The long awaited public-private investment program announced by Secretary Geithner on March 23, 2009 contains two key components: a securities purchase program, designed to remedy the illiquidity in the secondary markets for certain mortgage-backed securities, and a loan purchase program, designed to create a market for troubled loans on the balance sheets of US banks and thrifts. The assets will be purchased by funds capitalized by equity contributed by Treasury and private investors and leveraged by potentially attractive direct government or FDIC-guaranteed debt financing.

The program revolves around three principles:

» maximizing the impact of each taxpayer dollar by leveraging $75 to $100 billion of TARP funds to generate between $375 and $500 billion in purchasing power, with the potential to expand to $1 trillion over time

» sharing risks and rewards between the taxpayer and the private sector

» using private sector price discovery to protect the public from paying too much for the troubled assets

The initial stock market reaction was favorable, and a number of major asset managers have expressed an intention to participate in the programs despite the pessimism of some commentators in the financial press and elsewhere. A key business uncertainty concerns the intersection of pricing, valuation and the mark-to-market impact on sellers. It remains to be seen whether buyers and sellers will, in fact, find a clearing price for these troubled assets. Another key business uncertainty is whether a significant number of private investors will stay away because of a fear that the government might retroactively change the terms of the public-private partnership, impose conditions on unrelated activities, stigmatize them for as yet unidentified issues because of their participation or impose “windfall profits” taxes on them if their investments are “too successful”. There is further uncertainty about whether it is realistic to think that Treasury will, in fact, provide significant debt financing in the securities purchase program since both debt and equity will count toward the rapidly dwindling TARP funding cap. This suggests that, as a practical matter, debt financing provided to the securities purchase program is likely to come from the Federal Reserve Bank of New York under TALF or from private creditors.

It is also clear that many of the programs’ key elements remain unresolved, and that the announcement remains only a framework for further regulatory
Elaboration. The first two sections of this memorandum describe the basics of the two programs, including visual depictions. The third section sets forth our analysis of key concerns and unresolved questions in the announced framework from the perspective of the sellers into the programs, fund and asset managers and private investors.

Legacy Securities Program

Under the Legacy Securities Program, Treasury will select approximately five private sector fund managers to establish public-private investment funds (each, a “Legacy Securities Fund”) that will be capitalized with equity contributions from private investors and Treasury and with direct lending from Treasury and/or possibly TALF1 and other private sources. The diagram below sets forth the basics of the Legacy Securities Program.

Eligible Assets

- Commercial or residential mortgage-backed securities, although Treasury may later designate other eligible securities
- Issued before 2009
- Originally rated AAA or the equivalent
- Secured directly by mortgage loans, leases or other assets and not by other securities (other than certain swap positions - to be determined by Treasury)
- Purchased solely from “financial institutions” as defined under EESA
- The underlying assets must be situated predominantly in the United States (this criterion subject to further clarification by Treasury)

Initially Ineligible Assets

The terms suggest that the following will initially be excluded:

- Collateralized debt obligations
- Synthetic mortgage-backed securities

Eligible Assets

Treasury has announced that securities eligible for purchase by the Legacy Securities Funds will initially include only certain residential mortgage-backed

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The Public-Private Investment Program

**Pre-Qualification Criteria for Fund Managers**

- Demonstrated capacity to raise at least $500 million of private capital
- Demonstrated experience investing in eligible assets
- A minimum of $10 billion in market value of eligible assets under management
- Demonstrated operational capacity to manage funds so as to achieve attractive returns through a long-term buy-and-hold strategy
- Headquartered in the US (this criterion is not defined, but may resemble the eligible borrower criterion under TALF that investment funds be managed by fund managers with principal places of business in the US)

**Application Details**

- Applicants will be asked to describe the amount of time they anticipate needing to raise private capital
- Applications must be submitted to Treasury by April 10, 2009
- Treasury expects to inform applicants of preliminary approval on or before May 1, 2009
- After preliminary approval, applicants will have a limited period of time to raise at least $500 million in private capital
- Application form available at [www.financialstability.gov](http://www.financialstability.gov)

Securities and commercial mortgage-backed securities that are purchased from “financial institutions” as defined in the Economic Stabilization Act of 2008 (“EESA”). As a result of the broad definition of “financial institutions” in EESA, the range of possible sellers in the Legacy Securities Program will also be broad. Additional asset classes may be added later.

