedded options or forward contracts on the underlying equities, the development of mandatory and optional convertible securities that are issued in tax or accounting-driven capital-raising transactions, the design of hybrid securities, including Tier 1 hybrid securities, and the structuring of public and private hedging transactions using collars and variable prepaid forward contracts.

Over the last few years, Mr. Brandow has advised the underwriters on capital raising transactions for CIT, Washington Mutual, PNC Financial, AIG and Liberty Mutual, among others, involving the issuance of mandatorily convertible units, Tier 1 convertible preferred stock, Tier 1 hybrid securities and convertible preferred stock. He represented Morgan Stanley in its sale to China Investment Corporation of $5.75 billion of Tier 1 mandatorily convertible units, its sale to Mitsubishi UFG of $9.0 billion of convertible and straight preferred stock, its sale to Treasury of $10.0 billion of TARP preferred stock and warrants and its sales of debt securities under the TLGP. He also represents the FRBNY and Treasury in connection with their investment in AIG.

Mr. Brandow earned bachelor's degrees from Yale University, *cum laude*, in 1975 and Oxford University in 1977. He received his J.D., *cum laude*, in 1980 from the University of Pennsylvania Law School, where he was an articles editor for the *University of Pennsylvania Law Review*. He clerked for the Honorable Irving R. Kaufman, US Court of Appeals, Second Circuit, from 1980 to 1981.

Beverly Chase

Ms. Chase, a partner in our Executive Compensation and Employee Benefits Group, advises businesses, boards of directors and senior executives on all aspects of executive compensation, including design, disclosure, taxation and related governance issues. Her most recent projects include assignments for a number of high-profile TARP participants, as well as the FRBNY and Treasury in connection with compensation issues related to their investment in AIG.

Ms. Chase is also a partner in our Trusts and Estates Department, where she advises high net worth clients (at both public companies and private investment funds businesses) on their estate and charitable planning, including the integration of their personal planning with their compensation arrangements.

Ms. Chase graduated, *magna cum laude*, from Radcliffe College in 1970 and in 1974 received her J.D., *cum laude*, from Fordham University School of Law, where she was articles editor of the *Fordham Law Review*. She clerked for the Honorable Kevin Thomas Duffy, US District Court, Southern District of New York, from 1974 to 1976.

Davis Polk

Luigi L. De Ghenghi

Mr. De Ghenghi is a partner in Davis Polk's Financial Institutions Group. His practice focuses on bank regulatory advice, and mergers and acquisitions and capital markets transactions for US and non-US banks and other financial institutions, including transactions involving the acquisition of failed banks or their assets and liabilities. He is also experienced in advising banks and other financial institutions on corporate governance and compliance matters, bank insolvency issues, government investigations and enforcement actions, cross-border collateral transactions, and clearance and settlement systems. Mr. De Ghenghi has advised a number of financial institutions on capital-raising transactions ranging from Tier 1 and Tier 2 capital securities offerings to initial public offerings.

Mr. De Ghenghi received his B.A., with great distinction, from McGill University in 1980 and in 1982 received his B.A. in law from Oxford University. In 1985, he received his J.D., *cum laude*, from Northwestern University School of Law, where he was an articles editor of the *Northwestern University Law Review*.

John L. Douglas

Mr. Douglas is a partner in Davis Polk's Financial Institutions Group, heading the firm's bank regulatory practice and focusing on bank restructuring and resolutions and other issues arising from the current banking and financial crisis. He has been involved in some of the most difficult and sensitive matters during the crisis, including advising the boards of directors of IndyMac and Bank United, counseling Citigroup with respect to FDIC matters, advising various parties on the fallout from the failure of Washington Mutual and advising various private equity firms on proposed investments in troubled or failed banks.

Mr. Douglas was appointed General Counsel of the FDIC in 1987 and continued in that capacity through 1989. This was a period of unprecedented stress on the financial system, and he was involved in the major bank failures and restructurings of the late 1980s, participated in the landmark Financial Institutions Regulatory Reform and Restructuring Act of 1989 and assisted in the organization of the Resolution Trust Corporation.

Mr. Douglas is one of the leading bank insolvency lawyers in the nation.

