

Troubled Assets Relief Program: Q&A

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Today, the U.S. Congress completed legislative action on the Emergency Economic Stabilization Act of 2008 (the “Act”) – far-reaching legislation addressing the economic crisis currently crippling credit markets. The President is expected to sign the measure immediately.

The Troubled Assets Relief Program (the “TARP”) is at the heart of the Act. The TARP affords broad authority to the Secretary of the Treasury (the “Secretary”) to purchase certain troubled assets from eligible financial institutions in an aggregate amount potentially reaching \$700 billion outstanding at any one time. The TARP will be implemented through a new Office of Financial Stability, headed by an Assistant Secretary of the Treasury. The Act also provides for a Treasury program to offer financial institutions guarantees related to troubled assets.

The Act is designed to restore liquidity and stability to the U.S. financial system. At the same time, the purposes of the Act include protecting home values, college funds, retirement accounts and life savings, preserving home ownership, and promoting jobs and economic growth.

Key highlights of the Act include provisions:

- defining parameters for the Secretary’s exercise of authority to purchase troubled assets, including the institutions eligible to participate in the program, the assets eligible for purchase, and pricing considerations;
- requiring the U.S. Treasury to obtain debt or equity stakes in participating institutions;
- regulating certain compensation practices of participating institutions;
- establishing principles for asset management and servicing, including the role of the private sector and the implementation of foreclosure mitigation efforts;

- requiring the Secretary to make recommendations for regulatory modernization;
- authorizing the Securities and Exchange Commission (the “SEC”) to suspend mark-to-market accounting; and
- temporarily increasing the basic limit on federal deposit insurance from \$100,000 to \$250,000.

The Secretary’s authority to purchase or guarantee (but not hold) troubled assets will terminate on December 31, 2009, unless extended by the Secretary to the date that is two years after enactment of the Act upon submission of a certification to Congress.

Through questions and answers concerning these and other highlights of the Act, this memorandum summarizes key issues of interest to financial institutions and other market participants. Many details central to implementation of the Act, including the TARP, remain to be developed by the Secretary.

Questions and Answers

1. Q. What institutions are eligible to participate in the TARP?

A. Treasury may purchase troubled assets from “financial institutions”, which means any institution, including, but not limited to, any bank, savings association, credit union, security broker or dealer or insurance company, that (i) is “established and regulated” under the laws of the United States (or any U.S. state, territory, or possession) and (ii) has “significant operations” in the United States. As defined, eligible financial institutions appear to include branches and agencies of foreign banks established and regulated in the United States. The Act allows for the inclusion of institutions other than those specifically enumerated in the definition, such as pension plans, bank holding companies and non-bank subsidiaries.

The eligibility provisions expressly exclude any central bank of, or institution owned by, a foreign government. However, to the extent that such foreign financial authorities or banks have extended financing to financial institutions that have failed or defaulted on such financing and, as a result, hold troubled assets, those troubled assets will qualify for purchase by the Secretary. The Secretary is required to coordinate, as appropriate, with foreign financial authorities and central banks to work toward the establishment of programs similar to the TARP by such authorities and central banks.

The Act does not require that troubled assets be held by an institution for a particular length of time. Accordingly, it appears that an eligible financial institution could sell qualifying troubled assets into the TARP that were purchased from an ineligible institution.

2. ***Q. What assets may Treasury purchase?***

A. Treasury may purchase:

- residential or commercial mortgages that were originated on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability;
- any securities, obligations, or other instruments that are based on or related to such mortgages and were issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability; and
- any other financial instrument where the Secretary has determined after consultation with the Chairman of the Board of Governors of the Federal Reserve System (the “FRB”) that the purchase is “necessary to promote financial market stability” upon notice of such determination to the appropriate committees of Congress (collectively, “troubled assets”).

3. ***Q. What factors will Treasury consider in determining what assets to purchase?***

A. In exercising his authority under the Act, including decisions about which troubled assets to purchase, the Secretary must consider a number of factors, including:

- protecting the interests of taxpayers by maximizing overall returns and minimizing the impact on the national debt;
- providing stability to financial markets;
- the long-term viability of a selling institution, in order to determine whether a purchase represents the most efficient use of funds;
- ensuring that all financial institutions are eligible to participate in the program, without discrimination based on an institution’s size, location or form of organization, or the type and amount of troubled assets it holds;
- providing assistance to financial institutions with assets of less than \$1 billion that were well or adequately capitalized on June 30, 2008, and that suffered capital reductions based on the devaluation of Freddie Mac or Fannie Mae preferred stock; and
- the need to help families keep their homes.

4. Q. Will institutions that participate in the TARP become subject to executive compensation limits or other requirements?

A. Yes. Institutions selling assets into the TARP will be subject to requirements giving Treasury an economic stake in the institution and regulating certain of its compensation practices.