**Pre-Qualification of Fund Managers**

The five Treasury-selected fund managers will both raise private capital to invest in Legacy Securities Funds alongside Treasury and manage the funds. The criteria for fund managers for the Legacy Securities Program are quite stringent and may significantly narrow the pool of potential managers. For example, applicants must have $10 billion of eligible assets under management, and there is a limited universe of such managers. The requirement that fund managers provide performance track records could also limit eligible managers to those who specialize in investing in eligible assets.

Private asset managers must submit applications by April 10th, 2009 in order to be pre-qualified as fund managers. Treasury anticipates responding by May 1st, 2009. Treasury may select additional fund managers depending on its evaluation of the applications received and its determination of what is in the best interests of the taxpayer. Small asset managers that are veteran-, minority- and women-owned are encouraged to partner with larger fund managers, if necessary, in order to meet certain criteria.

**Eligible Investors**

Private investors will invest in each Legacy Securities Fund through a “private vehicle”, which will likely be a fund and which will be “controlled” by a fund manager. The private vehicle and Treasury will be the sole equity investors in the Legacy Securities Fund. The governance structure at the Legacy Securities Fund level remains an open question due to lack of detail in the term sheets.

**Generally.** Fund managers will raise capital from private investors to be invested side-by-side with capital contributed by Treasury. In the Legacy Securities Program, there appears to be no limit imposed by Treasury or the FDIC on the scope of eligible private investors.

**ERISA Investors.** Treasury expects that fund managers will structure private vehicles to accommodate ERISA investors, which likely means that ERISA investors can invest in up to 25% of a private vehicle or a higher amount if the fund manager is willing to comply with potentially onerous restrictions under ERISA.
Retail Investors. The term sheet indicates that Treasury “will consider suggestions from fund managers to raise equity capital from retail investors.” See further discussion in the Key Concerns and Unresolved Questions section below.

Other. Each fund manager must include in its application a statement of expectations as to the composition of its expected private investor base, such as financial institutions, foundations, public pension plans, university and other endowments, high net worth individuals and/or retail investors.

Financing

Equity. Treasury will match private investors’ equity investment in each Legacy Securities Fund. Treasury and the applicable private vehicle will invest in and divest the eligible assets proportionately, at the same time and on the same terms and conditions. Gains and losses on equity capital will be shared equally between Treasury and private investors, subject to Treasury’s right to receive warrants.

Treasury Warrants. Treasury will be issued warrants in the Legacy Securities Fund as required by EESA. The term sheet offers little detail about the terms of the warrants. See further discussion in the Key Concerns and Unresolved Questions section below.

Standard Treasury Debt Financing. Each fund manager has the option to subscribe for Treasury non-recourse loans secured by the Legacy Securities Fund’s eligible assets up to an aggregate amount of 50% of the fund’s total equity capital, so long as the private investors have no withdrawal rights. Any fund manager may request more Treasury debt financing, up to 100% of total equity capital, subject to restrictions on asset level leverage, withdrawal rights, disposition priorities and other factors Treasury deems relevant but has not yet described. The maximum leverage ratio for Treasury funding is 1 to 1. Fund managers may seek additional private funding that increases the fund’s leverage/purchasing power.

The maximum leverage ratio for Treasury funding is 1 to 1

Treasury’s non-recourse loans will have the same term as the underlying Legacy Securities Fund and will be repaid on a pro rata basis as principal repayments or disposition proceeds are realized by the underlying fund.
Interest on Treasury loans will accrue at an annual rate yet to be determined and will be payable in full upon termination of the fund. It is expected that the interest rates will be attractive.

**TALF, Other Treasury or Private Debt.** In addition to the Treasury debt financing described here, a fund manager may also choose to finance the purchase of eligible assets through TALF, any other Treasury facility or debt financing raised from private sources, provided that total equity capital is leveraged proportionally from such private debt financing sources.

