Emergency Economic Stabilization Act of 2008

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Table of Contents

Executive Summary 1
The Troubled Asset Relief Program 3
- Who Can Participate? 3
- What Assets are Eligible? 8
- Pricing, Market Mechanisms and Reverse Auctions 10
- Management and Monetization 13
- Spending Limits and Funding 13

Optional Guarantee Program 14
Impact on Wall Street 15
- Taxpayer Upside/Warrants 15
- Limits on Executive Compensation 18
- Disclosure and Market Transparency 21
- Mark-to-Market Accounting 23
- Interest on Federal Reserve Balances 25
- Money Market Fund Guarantee 26
- Recoupment 26
- Criminal and Civil Investigations 27

Impact on Main Street 28
- Increase in Deposit Insurance 28
- Amendments to the HOPE Act 29
- Foreclosure Relief 30
- Aid for Community Banks 31
- Tax Relief 32

Challenges and Opportunities for Asset Managers 32
- Private Fund Participation 32
- Sales of Troubled Assets by Private Funds to Financial Institutions 32
- Opportunities for Private Fund Managers and Other Investment Advisers 33
- Possible Future Regulation of Private Funds 37

New Regulatory Edifice 38
- Treasury Regulations and Guidelines 38
- Political Oversight Mechanisms 39
- Litigation and Judicial Review 41

The Next Phase—Regulatory Restructuring 43

Executive Summary

As anyone who has been near a television screen, a newspaper or the Internet this past week knows, the Emergency Economic Stabilization Act of 2008 (the "**Act**") was enacted under enormous pressure as the entire world watched credit markets lock up and the global financial system come under great stress. The financial crisis caused a political drama in the United States which featured a revolt in the House of Representatives that led to the initial rejection of the Act on Monday and, shortly thereafter, the largest ever one-day point drop in the Dow Jones Industrial Average. While Americans watched their 401(k) balances drop precipitously and Europeans rescued and nationalized one bank after another in quick succession, the Senate took up and voted on the proposed legislation in modified form and, on Friday, the House reconsidered and ultimately passed the Act. President Bush signed the bill into law that same afternoon, October 3, 2008.

This memorandum is aimed at those who need a more in-depth and technical analysis of the legal framework created in that crucible. The unusual circumstances that form the backdrop to the passage of the Act impact its technical analysis. The Act is, in many places, little more than a framework of principles for Treasury to implement in its discretion. In addition, after the initial rush of implementation in the coming days and weeks, there will be both a new President and a new Congress, which means that not only will the Treasury Secretary likely change, but that most of his top advisors and staff may as well. As a result, a settled technical legal analysis of the Act is not possible in many areas.

In this memorandum, a Davis Polk & Wardwell team composed of experts in our financial institutions, corporate governance, real estate, capital markets, executive compensation, hedge fund, private equity, asset management, white collar defense and litigation departments discusses our collective view on the likely interpretation of the Act's most important provisions, the key ambiguities and questions that will have to be resolved by the Treasury Secretary, and the policy issues that will shape not only the implementation of the Act, but also the future of the US financial regulatory system.

We believe that the Act is only the first step in a process that will include the recapitalization of the US and European banking sectors and a major reworking of the archaic US financial regulatory system. The analysis below reflects our expectation that bank recapitalization, regulatory restructuring and a hunt to assign blame will inform the political and regulatory agenda in the months to come.

The Act creates a new market player, the Office of Financial Stability, which will administer the Troubled Asset Relief Program or TARP. Treasury, acting through TARP, will have the authority to buy, sell and manage a wide range of troubled assets; to influence which homeowners are subject to foreclosure and which are spared; and to grant private sector contracts to asset managers and financial advisors. The Act requires Treasury to take non-voting equity or senior debt stakes in financial institutions from which it purchases troubled assets, and it will, for the first time, give the US government a role in setting executive compensation in the financial sector. At its core, the Act represents a fundamental shift – if possibly only a temporary one – in the role of the state in the American economy and the world's financial markets. Unlike traditional state capitalism, as practiced in Europe and elsewhere, Treasury's equity stakes in financial institutions will not give it voting power, but we may assume that the government's influence will nonetheless be felt in corporate boardrooms on Wall Street and beyond.

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TARP may ultimately have access to up to $700 billion to purchase or guarantee troubled assets. The funds will be released in stages, with an initial $250 billion purchase limit, measured by purchase prices paid, and an additional $100 billion upon written notice from the President to Congress. The remaining $350 billion will be made available if, after delivery of a written report by the President detailing Treasury's plan with respect to the additional funds, Congress fails to disapprove the plan within 15 days. Since TARP will operate as a kind of giant revolving purchase facility, with assets that leave the pool making room for further purchases, the liquidity that it provides to markets may be greater than the $700 billion limit on outstanding purchases. While the Act is in effect, Treasury will likely be by far the largest participant in the market for troubled real estate loans and possibly other troubled asset classes as well.

The Act creates two purchase options: *an auction option*, which is intended to discover prices through market mechanisms, and a *direct purchase option* when market prices are not available. Preliminary indications from Treasury officials are that they intend to treat financial institutions quite differently depending upon which of the two purchase options is used. We understand that Treasury views the direct purchase option as a tool to be used primarily for financial institutions that have lost access to the credit markets. In those circumstances, Treasury's intent would be to take a meaningful equity stake for the US taxpayer, possibly replace management, and make extensive use of its powers with respect to executive compensation and corporate governance. By sharp contrast, Treasury officials have indicated that in the case of auction purchases, they want to encourage financial institutions to participate. They envision setting up the auction processes and taking the required equity upside in a manner that encourages broad participation, for the benefit of the entire financial system.

Preliminary indications from Treasury officials are that they intend to treat financial institutions quite differently depending upon whether such institutions participate in TARP via auction or direct purchase

The Act gives Treasury extraordinary new powers and wide discretion to establish the rules and design the procedures governing purchases of troubled assets. An unusual feature of the Act is that where Treasury is required to flesh out the broad principles of the Act, it has been given the authority to do so either by program guidelines or by regulation. Program guidelines are a little-known feature of the US regulatory state that permit an agency to act without the usual prior notice and opportunity for public comment. Thus, Treasury has not only been given the power to be a major player in the market but, to a large extent, the ability to write the rules of engagement.

The Troubled Asset Relief Program

Who Can Participate?

The lynchpin of the Act is Congress' decision about whom to include or exclude as possible participants in sales of troubled assets to the government, a determination which is crystallized in the definition of "financial institution." A financial institution is defined as "any institution, including but not limited" to an example list of financial institutions that are "established and regulated" under the laws of the United States and have "significant operations in the United States." Only financial institutions may participate in TARP. As with

Clearly 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
- Any bank holding company and some or all of its unregulated affiliates

most elements of the Act, Congress left Treasury discretion to further refine the scope of this new term of art, which cannot be understood by a common sense application of what has been, until now, mainly an ordinary business word. When applied to the many different types of actors in the financial system, this definition generates a number of uncertainties, some of which will very likely be resolved by the regulations or guidelines that Treasury will issue. For the moment, we believe that the categories of financial actors set forth in the sidebar will be considered "financial institutions" so long as they have significant operations in the US.

Clearly excluded are foreign central banks and any institution owned by a foreign government. A third category of financial actors, including private equity funds and hedge funds, falls within a gray area that will most likely be clarified by Treasury regulations or guidelines.

"Significant Operations"

Under the Act, a financial institution must have significant operations in the United States in order to be eligible to participate. Yet, in exercising its authority under the Act, Treasury also has to ensure that financial institutions are eligible to participate in the program without discrimination based on their size, geography or form of organization, or the amount or type of troubled assets they hold. The tension between the significance test and the requirement to allow big and small financial institutions to participate on equal terms may be resolved, we believe, by considering the significance test as aimed primarily at institutions whose significant operations are outside the US.

Even so, the question of how "significant" should be construed is not entirely apparent. Are a financial institution's operations in the United States significant if their disappearance would significantly affect the US labor market? Should domestic activities of a group be compared to the group's activities overseas to establish the relative significance of its US operations?

Holding Companies

All major US commercial banks and investment banks operate through a bank holding company structure, the most common being a Delaware holding company listed on a US exchange that is the sole owner of a series of subsidiaries housing its commercial deposit-taking bank, its broker-dealer operations, or other affiliates. We believe that this top level holding company is included in the definition of financial institution.[1]

[1] After the decisions last week of Morgan Stanley and Goldman Sachs to become bank holding companies, every major US investment bank is or is in the process of coming under a bank holding company structure.

In the US system, all bank holding companies are regulated on a consolidated and comprehensive basis by the Board of Governors of the Federal Reserve System (the "**Board**"). We believe that affiliates of any US bank holding company, even though not directly regulated, will be treated as "regulated" on the basis of the umbrella supervision of the Board. The treatment of foreign bank holding companies may vary depending on the extent of their operations in the US.

Hedge Funds, Private Equity Funds and Pooled Vehicles

We understand that at least some members of Congress meant to exclude hedge funds and private equity 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. Also, many hedge funds and at least some private equity funds are organized in jurisdictions outside of the United States. It is doubtful that Treasury, in the first instance, will welcome the participation of hedge funds and private equity funds, but whether their inclusion is possible under Treasury discretion or whether, at some point in the future, further regulation or industry restructuring will bring them into the definition is unknown at this time. It is also doubtful that Treasury will be willing to purchase interests in troubled hedge funds from investors in such funds, even if the managers of the funds were willing to allow investors to transfer their interests.

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TARP may also exclude other types of unregistered pooled vehicles, such as unregistered mortgage-backed and asset-backed vehicles, structured investment vehicles and other unregistered special purpose vehicles. While the primary purpose of the program is to allow eligible holders of the interests in certain of these vehicles to sell their interests, the vehicles themselves may not be eligible to sell troubled assets which they hold, but again, the scope of the program remains largely in the discretion of Treasury.

(continued)

Although some small community and regional banks operate with a "bank" as the top level company, most of them also have a top level holding company that is a Delaware "Inc." This is for historical reasons and because the US bank regulatory system privileges this type of structure.

Registered Investment Companies and Pension Plans

US mutual funds (registered investment companies), including money market funds, are clearly eligible to participate in the program, and it seems reasonably clear from the provisions of the Act that US tax-qualified employee retirement plans are eligible to participate in the program.[2] It remains to be seen whether Treasury will impose any special rules or limitations on participation by mutual funds or retirement plans, but the Act explicitly states that one of the considerations that Treasury is to take into account in exercising its authority under the Act is protecting the retirement security of Americans by purchasing troubled assets held by or on behalf of tax-qualified employee retirement plans. Treasury cannot take equity in a retirement plan and would face regulatory challenges in acquiring equity in a mutual fund in the manner contemplated in the Act, because generally a mutual fund cannot issue stock for less than its net asset value. Further, from a policy perspective, Treasury might be reluctant to take equity interests in mutual funds if this would dilute passive investors in the funds.