Equity Stake. Publicly traded institutions may sell troubled assets into the program only if they provide Treasury a warrant for the right to receive non-voting common or preferred stock or voting stock with respect to which the Secretary agrees not to exercise voting rights. All other selling institutions must provide Treasury with either such a warrant or a senior debt instrument. The Secretary may establish a de minimis exception to these requirements based on the size of the cumulative purchases from an institution (not to exceed \$100 million). The terms and conditions of the warrant or senior debt instrument must be designed to provide the Secretary reasonable participation in equity appreciation in the case of a warrant, or a reasonable interest rate premium in the case of a senior debt instrument, and must be designed to provide additional protection against losses from the sale of assets by the Secretary. The Secretary has authority to sell or exercise the security received based on such conditions.

Warrants must contain anti-dilution provisions to protect the value of the securities in various market transactions, such as stock splits, stock distributions, dividends or mergers. The specific provisions are to be determined by the Secretary.

Executive Compensation Standards in Direct Purchases. The Secretary must require a financial institution to meet “appropriate standards” for executive compensation and corporate governance when Treasury (i) makes a direct purchase of troubled assets from the institution where no bidding process or market prices are available and (ii) receives a “meaningful” equity or debt position in the institution as a result of the transaction. These standards – which will be effective for a participating institution for the duration of the period that Treasury holds an equity or debt position in the institution – must include:

- limits on compensation to exclude incentives for senior executive officers to take risks that the Secretary deems to be unnecessary and excessive;
- a “claw back” provision for recovery by the financial institution of any incentive compensation paid to a senior executive officer based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate; and

- a prohibition on the financial institution making any golden parachute payment to its senior executive officers.¹

Executive Compensation Standards in Auction Purchases. When Treasury purchases troubled assets from a financial institution through an auction, the Secretary must prohibit the institution from making any new employment contract with a senior executive officer that provides a golden parachute payment in the event of an involuntary termination, bankruptcy filing, insolvency or receivership. This prohibition is only effective if Treasury's purchases of troubled assets from the institution (including direct purchases) exceed \$300 million.

Tax Treatment of Executive Compensation. When Treasury purchases more than \$300 million of troubled assets from a financial institution, the institution generally may not deduct as a business expense any executive remuneration over \$500,000 for its CEO, CFO, or any of its three most highly compensated officers determined using the disclosure rules of the SEC.² There is no exception, as there is under the existing \$1 million limitation of Section 162(m) of the Internal Revenue Code, for performance-based compensation or binding contracts. These rules apply even if the institution is not subject to the SEC rules. It appears that the executives covered are those for whom disclosure would be required in a proxy statement although it might be read only to incorporate the method of computing compensation from the proxy rules. In addition, for these same executives, severance payments in the event of involuntary termination or any bankruptcy, liquidation, or receivership of the institution will be subject to the Section 280G rules applicable to golden parachutes that can result both in loss of deduction to the institution and an additional 20 percent tax on the employee. The Secretary is to prescribe rules to deal with these limitations in the context of mergers and acquisitions.

5. Q. When will Treasury determine details of how the TARP will operate?

A. Within forty-five days of the Act becoming law (or sooner if the Secretary earlier exercises his authority to purchase troubled assets), the Secretary must publish program guidelines describing the mechanisms for purchasing troubled assets, the methods of pricing and valuing such assets, the procedures for selecting asset managers and the criteria for identifying troubled assets for purchase. The Secretary is generally authorized to establish a program to purchase, and to make and fund commitments to purchase, troubled assets on terms and

¹ A "senior executive officer" for these purposes is an individual who is one of the top five executives of a public company whose compensation is required to be disclosed under the U.S. Securities Exchange Act of 1934 (or a counterpart in a non-public company). In the case of a public company, these executives are essentially the executives named in the proxy statement, although the language is ambiguous in the case of a company with multiple CEOs, CFOs and other senior executives who turn over during a year.

² This restriction applies in the first taxable year of the institution in which its aggregate sales to Treasury over all taxable years exceeds the \$300 million threshold.

conditions determined by the Secretary in accordance with provisions of the Act and published policies and procedures developed by the Secretary. The Act provides that the Secretary may establish “vehicles” supervised by the Secretary to purchase, hold and sell troubled assets and issue obligations. In exercising authority under the TARP, the Secretary is required to consult with the FRB, the Federal Deposit Insurance Corporation (the “FDIC”), the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Chairman of the National Credit Union Administration Board, and the Secretary of Housing and Urban Development.

6. Q. How will Treasury price purchases of assets?

A. The Act does not provide specific pricing details. Generally, in pricing asset purchases, the Secretary is required to (i) make such purchases at the lowest price that the Secretary determines to be consistent with the purposes of the Act and (ii) maximize the efficient use of taxpayer resources by using market mechanisms, including auctions or reverse auctions, where appropriate. If the Secretary determines that a market mechanism is not feasible or appropriate, and that the purposes of the Act are best served through direct purchases from an individual financial institution, the Secretary is required to pursue additional measures to ensure that prices paid for assets are reasonable and reflect the underlying value of the asset.