Mr. Douglas graduated from Davidson College in 1972 and in 1977 received his J.D., Order of the Coif, from the University of Georgia, where he was an editor of the *Georgia Law Review* and a Woodruff Scholar.

Davis Polk

William J. Fenrich

Mr. Fenrich is a partner in Davis Polk's Litigation Department, with a principal focus on securities and antitrust law. He regularly represents banks, broker-dealers, hedge funds, auditing firms, corporations and individuals in a range of civil, regulatory and criminal matters. Currently, he is actively representing multiple clients in a range of civil and investigative matters, including a number of financial institutions in matters growing out of the recent financial crisis.

Mr. Fenrich graduated from the University of Pennsylvania in 1991 and in 1997 received his J.D., *magna cum laude*, Order of the Coif, from Fordham University School of Law, where he was writing and research editor of the *Fordham Law Review*. He clerked for the Honorable Thomas J. Meskill, US Court of Appeals, Second Circuit, from 1998 to 1999, and for the Honorable Loretta A. Preska, US District Court, Southern District of New York, from 1997 to 1998.

Edmond T. FitzGerald

Mr. FitzGerald, a partner in our Executive Compensation and Employee Benefits Group, advises financial and corporate clients on matters involving executive compensation and corporate governance, both in the ordinary course of clients' business and in the context of TARP participation, mergers and acquisitions, new ventures, and restructurings.

In addition, Mr. FitzGerald has expertise in structuring financial products and investment funds to include participation by management personnel and pension funds.

Mr. FitzGerald graduated from Cornell University in 1987 and received his J.D. from Brooklyn Law School in 1991.

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James A. Florack

Mr. Florack is a partner in the Davis Polk Credit group, who advises clients on a range of corporate finance transactions, including leveraged lending, structured finance, high-yield debt offerings and other capital markets transactions, with a particular focus on financings for leveraged acquisitions whether led by financial sponsors or otherwise. His practice includes transactions both in the US and in international and cross-border markets, particularly Europe and Latin America, and in a variety of industries ranging from oil and gas and basic manufacturing to technology. His clients have included many financial institutions, such as JPMorgan Chase, Morgan Stanley, Bank of America, Credit Suisse and Goldman Sachs, as well as a number of corporate clients.

Mr. Florack has advised clients on a number of financial crisis-related matters, including advice to Citigroup in connection with its loss-sharing arrangements with the Federal Reserve Bank of New York, the US Treasury and the FDIC.

Mr. Florack graduated from Cornell University in 1981 and in 1984 received his J.D. from the University of California at Los Angeles. He clerked for the Honorable Alicemarie H. Stotler, US District Court for the Central District of California, from 1984 to 1986.

Randall D. Guynn

Mr. Guynn is head of Davis Polk's Financial Institutions Group. His practice focuses on providing strategic bank regulatory and enforcement advice and advising on mergers and acquisitions and capital markets transactions when the target or issuer is a banking organization or other financial institution. He also advises on bank failures and recapitalizations, corporate governance and internal controls, cross-border collateral transactions, credit risk management, securities settlement systems and payment systems. His clients include all three of the largest US and many of the world's leading European and Asian banking organizations.

Mr. Guynn was recognized as one of the most widely consulted US legal advisers on matters arising out of the financial crisis. See "In the Red Zone," The American Lawyer (January 2009).

Mr. Guynn graduated, with highest honors, from Brigham Young University in 1981 and in 1984 received his J.D., Order of the Coif, from the University of Virginia School of Law, where he was executive editor of the *Virginia Law Review*. He was a law clerk for the Honorable William H. Rehnquist, US Supreme Court, from 1985 to 1986, following a clerkship with the Honorable J. Clifford Wallace, US Court of Appeals, Ninth Circuit, from 1984 to 1985.

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Michael Kaplan

Mr. Kaplan is a partner in Davis Polk's Capital Markets Group and regularly works for issuers and underwriters in connection with capital markets and leveraged finance transactions, including initial public offerings and other equity offerings, as well as offerings of convertible and high-yield debt. He has worked on offerings involving issuers from a variety of industries ranging from technology and telecommunications to basic industry. Mr. Kaplan also regularly advises investment banking clients on securities law-related matters and corporate clients on general corporate matters, including corporate governance, SEC and Sarbanes-Oxley matters.