Foreign Banks

The treatment of foreign banks under the Act remains a bit of a puzzle in some respects, which we predict will be heavily influenced by developments in the political and diplomatic arena. The Act includes a provision designed to encourage foreign governments to implement similar programs.[3] Today, there may be less need to prod some foreign countries than when this provision was first introduced. In the interim, Europeans have learned that their own banking institutions are not, in fact, immune from the credit crisis, and major European governments were forced to act

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[2] These plans include tax-qualified pension plans and retirement plans, such as 401(k) and similar plans, sponsored by US private sector employers, US labor unions or US Federal, State and local government entities and municipalities. Individual retirement accounts (IRAs) and non-US pension plans are not eligible to participate. Banks and asset managers that hold troubled assets for their own account while managing similar assets for the account of a mutual fund or an eligible US retirement plan will need to consider whether their existing conflicts and compliance procedures are sufficient to address any potential conflicts that might arise in the context of the auction processes to be employed by Treasury. The Act requires Treasury to adopt guidelines to address conflicts of interest, but the types of conflicts that Treasury will address and the guidelines it will issue remain to be seen.

[3] Section 112 states: "The Secretary shall coordinate, as appropriate, with foreign financial authorities and central banks to work toward the establishment of similar programs by such authorities and central banks."

unilaterally and collectively to shore up their banking systems. We believe that international cooperation among central banks and bank regulators will inform whatever regulatory compromise is eventually worked out concerning the extent to which the US taxpayer will shoulder the risks of foreign financial institutions, along with the politically loaded question of whether the US government will take equity stakes in foreign financial institutions. Whether by design or not, we believe the Act as drafted gives the US government considerable negotiating leverage with respect to its foreign counterparts.

Foreign-Owned Regional Banks. Some elements of foreign participation are clear. We believe that US community and regional banks owned by private sector foreign banks are covered. These banks serve Main Street in communities across the nation, usually operate under local brand names, and are not perceived by their customers as foreign. They are also FDIC-insured and it will be better for the US taxpayer if they remain sound and do not drain FDIC resources. We expect that these institutions will be treated as pure US players.

Branches and Agencies. We also believe that it will be within Treasury's interpretive discretion to make assets at the US branches and agencies of foreign banks eligible for TARP. "Established" is a term of art in US bank regulation covering foreign branches and agencies, which are regulated under the laws of the United States.[4] The key discretionary element left to Treasury will be whether any particular foreign bank has "significant operations" in the United States. With respect to assets in the offshore units of a foreign bank, the position is more tenuous. There may be an argument that if such assets were originally booked in the US branch, they ought to be covered. It is uncertain whether assets transferred to the US branch would qualify for resale to TARP. Furthermore, incentives to do so will be blunted by the impact of the required equity upside provisions.

Foreign Central Banks. Clearly excluded from the definition of financial institution are central banks of foreign countries, with one exception. To the extent that foreign financial authorities or central banks hold troubled assets as a result of extending financing to otherwise eligible financial institutions that have failed or defaulted on such financing, such troubled assets qualify for purchase.[5] Whether this exception is intended to include financing extended to foreign banks for assets booked offshore is unclear and may be controversial.

[4] Some, if established before 1991, are also FDIC-insured. Many are not.

[5] The absence of a reference to guarantees is possibly unintentional.

Owned by a Foreign Government. The scope of the exclusion from TARP of foreign banks "owned" by a foreign government is unclear. We believe that this is intended to exclude banks that are wholly-owned or majority-owned, and likely meant to exclude foreign banks controlled by a foreign government. The Congressional intent here was not to have US taxpayers put their funds at risk for banks run by foreign governments where, presumably, the home-country taxpayers should be picking up the tab. That said, the difference between the US system of free market capitalism and the state-led capitalism in many other countries will lead to some difficult choices. Many foreign governments have equity stakes in foreign banks that are listed on stock exchanges, have a large public float, and otherwise operate in a shareholder value culture. This is a position similar to the one in which Treasury will soon find itself.[6] We believe that the precise definition of "owned" is within the discretion of Treasury. We also expect that Treasury's interpretation will be influenced by the international compromises made with foreign central banks and other financial regulatory authorities about who will take responsibility for which risks.

What Assets are Eligible?

Real Estate and Mortgage-Related Assets. The definition of "troubled assets" is broad and also leaves discretion to Treasury. 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", the date of the Bear Stearns bailout, "the purchase of which the Secretary determines promotes financial market stability." This category includes synthetic instruments written, directly or indirectly, on mortgages. Because the Act directs Treasury to consider the utility of purchasing "other real estate owned," the regulatory term for foreclosed properties, it is reasonable to anticipate that Treasury will issue regulations treating such property as eligible for purchase under TARP.

Troubled assets fall into two broad categories. The first category includes real estate and mortgage-related assets. The second category includes everything else.

[6] Except, of course, that Treasury's stakes will be non-voting, whereas most foreign governments retain voting power, often accompanied by board seats.

Everything Else. 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 addition of the word "necessary" may imply that a somewhat higher threshold was intended. 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 conceivably Treasury could give the notice concurrently with a purchase. Possible asset categories include student loans, auto loans, credit card receivables, credit default swaps, auction-rate securities or leveraged loans that were provided by banks to private equity portfolio companies on terms that are no longer marketable following the credit crunch and have not been syndicated.

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Unjust Enrichment. The Act requires Treasury to take such steps as may be necessary to prevent unjust enrichment of financial institutions participating in TARP, including by preventing the sale of a troubled asset to Treasury at a higher price than what the seller paid to purchase the asset. In light of this clear directive, coupled with the tone of legislative hearings, which were replete with hostility towards Wall Street, Treasury is likely to take a strict view of this general prohibition. The concept of "on-sales" for a fee has been discussed by some, but we believe that the regulatory environment, combined with the required equity upside, will discourage such on-sales.

An important exception to the general prohibition should encourage acquisitions of troubled institutions. The prohibition against unjust enrichment 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. Effectively, this exception should allow the acquirers in recent emergency takeovers, as well as the purchasers of assets in recent insolvency/receivership proceedings, to sell certain troubled assets acquired in the process at a gain. For future transactions, the legislative intent, presumably,

is that these exemptions create an opportunity for profit and thereby encourage the participation of multiple private sector participants in troubled situations.

Pricing, Market Mechanisms and Reverse Auctions

The hope is that the new large player in the market will create market volume, increase pricing efficiency and create pricing transparency in a way that will also have a positive impact in the credit markets. To that end, the Act 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. The Act 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."[7] Until Treasury makes its intentions public or engages in more detailed discussions with the private sector, however, the scope of the auction procedures and the market mechanisms is largely unknown. It is expected that Treasury will actively seek private sector input and will hire private sector advisors.

> Treasury will purchase assets at the "lowest price that the Secretary determines to be consistent with the purposes of the Act"

Reverse auctions provide an illustration of the challenges that Treasury faces in implementing the Act. Reverse auctions are used by a number of commercial companies to manage supply costs, among other things. A reverse auction is typically conducted via the Internet by a specialized auction agent working for the purchaser. The auction agent's responsibilities include selecting bidders (prospective suppliers), specifying the required characteristics of the items to be purchased, and publishing and enforcing auction rules. Typically, electronic bids, visible to all participants, are submitted and revised by a number of potential suppliers during a relatively short time period. The ultimate sale price is the lowest price at which a bid or combination of bids will provide the

> Reverse auctions provide an illustration of the challenges that Treasury faces in implementing the Act

7 The Act contemplates that there may be circumstances where "the use of a market mechanism is not feasible or appropriate, and the purposes of the Act are best met through direct purchases from an individual financial institution, [in which case] the Secretary shall pursue additional measures to ensure that prices paid for assets are reasonable and reflect the underlying value of the asset."

required quantity of the specified item. The reverse auction process has been praised by some for achieving substantial cost savings and criticized by others for undermining stable supplier-customer relationships and thereby delivering far less value than gross cost savings would indicate.

The task of designing market mechanisms such as reverse auctions for purchasing troubled assets will require a high degree of technical expertise. The Act identifies some of the issues to be addressed in its direction to Treasury to publish, two business days after the first asset purchase or, if earlier, no later than 45 days after passage of the Act, program guidelines including mechanisms for purchasing troubled assets, methods for pricing and valuing troubled assets, procedures for selecting asset managers, and criteria for identifying troubled assets for purchase.

To begin with, decisions must be made regarding where to begin the price discovery process. The most fundamental question relates to the value of residential real estate itself. Treasury may decide that its purchases of troubled assets should extend to acquisitions of residential real estate held by financial institutions as a result of mortgage foreclosures. In other cases, Treasury may decide to purchase whole mortgage pools. Frequently, however, whole mortgages are embedded in a dizzyingly complex financial superstructure. This superstructure includes:

The most fundamental question relates to the value of the real estate itself

- vehicles that own pools of whole mortgages and issue tranches of residential mortgage-backed securities ("**RMBS's**") with varying seniority levels and payment terms;
- vehicles that own tranches of RMBS's and in turn issue tranches of securities, referred to as collateralized debt obligations ("**CDO's**"), with varying seniority levels and payment terms;
- vehicles that own tranches of CDO securities and in turn issue tranches of securities, sometimes referred to as "CDO-squared" securities, with varying seniority levels and payment terms;
- related credit default swaps on any of the securities described above, in which a protection seller typically agrees to pay amounts equal to defined measures of economic loss on a specified tranche of such securities to a protection buyer, which may or may not own the tranche of securities in question, upon each occurrence of a defined credit event; and

- vehicles that issue tranches of securities designed to mimic the performance of CDO securities ("**synthetic CDO's**") by combining an investment in low risk non-mortgage assets with a protection seller position in a credit default swap on residential mortgage-backed securities.

While this description of instruments suggests the basic contours of the superstructure over residential mortgages, many variations on these instruments exist and, in some cases, these instruments are combined with other types of assets. For example, both RMBS's and securities backed by auto loans may underlie a single CDO vehicle.

A key issue to be addressed by the purchase program is establishing credible valuations for the underlying real estate itself through the use of market mechanisms. This suggests that targeted purchases of whole mortgage pools or securities that are relatively "close" to the real estate itself, such as RMBS's, may be most effective. Establishing more credible valuations at the lower levels may also shed light on the value of positions higher in the superstructure, such as tranches of CDO's, CDO-squared securities, credit default swaps and synthetic CDO's. It is less clear that establishing valuations higher in the superstructure will translate into reliable valuations of the underlying real estate itself.

Targeted purchases of whole mortgage pools or securities that are relatively "close" to the real estate itself, such as RMBS's, may be most effective

Decisions must also be made regarding the mix of asset classes to be targeted in line with the Act's policy goals. Examples of asset classes include Alt-A mortgages, which are considered riskier than prime mortgages but less risky than subprime mortgages; subprime mortgages; and second-lien mortgages.

This is by no means the end of the design process. In order to mitigate the risk that Treasury will purchase assets at inflated prices, it will be necessary to ensure that the assets to be purchased at a given price are substantially identical for pricing purposes. A knowledgeable purchasing agent might, for instance, use its proprietary data and valuation processes to identify by CUSIP number specific RMBS tranches that it believes satisfy this requirement. It will also be necessary to ensure that ownership of the assets to be purchased is sufficiently dispersed to support competitive bidding. Again, this will require depth of market knowledge.