**Other Terms**

**Drawdown.** Fund managers must draw down committed private and Treasury equity capital into the Legacy Securities Fund at the same time and in the same proportion, and do so in tranches matching anticipated investments. Fund managers must also draw down debt financing concurrently with drawdowns of equity capital.

These drawdown provisions may be limited or altered by agreement with Treasury.

**Treasury Right to Refuse a Drawdown.** Treasury will have the right in its sole discretion to refuse to fund committed but undrawn Treasury equity capital and debt financing. See further discussion in the Key Concerns and Unresolved Questions section below.

**Fees.** Fund managers will charge private investors fees. Treasury will consider such fees when evaluating applications by private asset managers to become fund managers.

Fund managers may also propose to charge Treasury management fees. Such fees must be calculated as a percentage of Treasury’s equity capital contributions and, along with Treasury’s share of the Legacy Securities Fund’s expenses, will be payable solely out of distributions on Treasury’s equity capital.

Any other fees paid to a fund manager or its affiliates in connection with a Legacy Securities Fund will accrue to the benefit of Treasury and private investors on a pari passu basis in proportion to their equity capital commitments.
**Affiliate Restrictions.** No Legacy Securities Fund may purchase assets from affiliates of its manager or from 10%-or-larger private investors in that Legacy Securities Fund, nor may a Legacy Securities Fund purchase assets from any other fund managers in the Legacy Securities Program or from any of those fund managers’ affiliates.

**Withdrawal Rights.** Private investors may not voluntarily withdraw from a private vehicle for three years, beginning on the date of the private vehicle’s first investment in a Legacy Securities Fund. Availability of Treasury debt funding is in part contingent on a prohibition on voluntary withdrawal rights.

**Management and Governance**
Treasury will select only fund managers that pursue a long-term buy-and-hold strategy or a strategy involving limited trading.

Program materials indicate that Treasury will not have “control rights” over the Legacy Securities Funds. The fund manager will have full control over asset selection, pricing, asset liquidation, trading and disposition.

Fund managers must agree to waste, fraud and abuse provisions, to be defined by Treasury. The scope of intended Treasury oversight and governance is not clear. See further discussion in the Key Concerns and Unresolved Questions section below.

Private investors may not be informed of potential acquisitions of specific eligible assets prior to acquisition.

**Expansion of the Term Asset-Backed Securities Loan Facility (TALF)**

Under TALF, which began operations on March 17, 2009, the New York Fed provides non-recourse loans to investors in certain types of asset-backed securities so long as the investors qualify as “eligible borrowers”. In its current form, TALF is designed to make loans with a term of three years, secured by certain highly-rated US dollar-denominated asset-backed securities backed by new or recently-originated consumer and small business loans. Borrowers are only permitted to borrow an amount equal to the value of their pledged collateral minus a haircut.²

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² See the DPW memorandum, *The Financial Stability Plan and Its Impact on Financial Institutions and Private Capital*, dated February 17, 2009 for further information on the basic structure of TALF.
As part of the program, and specifically to address “the broken markets for securities tied to residential, commercial real estate, and consumer credit”, TALF is expanding to allow the use of certain so-called “legacy” assets as collateral. Although the definition of “legacy” asset is currently unclear, what is known is that newly eligible assets are expected to include certain non-agency residential mortgage-backed securities that were originally rated AAA, and outstanding and commercial mortgage-back securities and ABS that are rated AAA. Unless TALF is modified by the New York Fed, assets qualifying under the Legacy Securities Program will not necessarily qualify as collateral under TALF. Several key aspects of the expansion remain vague, including the term of the loans, which will presumably exceed the current three years and be more in line with the expected maturities of newly included asset classes. Also unknown are the proposed lending rates, minimum loan sizes and, perhaps most importantly, haircuts.