Mr. Kaplan advised on a number of financial crisis-related matters, including advice to the Federal Reserve Bank of New York in connection with the Capital Purchase Program and the Term Asset Loan Facility and advice to numerous financial institutions in connection with issuances of FDIC-guaranteed debt. Mr. Kaplan also advised Ford Motor Company on its debt reduction and equity raising efforts during 2009.

Mr. Kaplan graduated, *summa cum laude*, from Harvard College in 1992 and in 1995 received his J.D., *magna cum laude*, from Harvard Law School. He clerked for the Honorable Marie L. Garibaldi, Supreme Court of New Jersey, from 1995 to 1996.

Yukako Kawata

Ms. Kawata is co-head of Davis Polk's Investment Management/Private Funds Group. She advises clients on the formation and operation of private investment funds and other investment vehicles exempt under the US Investment Company Act, including private equity funds, hedge funds, venture capital funds, fund of funds and funds investing in particular sectors or countries. She also advises clients on the establishment and operations of private fund managers, including private equity and hedge fund firms. She currently serves as Chair of the New York City Bar's Committee on Private Investment Funds.

Ms. Kawata graduated from Princeton University in 1979 and in 1982 received her J.D. from New York University School of Law, where she was a member of the *New York University Law Review* and the recipient of an American Jurisprudence Award in Torts.

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Leor Landa

Mr. Landa is a partner in Davis Polk's Investment Management/Private Funds Group. He advises a wide range of clients on the development, formation, marketing and operation of private investment fund complexes, including private equity funds, hedge funds, hybrid funds, real estate funds, funds of funds and asset allocation products. He also regularly provides regulatory and compliance advice to his private fund clients.

Mr. Landa advises private fund managers in connection with compensation and profit sharing arrangements. He also advises clients in connection with structuring and executing private equity, structured equity and public market transactions as well as acquisitions of investment advisers. In addition, he represents institutional investors investing in private funds.

Mr. Landa graduated from The Johns Hopkins University in 1994 and in 1997 received his J.D. from Columbia Law School, where he was a Harlan Fiske Stone Scholar. He clerked for the Senior Judges of the District of Columbia Court of Appeals from 1997 to 1998.

Kyoko Takahashi Lin

Ms. Lin is a partner in Davis Polk's Executive Compensation and Employee Benefits Group, advising clients on executive compensation and corporate governance matters, with particular emphasis on issues arising in mergers and acquisitions transactions, initial public offerings and new and joint ventures. She has also advised a number of financial institution clients on issues relating to TARP participation, compliance and exit.

In addition, Ms. Lin advises on employment and consulting arrangements, the design and implementation of equity compensation plans, deferred compensation, severance plans, the applicability of securities and tax laws to executives and employers and general employment-related matters.

Ms. Lin graduated, *magna cum laude*, from Harvard College in 1993 and in 1996 received her J.D. from Harvard Law School, where she was on the Board of Student Advisers and taught legal research and writing to first-year students.

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Jean M. McLoughlin

Ms. McLoughlin, a partner in Davis Polk's Executive Compensation and Employee Benefits Group, headed this practice in Davis Polk's Menlo Park office from 2001 through 2005. She regularly advises corporate and financial clients on executive compensation and corporate governance matters, including in connection with issues involving TARP, mergers and acquisitions and capital markets transactions.

In addition, Ms. McLoughlin is experienced in the implementation of management equity programs, the negotiation of executive employment arrangements and the securities and tax implications of such arrangements.

Ms. McLoughlin graduated, *summa cum laude*, from Yale University in 1988 and in 1992 received her J.D., *cum laude*, from Harvard Law School, where she was on the Board of Student Advisors and recent developments editor of the *Harvard Civil Rights – Civil Liberties Law Review*. She clerked for the Honorable J. Spencer Letts, US District Court, Central District of California, from 1992 to 1993.

Annette L. Nazareth

Ms. Nazareth is a partner in Davis Polk's Financial Institutions Group, practicing in our Washington DC office. She advises clients across a broad range of complex regulatory matters and transactions. She also works closely with Davis Polk's SEC enforcement practice, counseling non-financial sector corporations that are subject to government regulatory and enforcement actions.