Treasury might also rely on the purchasing agent for a particular reverse auction to provide estimated "fair values" for the securities in question. This data would not dictate the final price (otherwise there might be no competitive bidding) and indeed might serve to identify the maximum price the agent would be willing to pay, which might or might not be announced in advance to auction participants. The purchasing agent might also target the purchase of a "Goldilocks" percentage of the relevant securities offered by auction participants, so that the price paid would provide a reliable indication of how a liquid market would value the assets, not the price at which only the most desperate sellers would be willing to transact. Such a percentage might be expressed as a specific face value of securities, or possibly a range of face values, which might or might not be announced in advance to auction participants.

The complexity of the auction process will be increased if Treasury decides to allow private investors to participate as purchasers in an auction.

Management and Monetization

Treasury is given various options to manage and monetize the real estate and financial assets acquired under TARP, including sales, repo transactions and securities loans. In order to maximize value to taxpayers, Treasury may either hold assets to maturity or resell them when it determines that the market is optimal for a sale and that the assets can be sold at a price maximizing the federal government's return on investment. All revenues and sales proceeds, including from the sale, exercise or surrender of warrants or senior debt acquired in connection with the equity participation provisions, are to be paid into the general fund of Treasury for reduction of the general debt.

Spending Limits and Funding

The Act provides for limits on the amount of troubled assets Treasury has the power to purchase under TARP, taking into account guarantees extended for troubled assets under the Guarantee Program discussed below. The limits are measured by reference to the amount of troubled assets "outstanding at any one time," determined by aggregating the purchase prices of all troubled assets held at such time. TARP thus operates as a revolving purchase facility with assets that leave the pool making room for further purchases.

TARP thus operates as a revolving purchase facility, with assets that leave the pool making room for further purchases

Initially, upon enactment, Treasury's authority to purchase troubled assets is limited to $250 billion outstanding, which can be increased to $350 billion at any

time upon the President's certification to Congress that Treasury needs to exercise that further authority. Authorization of the remaining $350 billion requires a written report by the President to Congress detailing Treasury's plan for the additional funds. Release is then automatic unless Congress acts within 15 days to disapprove the plan, subject to a Presidential veto.

To fund TARP, Treasury is authorized to issue US Treasury bills and certain other US public debt instruments. By contrast, the Guarantee Program is to be funded by premiums charged for guarantees extended, which will be set to meet anticipated claims based on an actuarial analysis.

Treasury's authority to purchase or guarantee troubled assets will terminate on December 31, 2009, but may be extended by Treasury for one additional year upon submission of a certification to Congress explaining why the extension is necessary. Treasury's authority to hold and manage purchased assets is unaffected by the sunset provision. It is unclear whether the same holds true for the authority to continue guaranteeing assets, as the Act lacks a parallel provision under the Guarantee Program.

Optional Guarantee Program

At the request of House Republicans, an insurance or guarantee component was added to Treasury's toolkit, and Treasury officials have indicated that they view this as an exciting option that will be suitable for certain as-of-yet unspecified asset classes. The Act provides that Treasury "shall establish" a program to guarantee troubled assets originated or issued prior to March 14, 2008 (the "**Guarantee Program**"). Up to 100% of the principal and interest payments of a troubled asset may be guaranteed under the 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.

> Treasury officials have indicated that they view the Guarantee Program as an exciting option that will be suitable for certain as-of-yet unspecified asset classes

In addition to the challenge of properly pricing premiums, key challenges for design of the Guarantee Program include:

- complementing the asset purchase program and the related policy goal of establishing credible asset values through the use of market mechanisms;
- supporting homeowner relief initiatives; and
- avoiding unintended effects on the value of other financial positions that vary, directly or inversely, with the values of guaranteed troubled assets.

The Guarantee Program will likely require extensive development by experts in general market dynamics as well as in specific classes of troubled assets in order to ensure that it addresses these challenges.

Interestingly, a number of the more general provisions of the Act that apply to TARP do not, by their terms, seem to apply to the Guarantee Program. This may be a result of the hasty drafting of the Act.

Impact on Wall Street

Taxpayer Upside/Warrants

The possibility of an upside for the US taxpayer was an important element in the political compromise that led to the Act's passage, and TARP was sold to reluctant members of Congress on the basis that the US taxpayer might eventually recoup some of the cost of the program. While the main form of recoupment of capital and upside should be the eventual resale of troubled assets and their proceeds by Treasury at appreciated prices, the possibility of equity upside is also a feature of the Act. The Act provides that, subject to certain exceptions, each financial institution that sells assets to TARP must also grant Treasury equity warrants or, in the case of non-listed companies, equity or senior debt securities. The Act sets out general parameters for the terms of these securities, but provides discretion for Treasury to determine the amount and other economic terms. As noted above, preliminary indications are that Treasury will not insist upon punitive economic terms from institutions selling assets in auctions, although Treasury is likely to insist upon significant economics in direct purchases that are essentially bailouts, consistent with prior practice in situations like AIG, Freddie Mac and Fannie Mae.

The possibility of an upside for the US taxpayer was an important element in the political compromise that led to the Act's passage

The Act treats publicly-listed financial institutions and their non-public subsidiaries differently. In the case of a company listed on a US stock exchange, Treasury must receive a warrant with the right to purchase preferred stock, non-voting common stock or voting stock that Treasury agrees not to vote while it holds the position. If a company is not listed on a US stock exchange, Treasury has the additional option to take equity or senior debt.[8]

> The Act treats publicly-listed financial institutions and their non-public subsidiaries differently

There are two aspects of this provision that did not receive much attention as the bill made its way through Congress and which we expect Treasury will address in guidelines or regulations. First, as noted above, many of the financial institutions participating in the program will be subsidiaries of US-listed companies but not publicly-traded themselves. We expect that Treasury will adopt regulations permitting the receipt of warrants from the listed parent of such a financial institution when the subsidiary institution sells into TARP. Second, the application of the equity upside to bank subsidiaries or branches and agencies of foreign bank holding companies, only some of whom are listed in the United States, will need to be fleshed out in guidelines or regulations. As an international relations and diplomatic matter, will the US government want to avoid taking equity positions in foreign banks and limit itself to senior debt or preferred stock? The home country law of such foreign banks and bank holding companies will govern their ability to give warrants for common stock (many countries have pre-emptive rights) and preferred stock, a category that does not exist in many countries. Some foreign banks may therefore be discouraged by the equity upside provisions from participating. Depending upon their circumstances, others may have no choice. We expect that these issues will be worked out in international negotiations and we view the Act, whether accidentally or intentionally, as giving the US government negotiating leverage.

Any warrants are to be for non-voting stock or, if they are for voting stock, Treasury will agree not to vote the stock while held by it.[9] For financial institutions that do not have sufficient authorized capital to issue warrants,

[8] We believe that the lack of a limit on voting of common stock for private companies (*i.e.*, wholly-owned subsidiaries) was accidental.

[9] Traditionally, for control purposes, the Federal Reserve had treated such stock as voting for its control regulations. Presumably, a regulatory accommodation will be worked out here. The interaction of Treasury equity stakes and the Board's recent liberalization of its control regulations with the intent of encouraging private equity and sovereign wealth funds to participate in the recapitalization of the US banking sector will presumably be a topic for later regulatory elaboration.

Treasury may instead accept a senior note with terms that are sufficient to compensate Treasury in the event that shareholder approval is not obtained. This provision should give Treasury, if it so wishes, the authority to make an accommodation with a foreign financial institution that desires to participate but for which an equity stake by the US government is politically unacceptable, either here or in the home country, or not possible for technical reasons under the home country corporate law. This debt option may also work for mutual funds and pension plans.

The Act 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 and debt must provide a "reasonable interest rate premium";
- the securities must be designed to provide additional protection against losses by the taxpayers 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 will be set by Treasury, in the interest of taxpayers.

These requirements are drafted in an open-ended manner and, in general, describe terms that are fairly typical to any warrant or debt security. Earlier drafts of the legislation set tighter parameters and constrained Treasury's discretion in a way that led to concerns that the warrants would be punitive and a disincentive to participation in the program. In the final version of the legislation, because Treasury will determine the terms of the instruments, and given the open-ended requirements described above, Treasury will have broad latitude to impose requirements that are flexible and preserve the attractiveness of the program to financial institutions. There are likely to be a series of complex structuring, tax and accounting issues arising out of the warrant provisions which will have to be sorted out in the implementation.

Treasury will have broad latitude to impose requirements that are flexible and preserve the attractiveness of the program to financial institutions

There are two exceptions to the general requirements set out above. First, any institution that sells assets for less than $100 million, in the aggregate, is not required to grant warrants. Second, if a financial institution is legally prohibited from issuing securities and debt instruments, Treasury is permitted to establish an exception and alternate provisions to avoid circumvention of this section. This exception may also come in handy for foreign banks, mutual funds and pension plans.

Limits on Executive Compensation

The Act establishes two separate sets of executive compensation standards depending on how assets were acquired by Treasury.

In either case, these standards will apply to both public and privately-held financial institutions, including non-US companies. Although not explicit under the Act, Treasury officials have indicated that they view at least certain of the executive compensation standards of the Act as applying to financial institutions that seek a guarantee under the Act. For example, it is possible that Treasury might extend the prohibition described below against new golden parachute arrangements to financial institutions which take advantage of the Guarantee Program.

The Act establishes two sets of executive compensation standards depending on how assets were acquired by Treasury

Standards Applicable To Financial Institutions From Whom Troubled Assets In Excess of $300 Million Are Acquired In Auction Purchases or In a Combination of Auctions and Direct Purchases

With respect to any financial institution that sells an aggregate of more than $300 million of troubled assets in one or more auctions or in a combination of auctions and direct sales under the program:

» The financial institution is prohibited from entering into any ***new*** employment contract with a senior executive providing a golden parachute upon an involuntary termination of employment or upon the bankruptcy, insolvency or receivership of the financial institution.[10]

[10] Senior executives generally include the five most highly compensated executive officers of the financial institution, including the principal executive and financial officers, and in some cases former officers, determined based on the US Securities and Exchange Commission rules for the disclosure of executive compensation in annual proxy statements (the "**Proxy Rules**"). Although only certain US public companies are subject to the Proxy Rules, companies that are not otherwise subject to the Proxy Rules, including foreign banks, but who wish to take advantage of the auction program will have to apply the Proxy Rules for purposes of determining their senior executives if they sell assets in excess of $300 million under the program. The Proxy Rules are fairly complex, including their reliance in part on US accounting standards

The prohibition will start as of the date that the aggregate amount of troubled assets sold by the institution exceeds $300 million and will continue for the duration of the program, even if the financial institution curtails its participation.