To the extent funding from both the New York Fed under TALF and from Treasury under the Legacy Securities Program is available, such as in the case of residential mortgage-backed securities that were originally rated AAA, combining both will be an efficient way for investors to increase non-recourse leverage. The Treasury loans will be structurally subordinated to TALF loans, perhaps reflecting the greater risk aversion of the New York Fed, which must lend on a fully secured basis and avoid taking credit risk.
Legacy Loans Program

Under the Legacy Loans Program, the FDIC will establish public-private investment funds (each, a “Legacy Loans Fund”) that will be capitalized with equity contributions from private investors and Treasury and with FDIC-guaranteed debt to be issued by the Legacy Loans Fund. The diagram below sets forth the basics of the Legacy Loans Program.

The scope of eligible private investors under the Legacy Loans Program is unclear. The definition of “private investor” differs slightly across program materials. The Legacy Loans Program FAQ define private investors to include, among others, “foreign investors with a headquarters in the United States.” None of the other materials suggests a US headquartering limitation, but as discussed below tax concerns may limit participation by foreign investors in the Legacy Loans Program. In addition, certain of the materials place a greater emphasis on individual and retail investors.

Identifying Eligible Assets

Troubled assets held by US banks and thrifts, including but not limited to whole loans and pools of loans in the residential and commercial mortgage...
sectors, are eligible for the Legacy Loans Program. To be eligible, assets and any collateral supporting them must be located predominantly in the US.

A selling bank is expected to work with its primary banking regulator, the FDIC and Treasury to identify which troubled assets the bank will try to sell to a Legacy Loans Fund. The term sheet notes that eligible assets must satisfy “minimum requirements” agreed on by the FDIC and Treasury in order to be eligible. No additional information on these “minimum requirements” is available at this time.

**Initial Valuation**

Once an asset is deemed eligible, the FDIC will hire a third-party valuation firm to produce an initial valuation. The firm will base this initial valuation on an analysis of expected cash flows based on type of interest rates, risk of underlying assets, expected lifetime losses, geographic exposures, maturity profiles and other unnamed characteristics. The FDIC will use the initial valuation to determine the degree of leverage that the FDIC believes the asset can support, thereby establishing the ratio of debt to equity that it will guarantee for a Legacy Loans Fund bidding on a troubled asset pool.

**Auction**

The auction will be conducted by the FDIC. Selling banks will make information available to the FDIC and potential private investors to facilitate the bidding process according to as yet undescribed “pre-established criteria”. The FDIC will review and select the winning bid. Following the announcement of the winning bid, the selling bank may accept or reject the bid within a time frame to be announced.

**Structure**

The Legacy Loans Program will increase the purchasing power of private investors by two means: equity capital co-investment by Treasury and FDIC guarantees of Legacy Loans Fund-issued debt. Following an auction, the winning bidder and Treasury will each contribute a previously agreed upon percentage of equity capital, capped at 50% for Treasury, to a Legacy Loans Fund created for the purpose of investing in the auctioned assets. The Legacy Loans Fund will then issue FDIC-guaranteed debt in the amount necessary to cover the remainder of the purchase price. This debt will initially be placed at the selling bank, and the selling bank may choose to resell the debt into the

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**Features of FDIC-Guaranteed Debt**

- Available guarantee capped per fund according to a leverage ratio established by the FDIC before the auction
- FDIC receives a pledge of the Legacy Loans Fund’s assets to secure its guarantee
- Fund required to maintain a debt service coverage account, initially funded by a holdback of a portion of a selling bank’s cash proceeds
- Other financing terms to be set forth in the FDIC’s guaranteed secured debt for PPIF term sheet, to be released
- FDIC will be reimbursed for auction expenses and paid an administrative fee

**Debt to equity ratio will not exceed 6 to 1 for each fund**
market. Alternatively, capital-neutral funding arrangements may be allowed so long as the collateral protection for the FDIC-guaranteed debt is not diminished. Investors may choose to take less Treasury equity subject to an as yet undetermined minimum.

Private investors and Treasury will share profits and losses in proportion to equity invested.

As in the Legacy Securities Program, Treasury will be issued warrants in each Legacy Loans Fund as required by EESA.

**Management and Governance**

Legacy Loans Program materials indicate that asset managers approved by and subject to “strict” FDIC oversight will manage the disposition of the asset pool on an ongoing basis. Unlike the Legacy Securities Program materials, the Legacy Loans Program materials do not indicate the criteria for selecting asset managers or whether asset managers will have any role in raising capital for or structuring the Legacy Loans Funds. Treasury and the FDIC will establish governance procedures relating to management, servicing agreements, financial and operating reporting requirements, exit timing and alternatives for each eligible asset. To the extent practicable, standard documentation will be used.