Ms. Nazareth was a key financial services policymaker for more than a decade. She joined the SEC Staff in 1998 as a Senior Counsel to Chairman Arthur Levitt and then served as Interim Director of the Division of Investment Management. She served as Director of the Division of Market Regulation (now the Division of Trading and Markets) from 1999 to 2005. As Director, she oversaw the regulation of broker-dealers, exchanges, clearing agencies, transfer agents and securities information processors. In 2005, she was appointed an SEC Commissioner by President Bush. Ms. Nazareth also served as the Commission's representative on the Financial Stability Forum from 1999 to 2008.

After leaving the SEC in January 2008, she served as Rapporteur for the Group of Thirty's report, The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace. Earlier in her career, she held a number of senior legal positions at several investment banks.

Ms. Nazareth graduated, *magna cum laude*, Phi Beta Kappa, from Brown University in 1978 and received her J.D. from Columbia Law School in 1981, where she was a Harlan Fiske Stone Scholar.

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Jennifer G. Newstead

Ms. Newstead is a partner in Davis Polk's Litigation Department. She represents clients in white collar criminal matters and securities enforcement actions, Board-level internal investigations, Congressional and administrative agency investigations, and complex commercial litigation. Her clients include leading corporations, banks, professional service firms and individuals. She frequently represents clients in cross-border, multi-jurisdictional investigations and litigation, and has experience with matters arising under the Foreign Corrupt Practices Act, OFAC and anti-money laundering rules. Both in private practice and in government, her experience has spanned a range of industry sectors, including financial services, health care, energy, defense systems and consumer products.

In 2001, Ms. Newstead left Davis Polk to serve as a Deputy Assistant Attorney General at the US Department of Justice. She later served an Associate White House Counsel. In 2003, she became General Counsel of the White House Office of Management and Budget. She rejoined the firm in 2005 and became a partner in 2006.

Ms. Newstead graduated, *magna cum laude*, from Harvard University in 1991 and in 1994 received her J.D. from Yale Law School, where she was managing editor of the *Yale Law Journal*. She clerked for the Honorable Stephen G. Breyer of the US Supreme Court from 1995 to 1996 and for the Honorable Laurence H. Silberman, US Court of Appeals, District of Columbia Circuit from 1994 to 1995.

Barbara Nims

Ms. Nims, a partner in Davis Polk's Executive Compensation and Employee Benefits Group, advises companies and boards on matters involving executive compensation and corporate governance. She is experienced in issues arising in the contexts of TARP participation, mergers, other acquisitions, corporate reorganizations and bankruptcy and workout transactions.

In addition, Ms. Nims advises clients on executive compensation, equity-based incentive, deferred compensation and pension plans and other employee benefit arrangements. She also advises on pension investment and fiduciary considerations, employment and consulting arrangements, the applicability of federal securities and tax laws to executives and employees, and on general employment-related matters.

She graduated, *magna cum laude*, from Duke University in 1971 and served in the U.S. Army Nurse Corps from 1971 to 1976. She received her J.D., Order of the Coif, in 1983 from the University of Virginia School of Law, where she was managing editor of the *Virginia Journal of International Law*.

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Reena Agrawal Sahni

Ms. Sahni is a counsel in Davis Polk's Financial Institutions Group. Her practice focuses on bank regulatory advice, and mergers and acquisitions and capital markets transactions for US and non-US banks, private equity firms and other financial institutions. She is also experienced in advising banks and other financial institutions on corporate governance, OFAC and anti-money laundering compliance matters, internal investigations and enforcement actions. Ms. Sahni has been actively involved in Davis Polk's regulatory reform memos, and advises SIFMA and other organizations on regulatory reform issues. Ms. Sahni was a senior attorney at the SEC, in the Division of Enforcement, from 2007 through 2009.

Ms. Sahni graduated, *magna cum laude*, from Harvard College in 1996 and in 2001 received her J.D. from Columbia Law School, where she was a James Kent Scholar and managing editor of the *Columbia Law Review*. She clerked for the Honorable Jon O. Newman, U.S. Court of Appeals, Second Circuit, from 2001 to 2002.