» The federal tax code will be amended to limit to $500,000 the annual deduction that the institution may take with respect to compensation paid to certain executives.[11]

» The financial institution and certain of its senior executives will be subject to a new provision of the federal tax code which extends the rules currently applicable to change-in-control golden parachutes to severance benefits. Accordingly, certain severance benefits will be non-deductible by the financial institution and also subject to a 20% excise tax payable by the executive. These provisions will apply to the category of senior executives covered by the $500,000 compensation deduction limit described above and will include any severance benefits triggered by an involuntary termination of employment or bankruptcy, liquidation or receivership of the financial institution occurring during an Applicable Tax Year, even if the benefits are received by the executive at a later date. Financial institutions with existing arrangements providing excise tax gross-ups to executives under the existing golden parachute rules will need to review those arrangements to determine whether the gross-up will apply to excise taxes imposed under this new rule.

(continued)

for valuing equity compensation awards, and will present difficult challenges for financial institutions not currently subject to the Proxy Rules. Treasury is required to issue regulations within two months clarifying the application of this standard.

[11] This limitation will apply to any participating financial institution (1) starting with the first tax year during which the aggregate amount of troubled assets sold by the financial institution exceeds $300 million and (2) as to each future tax year in which the program remains in effect as of the beginning of the tax year (each, an "**Applicable Tax Year**"). The executives covered include any executive who served as CEO or CFO at any time during an Applicable Tax Year and the three most highly compensated executive officers as determined by the Proxy Rules (other than the CEO and CFO). While this officer group is likely to be the same for most financial institutions as the senior executives described in the preceding footnote, there are slight differences between the two definitions, again adding to the complexity. All compensation awarded or earned in an Applicable Tax Year is subject to this deduction limit, including equity compensation and performance-based awards, as well as amounts earned in the Applicable Tax Year, but paid in a future year. It remains to be seen what other elements of compensation institutions may be required to include in the calculation of compensation for the Applicable Tax Year.

Standards Applicable To Financial Institutions In Which Treasury Acquires a Meaningful Equity or Debt Position as a Result of Direct Purchases

With respect to financial institutions in which Treasury acquires a meaningful equity or debt position as a result of the direct purchase of assets from the financial institution without a bidding process or available market prices, the financial institution must meet standards for executive compensation and corporate governance to be established by Treasury. These standards will apply to a financial institution for the duration of the period that Treasury continues to hold any equity or debt position of any size in the financial institution. The Act does not indicate what might be deemed a meaningful equity or debt position for these purposes. If Treasury uses direct purchases as an intervention of last resort to rescue a failing financial institution, it would appear that whatever equity or debt stake stabilizes such a financial institution would also satisfy the meaningful requirement.

The Act is silent as to what corporate governance standards Treasury might apply

The Act is silent as to what corporate governance standards Treasury might apply, but given the preliminary indications from Treasury that it understands direct purchases to be a last resort for failing financial institutions, the corporate governance standards will be whatever Treasury decides they would be, presumably after it has completely changed existing management. With respect to the applicable executive compensation standards, the Act provides that these standards will require financial institutions to:

- eliminate incentives for senior executives to take unnecessary and excessive risks which threaten the value of the financial institution;
- provide for the clawback of bonus or incentive compensation paid to senior executives based on earnings, gains or other criteria later proven to be materially inaccurate; and
- prohibit payment of golden parachutes to senior executives.

These standards apply with respect to a financial institution's five most highly compensated executive officers, as determined under the Proxy Rules. Each of these standards is subject to

These standards apply to a financial institution's five most highly compensated officers

further clarification by Treasury, which could be in the form of general guidelines or case-by-case requirements. The Act does not explain what is meant by "unnecessary and excessive risk".

With respect to the clawback standard, existing provisions adopted under the Sarbanes-Oxley Act permit the SEC to take action to recoup payments made to a CEO or CFO in cases of misconduct resulting in the restatement of the financial statements of a publicly-held company. The new clawback standard may be broader in scope, or it might prove to be the same standard applied by the SEC, but also applied to companies not subject to SEC regulation.

Finally, the standard prohibiting the payment of golden parachutes to senior executives appears to preclude not only newly agreed severance benefits, but also severance benefits under existing agreements. In order for financial institutions with existing severance arrangements to participate in the direct sale aspect of the program, they may need to handle existing contractual obligations, perhaps by obtaining conditional waivers of severance benefits from their executives.

Disclosure and Market Transparency

TARP-Related Disclosure

The numerous oversight and reporting mechanisms in the Act will result in a large amount of new public disclosure regarding nearly every aspect of TARP, including detailed disclosures regarding purchases of troubled assets, participation by financial institutions in TARP, the identity and activities of asset managers engaged by TARP and the impact of the program on a systemic basis. The exact scope and nature of this disclosure remains to be seen, and will have to be worked out as the Act is implemented. The only safe starting assumption for participants in TARP – including both financial institutions that sell troubled assets and asset managers that administer the program – is that nearly every aspect of their participation in TARP will be a matter of public record sooner or later. The important question with respect to market impact is not whether, but when, these disclosures will be made.

> The only safe starting assumption for participants in TARP is that nearly every aspect of their participation in the program will become a matter of public record

The timing of disclosures may vary greatly depending on the source and nature of the information. The most accelerated disclosure requirements require Treasury to make publicly available, in electronic form, "a description, amounts,

and pricing" of troubled assets purchased under TARP within two business days of the date of purchase. By contrast, the detailed asset purchase reporting required under some of the Act's oversight mechanisms, such as the tranche reporting obligations, may not reach the market and the public for some time after the relevant reporting period.

In order to help make sense of the various disclosure obligations under the Act, we have prepared a chart summarizing the various reporting requirements and the timing of each mandated disclosure. The chart is only a rough summary because, like much else involving the Act, many of the market transparency obligations will depend heavily on the manner in which they are implemented by Treasury, as well as the various other entities that will play a role in disclosure and reporting (*e.g.*, the Financial Stability Oversight Board, the GAO, the Special Inspector General, etc.).

New Treasury Mandate Regarding Disclosure of Off-Balance Sheet and Other Exposures

The Act also contains an unusual disclosure-related provision that is not directly related to TARP itself. Treasury is required, for each type of financial institution that sells troubled assets under TARP, to determine whether the public disclosure required with respect to off-balance sheet transactions, derivative instruments, contingent liabilities, and similar sources of potential exposure is adequate to provide sufficient information as to the true financial position of such financial institutions. If Treasury determines that disclosure is inadequate, it must make recommendations to "the relevant regulators." We believe this includes foreign financial regulatory authorities as well as the relevant US regulators which would include the SEC, the OCC, the OTS, the FDIC and the Board, as well as various state banking regulators.

Treasury is required to assess the sufficiency of disclosure of off-balance sheet liabilities and other similar exposures

It is not clear whether this requirement applies to categories of financial institutions (*e.g.*, do commercial banks, insurance companies, and thrifts generally account for and disclose off-balance sheet exposure adequately in their investor reporting or in call reports to their regulator?) or to the quality of the disclosure of specific financial institutions (*e.g.*, is Bank X's disclosure adequate?). Put differently, it is not clear whether this provision is a subset of Treasury's broader mission under the Act to assess the current state of the financial regulatory system and recommend regulatory reforms, or whether it is a mandate for Treasury to step in as a new regulatory cop on the disclosure beat, involving itself in company-specific disclosure issues and further supplanting the

authority of the SEC. In either case, it presents novel questions regarding Treasury's role in the regulatory system and the future of the disclosure regime for financial institutions that will be worked out in the regulatory restructuring discussions to come.

Mark-to-market accounting became increasingly politically controversial during the discussions surrounding the Act

Mark-to-Market Accounting

Already controversial within the financial sector and certain academic circles, mark-to-market accounting also became increasingly controversial as a political matter during the discussions surrounding the Act. One of the great unknowns and concerns about the operation of TARP is the extent to which price discovery by means of auctions targeting currently illiquid or thinly traded assets will thereafter "set the mark" for the value of the same assets that remain on the books of other non-participating financial institutions. As a result, some worry that market pricing mechanisms will expose substantial weaknesses in the balance sheets of many financial institutions, whether or not they choose to participate in TARP, increasing rather than mitigating the risk that these institutions will fail – hence the pressure to suspend mark-to-market accounting. If Treasury limits the use of auctions to assets that are relatively liquid and widely held, which would be the natural focus of auctions, this concern may be alleviated.

The mark-to-market accounting standard, known as Statement of Financial Accounting Standards No. 157, Fair-Value Measurements ("**FAS 157**"), came into effect on November 15, 2007 for fiscal years beginning after that date, just in time for the credit crisis, although most of the large Wall Street financial institutions had adopted it early. While financial institutions were previously required to report the value of most assets at "fair value" FAS 157 imposed new requirements involving a host of methodological rules designed to prioritize market pricing information over other methods that seek to identify an asset's current fair value, including sophisticated modeling of valuation. Generally, market

The effect of FAS 157 has been to force balance sheet write-downs and, with respect to certain instruments, income statement losses based on market prices that may not reflect the actual long-term value of the instruments to their holders

pricing information is to be used for assets that have quoted market prices or are similar to assets that have quoted market prices, unless the market is not orderly, in which case other inputs can be used. The effect of FAS 157 has been to force balance sheet write-downs and, with respect to certain instruments, income statement losses based on market prices that may not reflect the actual long-term value of the instruments to their holders.

From even before the time that FAS 157 came into effect, some commentators had expressed concern that it could have a distorting effect on the financial statements of companies and exacerbate market trends. They argued that in a market decline, a financial institution's earnings would deteriorate rapidly as its operating results were affected by a weaker market and as the fair value of its assets had to be decreased. Supporters of FAS 157 have insisted that using fair value accounting provides a better snapshot of a company's worth, and that moving away from fair value accounting leads to opacity and hiding of problems. Of course this assumes that each company will use a similar fair value methodology. Some have noted that part of the problem in today's market is that different companies are using different marks for similar assets.

> Some have argued that fair value accounting has been a major contributor to the problems facing financial institutions and that it should be suspended

In particular, some have noted that the market for many exotic securities is effectively shut down, such that any sales are disorderly and not determinative, and that in fact the underlying assets are still solid. Despite this, companies and their auditors have generally used these sales as reference points, leading to a continued chain of asset write-downs with knock-on effects of ratings downgrades, concern about counterparty risk, increase in credit default swap spreads and decreasing share prices. In fact, some prominent voices, including most recently President Sarkozy of France, have argued that fair value accounting should be suspended and that it has been a major contributor to the problems facing financial institutions.

In reaction to these concerns, and as a strong political message, the Act reaffirms the SEC's pre-existing authority to suspend FAS 157 and orders the SEC to conduct a study of FAS 157, including its impact on the credit crisis and on the quality of financial statements, within 90 days of passage of the legislation. This reaffirmation is mostly symbolic and designed to put additional political pressure on the SEC, an agency that has come under increasing criticism for its regulation of investment banks.