Although the Legacy Loans Program’s documents are not clear, it appears that no Legacy Loans Fund may purchase assets from a seller that is an affiliate of any of its private investors or from 10%-or-larger private investors in that Legacy Loans Fund.
Key Concerns and Unresolved Questions

The announcement of the Legacy Securities and Legacy Loans Programs set forth a general framework, and major elements of the programs will be fleshed out in the coming weeks by Treasury and the FDIC. With respect to the Legacy Loans Program, the FDIC has announced a public comment period. With respect to the Legacy Securities Program, it appears more likely that Treasury will use guidelines, contracts and FAQs as it has throughout the financial crisis, acting under its EESA authority.

The following section analyzes key concerns and unresolved questions of the programs from the perspectives of the three major stakeholders: financial institutions selling troubled assets, fund and asset managers and private investors. The overarching question, however, is that of the political risk of regulatory and Congressional changes for sellers, investors and fund managers even after the programs are in place and the contracts are signed. It would not be surprising if potential participants sought comfort on political risk from Treasury, the FDIC and key members of Congress.

Questions and Concerns from the Perspective of a Selling Financial Institution

Sellers of assets under both the Legacy Securities Program and the Legacy Loans Program, be they “financial institutions” under EESA or “insured depository institutions,” will likely want a number of questions answered with respect to the following:

TARP Restrictions/Executive Compensation

A key question likely to be asked by selling institutions is whether they will be subject to executive compensation and other restrictions, like those on the hiring of H-1B visa holders and on travel, expenses and corporate jet usage, by virtue of participating in either program. These restrictions attach to institutions deemed to be TARP participants under EESA and “recipients” of TARP funds under the American Recovery and Reinvestment Act of 2009. In the initial stages of the programs, this may be of little concern, as most participating sellers may already have accepted TARP funds. But for those sellers that exit the TARP program and for those sellers that have not yet taken TARP funds, clarity around the applicability of these restrictions, or the possibility of other restrictions being added retroactively in the future, will be crucial. The question who should be considered a TARP participant and "recipient" is probably best answered in the same way Treasury has answered it for purposes of determining which entity to obtain warrants from. By receiving
warrants from the funds "as required by EESA," Treasury treats the funds as TARP participants. This implies that Treasury should also treat the fund as the TARP participant or “recipient” under the American Recovery and Reinvestment Act of 2009 for purposes of the executive compensation and other restrictions.

**Valuation/Mark-to-Market Impact**

Unknowns with respect to valuation and, in the case of the Legacy Loans Program, the auction process, are a key concern for potential sellers. They include the following:

- Can a seller set a reserve price for an auction in the Legacy Loans Program?
- Can the conclusions of the third-party contractor conducting pre-auction valuations in the Legacy Loans Program be challenged by a selling bank?
- What information will the selling bank make available to the FDIC in the Legacy Loans Program to “facilitate the bidding process according to pre-established criteria”?
- What is the timeframe for a selling bank to accept or reject a winning bid in the Legacy Loans Program? Will regulators seek to influence a bank’s decision?
- What are the “minimum requirements” that assets must satisfy in order to be eligible for inclusion in the Legacy Loans Program?
- Under either program, may an eligible seller buy assets from an ineligible institution and sell them into the program?

Some are already suggesting that selling banks and thrifts, especially those subject to the stress tests, may be gently nudged or even strongly encouraged by their primary banking regulator to participate, perhaps even at price levels that they would not otherwise accept.

It is an assumption embedded in both programs that sellers will have to mark to market both the assets they sell and other similar assets on their books. It is quite likely that the prices established by the programs will require non-participants to mark to this newly created market. To the extent that the government is acting both as a regulator and as an equity investor, this kind of
pricing pressure could raise conflict of interest issues against which sellers may want to seek protection.