Margaret E. Tahyar

Margaret Tahyar is a partner in Davis Polk's Financial Institutions Group, recently relocated to New York from Paris. She has been actively involved in advising US and international clients on the US aspects of financial crisis laws and policies. She regularly advises major US and international banking organizations on complex cross-border transactions, including capital markets, private equity and mergers and acquisitions. Ms. Tahyar has been actively involved in the writing of Davis Polk's financial crisis and regulatory reform memos.

Ms. Tahyar received her A.B. from the University of Michigan in 1982 and her J.D. from Columbia Law School in 1987, where she was a James Kent Scholar and an articles editor of the *Columbia Law Review*. She clerked for the Honorable Thurgood Marshall, US Supreme Court, from 1988 to 1989 and for the Honorable Robert H. Bork, US Court of Appeals for the D.C. Circuit, in 1988.

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Linda Chatman Thomsen

Ms. Thomsen is a partner in Davis Polk's Litigation Department and practices in our Washington DC office. Her practice concentrates on matters related to the enforcement of the federal securities laws.

She returned to Davis Polk after serving for 14 years in various positions within the SEC. Ms. Thomsen joined the SEC staff in 1995 as Assistant Chief Litigation Counsel. In 1997, she was named Assistant Director of the Enforcement Division. She became an Associate Director in 2000, Deputy Director in 2002 and was named Director of the Enforcement Division by Chairman William H. Donaldson in 2005, a position she held until earlier this year. During her tenure as Enforcement Director, she led the Enron investigation, the auction rate securities settlements, the stock option back dating cases and the expansion of the enforcement of the Foreign Corrupt Practices Act. Before joining the SEC, Ms. Thomsen served as an Assistant US Attorney for the District of Maryland.

Ms. Thomsen graduated, with high honors, from Smith College in 1976 and in 1979 received her J.D. from Harvard Law School.

Danforth Townley

Mr. Townley is a partner in Davis Polk's Investment Management/Private Funds Group. He advises clients on investment funds and related corporate finance transactions, including the structuring and offering of hedge funds, private equity funds and other investment vehicles. In addition, Mr. Townley advises financial institutions, fund sponsors, corporations, employees' securities companies, and other entities regarding regulatory compliance with, and exemptions under, the Investment Company Act and Investment Advisers Act. His work often focuses on the utilization of derivative instruments or structured products in connection with private funds and investment companies. Mr. Townley also advises clients on the establishment and operation of hedge fund managers and private equity sponsors, including the structuring of carried interest plans and other profit sharing arrangements, as well as on mergers and acquisitions of fund managers.

Mr. Townley graduated from Yale College in 1979 and in 1985 received his J.D. from Yale Law School, where he was an editor of the *Yale Law Journal*. He clerked for the Honorable Robert W. Sweet, US District Court, Southern District of New York, from 1985 to 1986.

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Raul F. Yanes

Mr. Yanes is a partner in Davis Polk's Litigation Department and practices in our Washington DC office. He represents clients in white collar criminal defense matters, securities enforcement actions, Congressional investigations, internal investigations and complex civil litigation. His cases have included grand jury investigations of a US oil and gas company, of a US bank, of a Spanish bank, and of political contributions made by a broker-dealer, and a Congressional investigation of a US bank. Mr. Yanes also has represented clients in connection with issues arising under the Foreign Corrupt Practices Act, and has conducted reviews of compliance programs, including anti-money laundering programs.

In 2003, Mr. Yanes left Davis Polk to become Associate Counsel to the President. In 2005, he became Senior Counselor to the Attorney General at the US Department of Justice and later served as General Counsel of the Office of Management and Budget. From 2006 to 2009, he was Assistant to the President of the United States and Staff Secretary.

He is admitted only to the bar of New York and is practicing in Washington DC under the supervision of partners of the firm.

Mr. Yanes graduated, *summa cum laude*, from Dartmouth College in 1987 and in 1991 received his J.D., *cum laude*, from Harvard Law School. He clerked for the Honorable John L. Coffey, US Court of Appeals, Seventh Circuit, from 1991 to 1993.

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FOR ADDITIONAL COPIES OF THIS MANUAL, CONTACT:
Kevin A. Cavanaugh
Director of Business Development
212 450 6811 tel
212 607 7533 fax
kevin.cavanaugh@davispolk.com