The criticism of FAS 157, and the symbolism of the legislation, perhaps contributed to the SEC's decision earlier this week to issue interpretative guidance. The guidance reaffirms that mark-to-market accounting involves complex judgment, but notes that markets can be considered inactive or disorderly even if some price quotes do exist. In those circumstances companies and their auditors should use their own models to value assets. This guidance may lead more companies and their accountants to decide that they need not take into account the most recent market prices for thinly-traded assets and use their own models, under which the assets may be viewed as valuable, thus avoiding further write-downs. If auctions for troubled assets appear successful, it would seem difficult, absent a suspension of FAS 157 by the SEC, to ignore the auction price, not only for the specific class of securities auctioned, but also for other substantially identical securities. Indeed, if the auction process brings credible price discovery to a wide range of RMBS's, for instance, there may be pressure to adjust pricing models whose answers appear inconsistent with data available from the auction process.

Interest on Federal Reserve Balances

The Act gives the Board increased power over short-term interest rates by allowing it to pay interest on balances held at the Board on behalf of depository institutions. This change had previously been scheduled to take effect on October 1, 2011.

The Board currently influences short-term interest rates through purchases and sales of securities on the open market. Allowing the Board to pay interest on reserves would remove the disincentive for banks to deposit excess reserves (*i.e.*, beyond the minimum required reserves) with the Federal Reserve, and could potentially allow the Board to use open market operations to pursue other goals.

Over the past several months, the Board has used its emergency powers to extend credit to investment banks and, more recently, AIG

The Act also obligates the Board to disclose certain material information regarding certain extensions of credit. Over the past several months, the Board has used its emergency powers to extend credit to investment banks and, more recently, AIG. Under the Act, within seven days of providing such credit, the Board must report to Congress the justification for exercising the authority and the material terms of the loan including the size of the loan, its duration, the value of any collateral, the existence of any warrants, and the expected cost to taxpayers. In addition, the Board must provide periodic updates

at least once every 60 days describing the status of the loan, the value of the collateral, and the cost to taxpayers.

Money Market Fund Guarantee

On September 19, 2008, in order to stem the massive tide of withdrawals from money market funds in the wake of the Lehman bankruptcy and the AIG bailout, Treasury announced a temporary guarantee program for US money market funds. Under the program, Treasury committed to take up to $50 billion from the Exchange Stabilization Fund[12] to guarantee investments in money market funds that elect to participate in the program. The guarantee applies to amounts held in participating money market funds as of September 19, and will last for one year.

The Act prohibits Treasury from establishing any future guarantees for money market funds using funds from the Exchange Stabilization Fund, and requires Treasury to reimburse the Exchange Stabilization Fund for any funds used under the temporary guarantee program with funds appropriated under the Act. This means that losses in money market funds that are covered by the Treasury guarantee will effectively reduce the amount of funds available to TARP to purchase troubled assets. The Act does not specify exactly how this reimbursement mechanism would work if there were insufficient funds remaining under TARP. For example, would Treasury be required to sell troubled assets in order to raise cash to reimburse the Exchange Stabilization Fund?

Recoupment

The recoupment provisions make no distinction between those financial institutions who use TARP and those who do not

Five years after the date of enactment of the Act, the Director of the Office of Management and Budget is required to submit to Congress a report regarding the financial status of TARP. In the event of any shortfall, the President is required to submit a legislative proposal that recoups from the "financial industry" an amount equal to such shortfall, "in order to ensure that the Troubled Asset Relief Program does not add to the deficit or national debt." This provision only requires the President to submit a proposal to Congress. There is no requirement to undertake further acts if Congress fails to approve the proposal. As drafted, the recoupment provisions make no distinction between those

[12] The Exchange Stabilization Fund is an emergency reserve fund that was created by the Gold Reserve Act of 1934 in order to allow Treasury to purchase and sell foreign currencies and to provide financing to foreign governments. The Fund is typically used by Treasury to influence foreign currency exchange rates.

financial institutions who use TARP and those who do not, most likely because all financial institutions are expected to benefit if the program works as intended and also because of the practical difficulty of making such distinctions in a changing marketplace.

Criminal and Civil Investigations

We anticipate an increase in investigations, both civil and criminal, designed to find and punish those who are deemed to be responsible for the mess. This wave of investigations, just like the wave after the failure of Enron and WorldCom – while a subject of bemusement outside of the United States and of terror for those caught up by it – is a deeply embedded American response to crises of this nature. While Americans accept winners and losers in the economic game of life and tolerate income inequality, winners are expected to have played by the rules. Hence, the cultural impulse to find and punish bad actors. Unfortunately, in times such as these, the net can be cast widely, and many people and institutions may wind up being subject to investigation or indictment who ought not to be.

The wave of investigations is a deeply embedded American response to crises of this nature

The press has reported FBI probes into potential corporate fraud at a number of failed financial institutions. In addition, the FBI and various state and local law enforcement agencies have reportedly been investigating mortgage fraud by smaller companies and individuals on a broader scale. Both the SEC and various state government enforcement authorities have been pursuing publicized investigations into home mortgage lenders, such as Countrywide. Given the current political environment, we anticipate that the FBI, federal regulators and state authorities will come under increasing pressure from lawmakers to investigate fraud related to the subprime mortgage lending industry, and also to expand the scope of their inquiries to other areas of the financial markets affected by the expanding crisis. For entities unfortunate enough to be on the receiving end of such inquiries, it can be critical to take early and energetic action to limit possible negative outcomes. Additional probes should be expected as part of the fallout.

In keeping with the political desire for accountability, the Act requires all federal financial regulatory agencies to cooperate with the FBI and other law enforcement agencies investigating "fraud, misrepresentation, and malfeasance with respect to development, advertising, and sale of financial products."

Impact on Main Street

Many commentators have speculated that the Act would have been easier to sell to the public if it had been labeled as a rescue for homeowners rather than a bailout for Wall Street. As passed, the Act contains several provisions designed to mitigate the impact of homeowner foreclosures, and, depending on how the Act is implemented, it may provide real assistance to distressed borrowers. In addition to the foreclosure mitigation provisions, and the last-minute addition of a temporary increase in the FDIC's limits on deposit insurance, the Act contains a number of other provisions that will have a direct impact on Main Street.

Increase in Deposit Insurance

One of the political compromises that allowed the Act to move forward after its initial defeat in the House was the addition of a provision to increase the maximum federal deposit insurance amount from $100,000 to $250,000 until December 31, 2009. A number of commentators have noted that it will be difficult not to continue the higher limit after that date. The Act authorizes the FDIC to fund this increase in deposit insurance with unlimited borrowing from Treasury and also prohibits the FDIC from taking the increases in maximum deposit insurance into account when calculating participating banks' insurance fund assessments.

One of the political compromises that allowed the Act to move forward after its initial defeat in the House was the addition of a provision to temporarily increase the maximum federal deposit insurance amount from $100,000 to $250,000

Although the provision's stated purpose was to increase consumer and small business confidence in the face of recent bank failures, this change also addresses the concerns of a number of other constituencies. Main Street constituencies such as community banks lobbied for this amendment in order to stay competitive for deposits with money market mutual funds that are now also insured by the federal government, while Wall Street constituencies, such as the nation's largest bank holding companies, were concerned that one of their cheapest and most readily available forms of capital, consumer deposits, would flee the system without such a change. This change was also of key importance to the federal government because the FDIC's insurance fund has been operating at dangerously low levels as a result of several recent bank failures. It can be argued that increased borrowing authority for the FDIC was necessary in order to

ensure that the insurance fund could stay solvent and have the ability to cover the insured consumer deposits arising out of any other future bank failures.

Amendments to the HOPE Act

The HOPE for Homeowners Act was enacted on July 30, 2008 as part of Congress' initial response to the mortgage crisis. The HOPE Act created a temporary, voluntary program to help struggling borrowers refinance into more affordable, fixed-rate government-insured mortgages. The Congressional Budget Office estimates that the HOPE program will help as many as 400,000 borrowers avoid foreclosure and keep their homes. Critics have expressed skepticism, however, about the efficacy of the program, since lenders have little incentive to participate on a voluntary basis. Mortgage lenders may view it as an option of last resort, since the HOPE program requires them to write down the principal amount of the mortgage, which is often less economically advantageous than other loan work-out options, including lower interest rates. As the HOPE program was only launched on October 1, it is not yet clear whether the skeptics are right.

> The amendments attempt to address the fundamental criticism of the HOPE program — namely, that lenders seem to have little incentive to voluntarily modify loans

In order for a mortgage to be eligible to participate in the HOPE program, as originally enacted, among other things, the borrower must have a mortgage debt-to-income ratio greater than 31%, and the lender must be willing to write down the mortgage principal so that it does not exceed 90% of the current appraised value of the property. The Act amends these requirements to expand eligibility by also including homeowners who are "likely to have, due to the terms of the mortgage being reset," a mortgage debt-to-income ratio greater than 31%, and by giving the HOPE program the discretion to lower the required write-down of mortgage principal. In addition to these requirements, in connection with any refinancing under the HOPE program all subordinate lienholders (*e.g.*, holders of home equity loans or second mortgages) must agree to extinguish their liens. As originally enacted, the HOPE Act allowed the Federal Housing Administration to agree to share its interest in the future appreciation of the mortgaged property with the subordinate lienholders, in order to persuade them to agree to release their liens. The Act allows the Federal Housing Administration to make a payment to subordinate lienholders in lieu of a commitment to share future appreciation.

These amendments clearly expand the eligibility of borrowers to participate in the HOPE program, and they attempt to address the fundamental criticism of the program – namely, that lenders seem to have little incentive to voluntarily modify loans. It remains to be seen whether the inducements that the Act offers to mortgage holders will be sufficient to persuade them to participate, and this will likely depend in large part on how the HOPE program exercises its newly-granted discretion to reduce principal write-downs and to bargain with subordinate lienholders.

Foreclosure Relief

The Act directs Treasury to implement a plan with regard to mortgages, mortgage-backed securities and other assets backed by residential real estate acquired under TARP that will maximize assistance for homeowners and encourage mortgage servicers to participate in foreclosure mitigation programs such as the HOPE program. The Act similarly directs the Federal Housing Finance Agency, the FDIC and the Federal Reserve – which may hold mortgages and mortgage-based assets as a result of the takeover of financial institutions or, in the case of the Federal Reserve, open-market operations – to implement similar plans.

In contrast to the HOPE program, which is voluntary, the Act requires Treasury to consent to reasonable requests for loss mitigation measures for mortgages and mortgage-related structures under existing investment contracts, including term extensions, rate reductions, principal write-downs, increases in the proportion of loans within a trust or other structure, and removal of other limitations on modifications. The Act leaves to Treasury's discretion to determine which modifications are appropriate, also taking into consideration the impact on net present value to the taxpayer. The Federal Housing Finance Agency, the FDIC and the Fed may also enter into modifications for reductions in interest rates, reductions in loan principal and other similar modifications.

The extent to which Treasury and other agencies will be successful in modifying residential mortgages will depend, to a large degree, on the amount of control the agencies have over mortgage-related assets

The extent to which Treasury and the other agencies will be successful in modifying residential mortgages will depend, to a large degree, on the amount of control the agencies have over mortgage-related assets. Mortgages underlying mortgage-backed securities will be difficult to modify unless the agencies own

all of the tranches of an offering of mortgage-backed securities. The Act, perhaps with this point in mind, directs Treasury to coordinate with the other federal agencies and entities that hold troubled assets to "identify opportunities for the acquisition of classes of troubled assets that will improve the ability of [Treasury] to improve the loan modification and restructuring process."