Questions and Concerns from the Perspective of a Fund Manager

Fund managers under the Legacy Securities Program and asset managers under the Legacy Loans Program will likely seek clarifications on the following:

Role of Asset Manager for Legacy Loans Funds

There is very little information available that would outline the role of asset managers under the Legacy Loans Program. The FDIC’s “strict oversight” of the asset managers selected by private investors suggests that the FDIC may dictate goals for asset managers other than using all legitimate means to maximize recoveries, such as reflecting the FDIC’s policy goals on loan modifications, which may be inconsistent with the interests of private investors. Bidders in the loan auctions may therefore want to place limitations of their own on what sort of policy goals may be imposed.

Investment Strategy

Under the Legacy Securities Program, defining the precise parameters of an investment strategy that is “predominantly a long-term buy and hold strategy” is not obvious. It will be necessary to agree upfront on situations where the manager is permitted to sell or hedge assets. As fund managers will “control” the trading and disposition of assets, we believe that Treasury consent to dispositions or hedging is not contemplated, but this ought to be fleshed out in guidelines or in contracts.

Executive Compensation

In view of the recent public uproar over executive compensation at federally-assisted institutions, Treasury is certain to be concerned about any appearance of abuse involving compensation under the programs. At the same time, Treasury would presumably want to avoid taking such a controlling stance on the matter that it discourages the participation of managers or investors. Although typical fund compensation and fee structures are highly performance-driven, popular sentiment as to what constitutes a “reasonable” reward for success will need to be considered.

Program FAQs specifically note that executive compensation restrictions will not apply to “passive” investors in the funds, which Secretary Geithner reiterated in a press conference on March 23. He also noted in the same press conference that “[t]he [executive] comp[ensation] conditions will not apply to
the asset managers and investors”. The term sheets for both programs note, however, that funds will be subject to “waste, fraud and abuse” protections for the benefit of the taxpayers. Standards for these protections have yet to be articulated by Treasury, and Secretary Geithner has stated his view that appropriate standards will reflect a broad strategic approach intended above all to allow for the proper functioning of the markets. Additionally, it remains to be seen whether a fund manager who is also a general partner will be treated as a “passive” investor.

### Registered Funds and Exempt Funds

We expect that many funds and private vehicles will be set up in a manner exempt from the registration requirements of the Investment Company Act of 1940, meaning that only sophisticated investors such as qualified purchasers will be able to invest alongside Treasury. Participation by retail investors would probably entail the formation of a closed-end fund, registered under the Investment Company Act of 1940 and offered to the public in an underwritten public offering. In order to qualify for an exemption from US federal income tax, in addition to meeting certain asset diversification and qualifying income requirements, retail funds are generally required to distribute all of their income each year, and such distributions would therefore need to be permitted under the relevant debt arrangements. Retail investors have also typically required either a stock exchange listing or assurances from the fund’s board that it expects to make a tender offer on a regular basis to provide some liquidity to investors. Since it will be difficult to accommodate a tender offer structure, a stock exchange listing is likely to be an important element of a retail fund offering. One of the key benefits of a registered closed-end fund is that it could address tax and regulatory requirements that are essential for raising equity capital from pension plan and tax-exempt investors. Retail fund structures are possible for funds that are registered under the 1940 Act provided that they restrict the amount of debt incurred by the fund to satisfy a 300% asset coverage test.

### Debt Offerings by Legacy Loans Funds

Debt securities issued by any fund or private vehicle that relies on the Section 3(c)(7) exemption could only be sold to qualified purchasers. Alternatively, it might be possible for a private vehicle to be exempt pursuant to Rule 3a-7.

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3 The most likely exemption is that under Section 3(c)(7) of the Investment Company Act of 1940, which requires that each investor in a Fund and each investor in any private vehicle formed for the purpose of investing in a Fund be a qualified purchaser. A qualified purchaser is any entity with at least $25 million in its investment portfolio or any individual with at least $5 million of investment securities.
under the 1940 Act. Such a vehicle could sell fixed income securities with an investment grade rating to retail investors. However, Rule 3a-7 does impose severe constraints on the management activities of the fund, as it does not permit the sale of assets, or the reinvestment in new assets, for the primary purpose of realizing gains or decreasing losses based on changes in market value. These restrictions may not be acceptable to equity investor in a Legacy Loans Fund. It is to be expected that the issuance to retail investors of FDIC-guaranteed debt under the Legacy Loans Program will be exempt from registration under Section 3(a)(2) of the Securities Act, given that the SEC has issued a no-action letter to the FDIC to that effect under its Temporary Liquidity Guarantee Program which shares many features with the guarantee contemplated here.