The Act also authorizes Treasury to issue loan guarantees and credit enhancements to prevent avoidable foreclosures, thus granting Treasury powers similar to those held by the Federal Housing Administration under the HOPE Act. The Act does not place a dollar limit on the amount of any such guarantees or credit enhancements, and it is unclear whether they may be applied only to troubled assets. This provision, which was supported by the FDIC, could give Treasury leverage to negotiate with private sector lenders, servicers and holders of asset-backed securities. Loan guarantees and credit enhancements could be coupled with a requirement that loan modifications be agreed to first. FDIC chairwoman Sheila Bair has asserted that such an approach could help stabilize home prices at a much lower cost than buying loans outright.

In addition, the Act extends until January 1, 2013 existing tax relief to homeowners for certain cancellations of home mortgage indebtedness relating to declines in the home's value or to the homeowner's financial condition.

Aid for Community Banks

A number of community banks were major holders of Fannie Mae and Freddie Mac preferred stock, which has lost close to its entire value. In general, the sale of devalued securities held as an investment results in a capital loss, deductible only against capital gains. While the tax code excludes debt instruments sold by certain financial institutions from this general rule, that exclusion does not extend to preferred stock. As a consequence, absent the Act, community banks, which typically do not realize substantial capital gains, might have been unable to take tax deductions corresponding to their economic losses on Fannie Mae and Freddie Mac preferred stock. The Act provides relief by treating as ordinary the gain or loss on sale of this preferred stock by a financial institution, subject to certain limitations. This treatment allows such a company to obtain immediate tax liability reductions or refunds through the sale of this preferred stock so long as the company has ordinary income in the year of sale or the two preceding taxable years. Community banks lobbied hard for this tax relief, arguing that without it their ability to lend would be compromised and, in some cases, that they would become insolvent.

A number of community banks were major holders of Fannie Mae and Freddie Mac preferred stock

Tax Relief

The final version of the Act includes extensions of alternative minimum tax relief, deductions for state and local taxes, business tax credits for research and development, tax credits for renewable energy production and tax relief for victims of natural disasters. Most of these provisions were not controversial, having for the most part been previously passed by both the House and Senate. There was disagreement, however, about the amount of revenue raisers to include in order to offset these favorable provisions. After the Act was initially voted down in the House, a compromise was struck that reduced the amount of revenue raisers in the bill passed by the Senate. Among the revenue raisers that ultimately made their way into the Act is a provision that effectively eliminates the ability of hedge fund managers to defer taxes by deferring the receipt of compensation attributable to services rendered to tax-indifferent offshore hedge funds. The Act also imposes requirements for broker reporting of customers' basis in certain securities purchased after January 1, 2011.

Challenges and Opportunities for Asset Managers

Private Fund Participation

Ownership of troubled assets is not limited to banks and insurance companies. Many hedge funds and other private funds (including structured investment vehicles such as CDO vehicles) have large holdings of these assets as well. As explained above, our operative assumption is that Congress intended to exclude these types of private funds from the definition of "financial institutions" although we do not exclude the possibility of movement in this area.

Sales of Troubled Assets by Private Funds to Financial Institutions

If private funds are excluded from participating directly in TARP, two provisions of the Act described above seem to effectively foreclose the ability of private funds to sell troubled assets indirectly into TARP through a financial institution acting as an intermediary. First, a financial institution generally cannot sell an asset under TARP at a price higher than its purchase price, thus leaving no financial incentive for a financial institution to act as an intermediary. Efforts to circumvent this unjust enrichment provision would seem risky. In addition, acting as an intermediary and selling troubled assets acquired from a private fund would subject the intermediary, just as it would any seller of assets under the TARP, to the Act's executive compensation, corporate governance and taxpayer upside requirements, thus providing a strong disincentive to act as a TARP intermediary.

Opportunities for Private Fund Managers and Other Investment Advisers

Given the magnitude of the portfolio of troubled assets that Treasury will manage under TARP, it is clear that private sector assistance will be needed

Even if private funds are not permitted to sell assets into TARP or to participate in the Guarantee Program, TARP may offer business opportunities for their managers and other investment advisers. Given the magnitude of the portfolio of troubled assets that Treasury will manage under TARP, it is clear that private sector actors will be needed to help design auctions and to manage and sell assets. As a result, the Act specifically contemplates the use of third-party asset managers to manage the portfolio of troubled assets acquired by Treasury through TARP.

For example, under various provisions of the Act:

» Treasury may designate financial institutions as financial agents of the federal government;[13]

» Treasury may establish vehicles that are authorized, subject to Treasury supervision, to "purchase, hold and sell troubled assets and issue obligations"; and

» Within two business days after the first purchase of troubled assets pursuant to the Act (or, if earlier, within 45 days after enactment of the Act), Treasury must publish procedures for the selection of asset managers.

[13] The term "financial agent" is not defined in the Act. Section 201.1 of the Treasury's regulations governs the designation of financial agents of the federal government and their authorization to accept deposits of public money and to perform other services as may be required of them. Though the Act does explicitly provide that financial institutions may be appointed financial agents, we do not believe that the Act forecloses Treasury from retaining asset managers that do not qualify as "financial institutions." First, the reference in the Act to Treasury's authority to designate financial institutions as financial agents appears in an illustrative, but non-exclusive, list of examples of Treasury's authority "to take such actions as [it] deems necessary to carry out the authorities in th[e] Act." Second, other provisions of the Act make clear reference to the hiring of asset managers without regard to whether such managers are financial institutions or financial agents.

In addition, the Act may create investment opportunities. The Act requires Treasury to "encourage the private sector to participate in purchases of troubled assets, and to invest in financial institutions." Because the Act does not provide much in the way of further detail on the nature of such participation and investment (or the use of asset managers), a review of the methods of the Resolution Trust Corporation ("**RTC**") may provide insight into what is to come under TARP. The RTC made extensive use of public-private partnerships in liquidating assets inherited from failed thrifts, including both asset management contracts and equity partnerships with private sector investors.[14] While the RTC's experience may prove to be a useful historical precedent, due to the structural differences between the TARP and the RTC, it will not provide a perfect model.

Reviewing the methods of the RTC may provide insight into what is to come under TARP

Asset managers and investors should keep in mind that participation in TARP will likely involve a number of novel challenges and complications, bureaucratic and otherwise, some of which may be familiar to those who remember the days of the RTC. We have outlined below certain of the challenges that we anticipate relating to the government procurement process, including conflict-of-interest rules. Prospective participants in TARP should also be aware that they will likely be affected by the disclosure and reporting requirements and oversight mechanisms that will apply to TARP. As noted above, our recommendation is that, unless and until regulations or guidelines clearly make it otherwise apparent, any asset manager that contracts with Treasury should assume that all aspects of its participation in TARP, including its fees and contractual arrangements, will be public.

Contracting Provisions

Under normal circumstances, any purchase of services by Treasury or TARP under the Act would be subject to the Federal Acquisition Regulation ("**FAR**"), the extremely detailed and cumbersome government procurement rules that govern the process by which most federal agencies acquire supplies and services. Federal agency procurement contracts and requests for proposals typically

[14] RTC asset management contracts generally featured a "cost plus" compensation structure pursuant to which, in addition to reimbursing certain of the asset manager's expenses, the RTC paid a performance-based incentive fee. By contrast, under the equity partnership program, the RTC established joint ventures with third-party investors. The RTC, acting as a limited partner, contributed asset pools, while the private investor, acting as the general partner, invested equity capital and asset management services. Somewhat ironically, the RTC was driven to use the equity partnership model in part because it noticed that private sector purchasers of RTC asset portfolios were generating higher returns through the use of leverage, and did not want to be left out.

include a list of applicable FAR provisions, and bidders must either comply with the provisions, demonstrate that they will be able to comply at the time of award, or claim an exemption. The FAR also imposes certain diversity and socioeconomic requirements on federal contractors.

The Act permits Treasury to waive specific provisions of the FAR upon a determination that "urgent and compelling circumstances make compliance with such provisions contrary to the public interest."[15] To the extent that Treasury contracts for the services of private sector agents, such as asset managers, to administer TARP, compliance with the FAR could result in complications and delays as contractors acquaint themselves with FAR requirements. The prospect of complying with the FAR might also discourage some private sector participants from participating. Depending on how TARP's contracts with asset managers are structured and how aggressively Treasury interprets the FAR, they may qualify for a pre-existing streamlined contracting process under the FAR for "commercial items." Even this simplified process is likely to prove onerous for parties that are not already federal contractors, however. For this reason, we believe it is likely that Treasury will, at least initially, waive compliance with a number of the FAR requirements that would otherwise be applicable to TARP contracts, if only because of the difficulties that would be involved in implementing the FAR immediately while attempting, on an emergency basis, to stabilize the financial markets.[16]

The Act permits Treasury to waive specific provisions of the government procurement rules

Even if Treasury waives compliance with the FAR under the "urgent and compelling circumstances" exception, it will most likely develop a simplified contracting procedure that addresses, at a minimum, certain fundamental principles of government contracting (*e.g.*, preference for competitive bidding; protection of the public interest;

Treasury will most likely develop a streamlined procedure that addresses certain fundamental principles of government contracting

[15] In addition to the FAR, there are a number of federal statutes that may apply to contracts with TARP. The Act does not give Treasury the express authority to waive any of these additional statutory requirements.

[16] Due to the relatively short life-expectancy of TARP, it is doubtful whether it would make sense for Treasury to phase in full FAR compliance after an initial waiver period, since the program may well be winding down by the time that private sector participants are able to put in place the necessary internal systems.

transparency). The Act specifically provides that if Treasury waives any provision of the FAR pertaining to minority contracting, it must put in place standards "to ensure, to the maximum extent practicable, the inclusion and utilization" of minorities, women and businesses owned by each. The establishment of an alternative, streamlined process will likely result in some delays.

If TARP makes use of public-private investment vehicles similar to the equity partnership model pioneered by the RTC in the early 1990's, it is not clear that these arrangements would be subject to the FAR.[17] In contrast to an asset management contract, where the manager is paid a fee for the service of managing specified assets, these co-investment vehicles would presumably not involve the procurement of services using appropriated funds. Treasury could therefore take the position that the use of such vehicles is outside the scope of the procurement rules.

This position would be bolstered by the commitment of private sector funds to TARP investment vehicles – a possibility that Warren Buffett brought into sharp relief by suggesting, in the wake of his recent investment in GE, that he would be willing to take a 1% participation in TARP under certain admittedly unrealistic circumstances.

Conflicts of Interest

Treasury is required, as soon as practicable, to issue regulations or guidelines to address conflicts of interest that may arise in connection with the implementation of the Act, including:

- the selection or hiring of contractors or advisors, including asset managers;
- the purchase of troubled assets;
- the management of troubled assets;
- post-employment restrictions on employees; and
- any other potential conflict of interest, as Treasury deems necessary or appropriate in the public interest.

[17] Unfortunately, the equity partnership model does not appear to provide a useful precedent in this respect, since the RTC was not subject to the FAR.

Except for the categories of potential conflicts of interest listed above, the Act provides no guidance whatsoever with respect to the content of the required Treasury guidelines. The provision requiring the issuance of conflict-of-interest guidelines makes no reference to the FAR's extensive conflict-of-interest-related rules, which will presumably apply to TARP and its vehicles to the extent that the FAR itself does. Looking to history as our guide, we note that the RTC's conflict-of-interest rules were notoriously difficult to comply with, since they were drafted in a broad manner that required constant monitoring and reporting of "organizational" conflicts of interest. Many RTC contractors were tripped up by the scope of those rules, particularly in acquisition situations where the acquirer unknowingly inherited a conflict. Even if Treasury adopts less stringent guidelines than the RTC, we anticipate that asset managers participating in TARP will need to establish internal controls to ensure compliance with TARP's rules, whatever form they may take, and to otherwise minimize conflicts of interest – including, for example, creating internal walls around participating asset management teams.

> We anticipate that participating asset managers will need to establish internal controls to ensure compliance with TARP and to otherwise minimize conflicts of interest

For instance, banks and asset managers that hold troubled assets for their own account and also manage troubled assets for the account of a registered investment company or retirement plan will need to be sensitive to potential conflicts that might arise in participating in the program. In such a situation, conflicts would arise, among other ways, in entering sell bids in an auction for the sale of an asset type held by both a firm for its own account and an investment company or retirement plan account managed by the firm, particularly if the auction is one in which Treasury will buy only a limited quantity of the asset type from bidders willing to accept the lowest price. Firms will need to consider whether their existing information walls and other procedures are sufficient to address the particular auction processes to be employed by Treasury.

Possible Future Regulation of Private Funds

The Act contains several provisions that may foretell additional regulation for private funds and their managers. As noted below, the Act requires recommendations regarding "whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system."

New Regulatory Edifice

Treasury Regulations and Guidelines

The Act has created a new regulatory edifice in the crowded US financial regulatory scene. The Office of Financial Stability and other policymakers at Treasury are required, very quickly, to publish a host of program guidelines and regulations governing every aspect of TARP and its management. Some of these have been listed in the Act but we would not assume that such a list represents the complete universe of regulations to come. Typically, under the Administrative Procedure Act (the "**APA**"), which governs agency rulemaking, rules and regulations are required to be issued first in draft form for public notice and are then subject to a public comment period during which interested citizens can, and frequently do, comment.

> Despite its commitment to transparency, Treasury may be forced to rely on exceptions to the requirement for notice and comment

The US system typically demands transparency in the regulatory process, and regulates the extent to which regulators can deal on an *ad hoc* private basis with market participants. Unlike in many other countries, draft regulations are not shared with privileged members of the private sector (often known as "social partners" in Europe) for their review and comment prior to their broader publication. Instead, the APA requires that regulators give the public notice and an opportunity for comment and that, after draft regulations are placed in the public domain for comment, all contacts with the private sector are also placed in the public domain. Finally, in considering final rules, agencies are required to report why they did or did not accept the comments received. Typically the shortest comment period is 30 days.

The Secretary's first press release after the passage of the Act emphasized Treasury's commitment to transparency. Given the emergency nature of the Herculean task before Treasury and the need for speed, however, Treasury may be forced to rely on a number of exceptions to the requirement for notice and comment. Most agencies have the power to issue orders on an emergency basis without prior public notice or comment. The SEC, for example, recently used this authority to issue its emergency orders limiting short selling. Another exception to this requirement is the issuance of guidelines that are considered policy or interpretive statements and which also, in some instances, do not require prior public notice and comment.

One of the unusual features of the Act is that in most instances where Treasury is required to flesh out the overall framework, it has been given the power to do so by "program guidelines." In the ordinary course, Treasury would be required to publish any economically significant program guidelines and provide for a public comment period.[18] There are exceptions to this requirement and we expect that Treasury may pursue them in order to quickly issue program guidelines without prior public notice and comment. Even if Treasury does issue program guidelines without notice and comment it is still required to solicit and respond to public comments after the fact.

Political Oversight Mechanisms

The original Treasury draft provided for no oversight and a major element in the political compromise has been the addition of technical and political oversight mechanisms. The Act provides for five distinct oversight mechanisms for TARP.

Five distinct oversight mechanisms:

- Financial Stability Oversight Board
- Congressional Oversight Panel
- Special Inspector General
- Government Accountability Office
- Treasury reporting requirements

Financial Stability Oversight Board

The Financial Stability Oversight Board will be composed of five members, as set out in the sidebar.

Members of the Financial Stability Oversight Board:

- Chairman of the Fed
- Secretary of the Treasury
- Director of the Federal Housing Finance Agency
- Chairman of the SEC
- Secretary of Housing and Urban Development

The Financial Stability Oversight Board will be charged with reviewing Treasury's implementation of TARP, making recommendations to Treasury regarding the implementation of the Act, and reporting any suspected fraud, misrepresentation or malfeasance to the Special Inspector General for TARP. It may appoint a credit review committee to evaluate Treasury's use of its authority to purchase troubled assets under the Act. In addition to these responsibilities, the Financial Stability Oversight Board will have the power to ensure that the policies implemented by Treasury are in accordance with the Act and in the economic interests of the United States. The scope of the Financial Stability Oversight Board's authority under this provision is not clear; the word "ensure" in the final version of the Act replaced more specific and troublesome language in prior drafts giving an executive committee of the Financial Stability Oversight Board the power to "direct, limit or prohibit" Treasury's activities under the Act.

The Financial Stability Oversight Board will meet on a monthly basis and will report on a quarterly basis to certain committees of Congress and to the Oversight Panel, and will be dissolved upon termination of TARP.

[18] See Executive Order 13422 of January 18, 2007 and Office of Management and Budget Bulletin No. 07-02.

Members of the Oversight Panel:

- 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

Congressional Oversight Panel

The Oversight Panel will be composed of five members, as set out in the sidebar, and will be required to monitor and report on a monthly basis to Congress on Treasury's implementation of the Act, as well as the effectiveness of the Act vis-à-vis financial markets and financial institutions, market transparency, foreclosure mitigation, and taxpayers. It should be anticipated that these reports will be public events, that the data in them may become an important economic indicator for the US housing market and that, at least in the crucial phases of the program, the reports will be subject to attention by the media and the blogosphere. The Act does not appear to require that members of the Oversight Panel be members of Congress, and in fact the language of the Act implies that appointees may come from the private sector.

It should be anticipated that these reports will be public events

Special Inspector General for TARP

The Act establishes a new Office of the Inspector General for TARP, and provides for the appointment by the President with the advice and consent of the Senate of an independent Special Inspector General for TARP. The Special Inspector General, who will be chosen on the basis of "integrity and demonstrated ability in accounting, auditing, financial analysis, law, management analysis, public administration, or investigations," will be charged with auditing and investigating Treasury's purchase, management and sale of assets under TARP as well as Treasury's management of any insurance program established under the Act.

The Special Inspector General is required to collect specific information regarding the assets purchased under TARP, including current estimates of the total amount of troubled assets purchased under TARP, the amount of any troubled assets on the books of Treasury, the amount of troubled assets sold, and the profit and loss incurred on each such sale, and to maintain lists of each financial institution participating in TARP and each person or entity hired to manage troubled assets. The Special Inspector General is also required to submit quarterly reports to certain committees of Congress and to the Oversight Panel. The Act appropriates $50 million (out of the $700 billion total) to fund the Office of the Special Inspector General. It is to be expected that these reports will be public.

GAO Audits

The Government Accountability Office, which is the highly respected investigative arm of Congress charged with examining matters relating to the receipt and payment of public funds, is also required to conduct detailed, ongoing audits of almost every aspect of TARP, including the "programs, activities, receipts, expenditures and financial transactions of … any agents and representatives of TARP" to the extent related to such agent's or representative's activities on behalf of, or under the authority of, TARP.

Treasury Reporting Requirements

Treasury has a number of reporting obligations under the Act, including the obligation to disclose certain information regarding its purchases of troubled assets under the Act within two business days, and the obligation to submit both monthly and tranche reports to certain committees of Congress and to the Oversight Panel. These requirements are described in greater detail here. Some of these disclosures can be expected to inform pricing expectations.

Litigation and Judicial Review

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 every citizen expects to have his day in court and where the courts are seen as an important bulwark for individual rights. After the political compromise, Treasury is now subject to judicial review, but only in an extremely limited sense.

In its actions under TARP, Treasury will be buying assets from troubled financial institutions, collapsing where possible certain elements of the mortgage-securities superstructure, engaging in negotiations and actions with respect to borrowers and lenders in individual mortgages and generally subject to the risk that it is seen to be interfering in pre-existing contractual relationships. The incentives for unhappy parties to try to stop such actions are self-evident, as is the risk that an injunction, which generally can be issued by any federal judge across the country, might bring the entire program to a halt.

The initial Treasury proposal completely shielded the actions of Treasury from judicial review

As a result, the Act limits injunctive relief. Unless a constitutional issue is raised, the Act 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 customary for most administrative action, Treasury's actions under the Act 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.[19] Since Treasury will likely, in large part, be implementing TARP through regulation 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 the Act's provision that financial institutions that sell assets to Treasury may sue Treasury only in the case of a constitutional violation or as determined by contract between Treasury and the financial institution. This implies that financial institutions that sell into the auction program, which will likely be subject to standard contracts as of yet unwritten, may need to act as an industry through their trade associations or directly to be certain that such contracts do not waive any recourse they might otherwise expect to have.

[19] Under the APA, in relevant part, a reviewing court must set aside any agency action that is found to be: arbitrary, capricious, an abuse of discretion otherwise not in accordance with law; contrary to constitutional right, power, privilege, or immunity; in excess of statutory jurisdiction, authority, or limitations, or short of statutory right; or without observance of procedure required by law.

The Next Phase—Regulatory Restructuring

The Act is only the first step in the return to health for the US financial system. The idea of restructuring the archaic US financial regulatory system has been in the academic air for some time and was recently also taken up by Treasury in its Blueprint.[20] It should be clear to all by now that the fragmented nature of the current US regulatory system was a co-conspirator in the creation of the mess. None of this invalidates the critiques of those who have pointed out problems with the Sarbanes-Oxley Act and its impact on the competitiveness of the US capital markets. The problems are, in fact, larger than the false dichotomy between regulation and deregulation. They are worse than that. The problem is one of ineffective regulation leading to the wrong types of incentives within a fragmented regulatory structure that was unable to cope with new products and new circumstances in a changed world. What is needed is a complete re-ordering of the system, including both deregulation and re-regulation, depending upon which is more effective for the stability of the financial system, the competitiveness of the US capital markets and the economic health of the country. Naturally, there will be many interests to balance and the ability of our political leaders to make those changes cannot be assumed.