Treasury’s Unilateral Right to Refuse to Fund

Under the Legacy Securities Program, Treasury retains a unilateral right to terminate its unfunded commitments of equity and debt to a fund in its sole discretion. This unusual right will be of major concern to fund managers and private investors, especially in today’s climate where retroactive changes to programs and contracts have been discussed.

Tax

It seems likely that the Legacy Securities and Legacy Loans Funds and related private vehicles (other than registered closed-end funds, described above) will be structured as partnerships, which are not subject to US federal income tax at the entity level. Tax-exempt and non-US investors may wish to invest in such a private vehicle through a foreign feeder fund, treated as a corporation for US federal income tax purposes and organized in a low-tax jurisdiction. Using a foreign corporate feeder fund is a well-recognized structuring technique that allows tax-exempt investors to realize non-taxable investment income. By contrast, a direct investment in the private vehicle by a tax-exempt investor could entail substantial “unrelated business taxable income” if the fund uses debt financing. Non-US investors generally would not reduce their overall US tax burden, if any, by investing through a foreign corporate feeder fund, but nonetheless may prefer such a structure because the foreign corporate feeder fund, rather than the investor, would file any US tax returns with respect to the investment.

Recently proposed legislation would, if enacted, generally treat foreign corporate feeder funds as domestic corporations subject to US federal income tax. While there does not appear to be any imminent prospect of this proposal being enacted, tax-exempt and foreign investors may be uneasy, given the
generally volatile legislative environment, about any lock-up of their investments, including Treasury’s requirement of a three-year or longer lock-up for the Legacy Securities Program. It remains to be seen whether Treasury will allow the “lock-up” to be lifted in the case of a material adverse tax event such as enactment of the proposed legislation.

Under existing law, a foreign corporate feeder fund that indirectly participates in the Legacy Securities Program generally would not be expected to incur a material amount of US federal income or withholding tax, given the nature of the underlying investments and activities.

Of greater concern is the prospect that a foreign corporate feeder fund that indirectly participates in the Legacy Loans Program will be treated as engaged in a US trade or business, and therefore be subject to US tax on account of restructuring of the underlying mortgages. This may prove to be an acceptable risk if the activities of a Legacy Loans Fund are appropriately circumscribed. Even if a Legacy Loan Fund’s investment in mortgages does not rise to the level of a US trade or business, if the fund acquires a direct interest in the real property securing the mortgage (e.g., by taking title through foreclosure), the foreign corporate feeder fund would be subject to US net-income-based taxation on any gain or loss from the disposition of the property and would be required to file a US income tax return under the Foreign Investment in Real Property Act (“FIRPTA”). Fund managers may seek to structure the entities participating in the Legacy Loans Program in a manner designed to minimize the impact of FIRPTA, but it is unclear whether this can be accomplished easily or efficiently.

**Distribution**

It will be important to determine the priority of payments to be made by a fund from interest, principal and sales proceeds from eligible assets. For example, the fund manager and Treasury will need to agree on a schedule for amortization of the principal amount of the Treasury debt financing and the extent to which proceeds are available for reinvestment in other eligible or ineligible assets. In addition, negotiations regarding the priority of payment of indemnities, administrative expenses and management fees are likely to arise.

**Withdrawal Rights**

For each Legacy Securities Fund, Treasury and one private vehicle controlled by the fund manager will invest and divest proportionately in eligible assets. The terms of the Legacy Securities Program restrict investors in private vehicles from withdrawing their capital during the first three years. Since
Treasury debt financing is in part contingent on a prohibition on voluntary withdrawals, it is questionable whether withdrawals from private vehicles can be accommodated at any time. In the event of any withdrawals of private investors, a pro rata distribution to Treasury will be required.