The Act is only the first step in the return to health for the US financial system

The problems are, in fact, larger than the false dichotomy between regulation and deregulation

Congress has historically reminded both itself and future Congresses that an issue has been placed on the agenda for reform by calling for studies and reports to be issued at a later date. Depending upon the content of the report and its timing, the public delivery of the report may become a media news hook and even a reason to hold Congressional hearings. It is in this light that the reports commissioned by the Act with respect to the causes of the crisis and the potential regulatory restructuring should be understood. Arguably the most influential of these reports will be Treasury's Regulatory Modernization Report, to be issued no later than April 2009. The Act requires the report to analyze the current state and effectiveness of the regulatory system and also signals Congress' general concern that additional regulatory oversight may be necessary for some market

[20] The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure issued on March 31, 2008.

participants, such as hedge funds and the credit default swap market. The SEC report regarding an analysis of mark-to-market accounting as applied to financial institutions, to be issued in January 2009, is also likely to be very influential in framing the debate regarding the desirability of mark-to-market accounting going forward. For more details regarding the developments in mark-to-market accounting, click here. For a more complete exposition of all reports required to be issued under the Act, click here. All of the these reports will be completed and received by a different President, a different Congress (although it is expected that the leadership of the relevant committees will remain the same), and presumably a different Treasury Secretary.

If you have any questions about the matters covered in this publication, the names and offices of our partners appear on our website: www.dpw.com

This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice.

Summary of Certain Reporting Requirements[1]

<table>
<tr><th>Reporting Entity</th><th>Timing of Report(s)</th><th>Subject of Report(s)</th><th>Investigatory / Audit Powers</th></tr>
<tr><td rowspan="2">Treasury</td><td>Electronic real-time disclosure
Within 2 business days of purchase, trade or other disposition of troubled assets</td><td>Description, amounts and pricing of assets</td><td rowspan="2">None specified in the Act</td></tr>
<tr><td>Monthly reports
Within 60 days of purchase, trade or other disposition of troubled assets</td><td>» Overview of actions taken by Treasury
» Detailed financial statement, including:
• all agreements made or renewed;
• all insurance contracts;
• all transactions occurring during the reporting period, including the types of parties involved;
• nature of assets purchased;
• all projected costs and liabilities;
• operating expenses, including compensation for financial agents;
• valuation or pricing method used for each transaction; and
• description of vehicles established by Treasury.</td></tr>
</table>

[1] Please note that this chart does *not* attempt to summarize all reporting requirements under the Act, only those that are likely to be of immediate interest for private sector participants in TARP.

Reporting Entity	Timing of Report(s)	Subject of Report(s)	Investigatory / Audit Powers
Treasury (continued)	Tranche reports *Within 7 days after aggregate commitments to purchase troubled assets exceed each successive $50 billion threshold*	» Description of all transactions during the reporting period » Description of the pricing mechanism for such transactions » Justification of the price paid for and other financial terms associated with such transactions » Description of impact on financial system, supported to the extent possible by specific data » Description of challenges that remain in the financial system, including benchmarks yet to be achieved	None specified in the Act
TARP	Annual audited financial statements; report on internal controls	Financial condition of TARP; effectiveness of TARP's internal controls	None specified in the Act; TARP's financial statements will be audited by the GAO
FSOB	Quarterly reports	» Exercise of Treasury's authority under the Act, including: • implementation of TARP and the Guarantee Program; and • effect of Treasury's implementation in preserving home ownership, stabilizing financial markets, and protecting taxpayers. » Recommendations to Treasury regarding the use of its authority under the Act » Reporting any suspected fraud, misrepresentation or malfeasance to the Special Inspector General	No expressly granted investigatory powers; however, FSOB may have implied investigatory power as a result of its authority to ensure proper implementation of the Act by Treasury

Reporting Entity	Timing of Report(s)	Subject of Report(s)	Investigatory / Audit Powers
GAO	At least once every 60 days	GAO findings resulting from its ongoing oversight of the activities and performance of TARP *and of any agents or representatives* of TARP (as related to their activities under TARP), *including vehicles established by Treasury under the Act*. Such oversight shall include: » Performance of TARP in meeting the purposes of the Act, including (i) foreclosure mitigation, (ii) cost reduction, (iii) stabilization of financial markets and banking system, and (iv) protection of taxpayers » TARP financial condition and internal controls » Characteristics of transactions and commitments entered into, including: • transaction type; • frequency; • size; • prices paid; • all other relevant terms and conditions; and • timing, duration and terms of any future commitment to purchase assets. » Characteristics and disposition of acquired assets, including: • type of asset; • acquisition price; • current market value; • sale prices and terms; and • use of proceeds from sales. » Efficiency of TARP's use of appropriated funds » Compliance with applicable law and regulation by TARP and its agents and representatives » TARP's efforts to mitigate conflicts of interest » Efficacy of TARP's contracting procedures, including with respect to inclusion of minorities and women	» Broad rights to access information regarding TARP, *including vehicles established by Treasury, agents and representatives of TARP or of any such vehicle* » Express right to audit the "programs, activities, receipts, expenditures, and financial transactions" of TARP *and any agents or representatives of TARP* (to the extent related to their activities under TARP)

Reporting Entity	Timing of Report(s)	Subject of Report(s)	Investigatory / Audit Powers
Congressional Oversight Panel	Monthly reports *Within 30 days after purchase, trade or other disposition of troubled assets*	» Use of Treasury's authority under the Act, including contracting authority and administration of the program » Impact of purchases of troubled assets on financial markets and financial institutions » Extent to which the information made available on transactions under the program has contributed to market transparency » Effectiveness of foreclosure mitigation efforts » Effectiveness of program in "minimizing long-term costs to the taxpayers and maximizing the benefits for taxpayers"	» May secure from any US department or agency any information necessary for it to fulfill it purpose » May hold hearings
Office of Management and Budget	Semiannually *Within 60 days of the first exercise of authority but in no case later than December 31, 2008*	» The estimate of the cost of the troubled assets and the guarantees of the troubled assets » The information used to derive the estimate, including assets purchased and guaranteed, prices paid, revenues received, the impact on the deficit and debt and a description of any outstanding commitments to purchase troubled assets » A detailed analysis of how the estimate has changed from the previous report	

Reporting Entity	Timing of Report(s)	Subject of Report(s)	Investigatory / Audit Powers
Special Inspector General	Quarterly reports *Beginning not later than 60 days after confirmation of the Special Inspector General and quarterly thereafter.*	Summary of the activities of the Special Inspector General over the 120-day period ending on the day of the report, including: » Description of the categories of troubled assets purchased or otherwise procured by Treasury » Listing of the troubled assets purchased in each such category » Explanation of reasons why Treasury deemed it necessary to purchase each such troubled asset » Listing of each financial institution from which troubled assets were purchased » Listing of and detailed biographical information on each person or entity hired to manage troubled assets » Listing of insurance contracts issued under the Guarantee Program » Current estimate of the total amount of troubled assets purchased under TARP, the amount of troubled assets on Treasury's books, the amount of troubled assets sold, and the profit or loss incurred on each sale or disposition of each such troubled asset » Detailed statement of all purchases, obligations, expenditures and revenues under TARP and the Guarantee Program	» The Special Inspector General may make arrangements for audits, studies, analyses and other services with public agencies and private persons » Upon request of the Special Inspector General, the head of any department, agency or head of the federal government shall furnish such information (insofar as is practicable and not in contravention of any existing law) » Whenever information or assistance requested by the Special Inspector General is unreasonably refused or not provided, the Special Inspector General shall report the circumstances to the appropriate committees of Congress

<table>
<tr><th>Reporting Entity</th><th>Timing of Report(s)</th><th>Subject of Report(s)</th><th>Investigatory / Audit Powers</th></tr>
<tr><td rowspan="2">Fed</td><td>Reporting of any Fed loan to a non-depository institution under Section 13 of the Federal Reserve Act[2]
Within 7 days after any extension of credit by the Fed to a non-depository institution</td><td>» Justification for exercising such authority
» Specific terms and actions of the Fed, including:
• size and duration of the loan;
• available information concerning the value of any collateral held with respect to such loan;
• the recipient of warrants or any other potential equity in exchange for the loan; and
• any expected cost to taxpayers for such exercise.</td><td rowspan="2">None specified in the Act</td></tr>
<tr><td>Periodic updates
Not less frequently than once every 60 days while the loan is outstanding</td><td>» Status of the loan
» Value of the collateral
» Projected cost to taxpayers</td></tr>
</table>

[2] Confidentiality exception: Upon written request of the Chairman of the Fed, this information may be kept confidential, in which case it will be made available only to the chairpersons and ranking members of the appropriate committees of Congress.

Summary of Certain Reports and Studies Regarding the Financial Regulatory System

Reporting Entity	Timing of Report(s)	Subject of Report(s)
Secretary of the Treasury	Not later than April 30, 2009	***Regulatory Modernization Report.*** Treasury is required to review the current state of the financial markets and the regulatory system and issue a report analyzing the current state of the regulatory system and its effectiveness at overseeing the participants in the financial markets, including the over-the-counter swaps markets and government-sponsored enterprises. The report will: » provide recommendations for improvement, including: • recommendations regarding whether any participants in the financial markets that are currently outside the regulatory system and should become subject to the regulatory system; and • recommendations for the enhancement of the clearing and settlement of over-the-counter swaps; and » provide the rationale underlying such recommendations.
Comptroller General	Not later than June 1, 2009	***Study and Report on Margin Authority.*** The Comptroller General will undertake a study to determine the extent to which leverage and sudden deleveraging of financial institutions was a factor behind the current financial crisis, including: » an analysis of the roles and responsibilities of the Board, the SEC, Treasury and other federal banking agencies with respect to monitoring leverage and acting to curtail excessive leveraging; » an analysis of the authority of the Board to regulate leverage, including by setting margin requirements, and what process the Board used to determine whether or not to exercise its authority; » an analysis of any usage of the margin authority by the Board; and » recommendations for the Board and appropriate committees of Congress with respect to the existing authority of the Board.

Reporting Entity	Timing of Report(s)	Subject of Report(s)
Congressional Oversight Panel	Not later than January 20, 2009	***Special Report on Regulatory Reform.*** The Congressional Oversight Panel will submit a report that: » analyzes the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers; » provides recommendations for improvement, including whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system, and the rationale underlying such recommendations; and » addresses whether or not there are any gaps in existing consumer protections.
Securities and Exchange Commission	Before the end of the 90-day period beginning on the date of the enactment of the Act.	***Study on Mark-to-Market Accounting.*** The SEC, in consultation with the Board and Treasury, shall conduct a study on mark-to-market accounting standards, as such standards are applicable to financial institutions, including depository institutions. The study shall consider: » the effects of such accounting standards on a financial institution's balance sheet; » the impacts of such accounting on bank failures in 2008; » the impact of such standards on the quality of financial information available to investors; » the process used by the Financial Accounting Standards Board in developing accounting standards; » the advisability and feasibility of modifications to such standards; and » alternative accounting standards.