**Reporting Requirements**

Fund managers must agree to provide access to books and records of the Legacy Securities Funds they manage. This will likely require that records of the fund manager, including possibly email and other correspondence of portfolio managers relating to the fund, be made available. A fund manager should consider all of its relevant books and emails to be subject to review.

**Warrants**

The term sheets include no detail on the warrants to be issued by funds in either program to Treasury. We assume that warrants will be in addition to Treasury’s 50% equity stake, in particular under the Legacy Securities Program, where they are issued in recognition both of Treasury’s equity investment in the Legacy Securities Fund and of any debt financing extended by Treasury. Whether the warrants will be penny warrants (essentially equity securities) or true options with a strike price at or above fair market value on the date of issuance is unclear. If the Treasury warrants are “true options”, it may complicate fee arrangements between the fund manager and private investors if withdrawal of private investor capital is permitted prior to an exercise of Treasury warrants.
Questions and Concerns from the Perspective of a Private Investor

Private investors under both the Legacy Securities Program and the Legacy Loans Program will be concerned with many of the questions raised for sellers and fund managers above, such as valuation and executive compensation issues. In addition, private investors under both Programs will likely want to seek clarification of the following:

Executive Compensation

As noted above, Secretary Geithner in his briefing and Chairman Bair in hers have stated that they do not intend that the executive compensation restrictions imposed under EESA and its progeny will apply to “passive” private investors in either program. Nowhere in the program materials is “passive” defined, creating some uncertainty with respect to which private investors will be insulated from the executive compensation restrictions. It would also be helpful to clarify that ARRA’s restrictions on the hiring of H-1B visas will not apply to private investors.

Eligibility/Pre-Qualification Compensation

Under both programs it would seem most sensible that Treasury and the FDIC encourage wide participation by the broadest possible category of private investors, subject only to sophistication and suitability standards for the equity and non-FDIC guaranteed debt investments. As a portion of the debt funding in the Legacy Loans Program will be FDIC-guaranteed, the emphasis on retail investors in that component is more than understandable.

It would be unfortunate, however, if the financial pre-qualification and other standards for private investors in the Legacy Loans Program were used to discourage sovereign wealth funds and other well known reputable foreign private investors from participating. The apparent confusion in program materials about whether foreign private investors would need to be headquartered in the United States should be clarified and the restriction, if it exists, removed.

Valuation

A key uncertainty remains as to whether sellers and buyers will agree to a clearing price and the differing interests of private investors and sellers are apparent in this area. Given the government involvement and complexity of the programs, private investors will be deeply interested in both the results and
mechanics of valuations, including the process surrounding third-party valuations and auctions.

Windfall Profits
In the current political context, investors will have to be concerned about a retroactive windfall tax if they earn “too much” in profits over time.

Related Party Transactions
As the extent of the programs’ restrictions on purchasing and selling legacy assets to related parties is broad, organizations with financial institution affiliates may be precluded from participating absent further clarifications or waivers.

Side-by-Side Investors
One structural possibility to consider is whether certain private investors, in order to avoid executive compensation restrictions, ad hoc regulatory change, restrictions on related party transactions and reputational damage that could come with participation in the programs, might establish purely private funds to invest side-by-side with the public-private funds in the same pools of assets, but without any of the government debt or equity financing.

Withdrawal Rights/Investor Lock up
As noted above, this will be a key area of concern for private investors.
If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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**References**

- Public-Private Investment Program Press Release (March 23, 2009)
- Public-Private Investment Program Fact Sheet (March 23, 2009)
- Public-Private Investment Program White Paper (March 23, 2009)
- Legacy Securities Program Term Sheet (March 23, 2009)
- Legacy Securities Program FAQs (March 23, 2009)
- Application for Private Asset Managers under Legacy Securities Program (March 23, 2009)
- Legacy Loans Program Term Sheet (March 23, 2009)
- Legacy Loans Program FAQs (March 23, 2009)

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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.

To ensure compliance with requirements imposed by the Internal Revenue Service, we inform you that the discussion of U.S. federal tax issues contained in this memorandum is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.