The Secretary must take necessary measures to prevent unjust enrichment of financial institutions participating in the TARP, including by preventing the sale of troubled assets to the Secretary at a higher price than what the seller paid to purchase the asset (excluding cases in which a troubled asset was acquired from a financial institution under receivership or conservatorship or in bankruptcy under U.S. bankruptcy law).

Within two business days of purchasing, trading, or disposing of troubled assets, the Secretary must publish a description of the assets, the amounts involved and the pricing.

7. Q. How will Treasury manage the troubled assets it purchases?

A. The Secretary has broad authority to manage the troubled assets it purchases, including the revenues and portfolio risks of such assets. Treasury also may, at any time, exercise any rights received in connection with such assets.

8. Q. Is there a role for the private sector in managing purchased assets?

A. Yes. The Secretary may award contracts to asset managers, servicers, property managers, and other service providers or expert consultants pursuant to streamlined procedures (that may waive specific provisions of the Federal Acquisition Regulation in certain circumstances).³ Contracting procedures developed by the Secretary will, to the maximum

³ The Secretary is required to consider the FDIC in the selection of asset managers for residential mortgage loans and residential mortgage-backed securities.

extent practicable, ensure inclusion of minorities and women and minority- and women-owned businesses.

The Secretary must issue regulations or guidelines to manage or prohibit conflicts of interest, including conflicts arising in the selection of contractors or advisors (including asset managers) and in the management of troubled assets.

9. Q. *How will Treasury dispose of troubled assets?*

A. The Secretary may sell troubled assets or enter into securities loans, repurchase transactions, or other financial transactions with respect to such assets. The Secretary is required to hold assets to maturity or for resale until such time as the Secretary determines that the market is optimal for selling, in order to maximize the value for taxpayers. In disposing of assets, the Secretary will sell at a price that the Secretary determines will maximize return on investment for the U.S. government.

10. Q: *Will Treasury offer a guarantee of payments on troubled assets?*

A. Yes. If the Secretary establishes the TARP, he must also establish a program to guarantee troubled assets originated or issued prior to March 14, 2008 (the “Insurance Program”). Pursuant to this program, the Secretary may, upon request of a financial institution, guarantee the timely payment of principal of, and interest on, troubled assets in amounts not to exceed 100 percent of such payments. The Secretary has the authority to determine the terms and conditions of the guarantees, which may be determined by category or class of assets.

The Secretary is required to collect premiums for such guarantees and set premiums at a level sufficient to meet anticipated claims. Treasury must publish the methodology used to calculate the premiums for each class.

The limits on the Secretary’s authority to purchase troubled assets under the TARP will be reduced by the difference between the total outstanding obligations guaranteed under the Insurance Program and the balance of the fund into which premiums are paid.

While the Secretary’s authority to provide new guarantees will terminate as described above, it is unclear from the language of the Act whether existing guarantees will terminate at that time. The Act makes clear that the Secretary may continue to hold purchased assets, but it does not contain a parallel provision with respect to guarantees.

11. Q. *How much can the Secretary spend?*

A. Upon enactment, the Secretary’s authority to purchase troubled assets is limited to \$250 billion outstanding at any one time (determined by aggregating the purchase price of all

troubled assets held). Upon notification by the President to Congress, this limit will increase to \$350 billion. If the President submits a written report to Congress detailing the Secretary's plan to exercise his authority, the limit will increase to \$700 billion unless Congress acts within 15 days to disapprove the plan. The Secretary's purchase authority is subject to reduction in connection with the issuance of guarantees under the Insurance Program, as described above.

12. Q. *What oversight will apply to the Secretary's actions under the TARP?*

A. The Act establishes a Financial Stability Oversight Board to review the exercise of the Secretary's authority. It will consist of the Secretary, the Chairman of the FRB, the Director of the Federal Housing Finance Agency, the Chairman of the SEC, and the Secretary of Housing and Urban Development. The Oversight Board will review the use of authority under the Act and ensure that the Secretary's policies are in accordance with the purposes of the Act, in the economic interests of the United States and consistent with protecting taxpayers. The Secretary also is required to publish data concerning the activities of the TARP, submit the TARP to ongoing oversight and audits by the Government Accountability Office, and provide regular reports to Congress. In addition, the Act establishes a congressional oversight panel to review the current state of financial markets and the regulatory system and submit reports to Congress.

13. Q. *Are the Secretary's actions subject to judicial review?*

A. Yes, to determine if the Secretary's actions are arbitrary, capricious, an abuse of discretion or not in accordance with law. However, injunctive and other equitable relief is severely restricted.

14. Q. *Will the Act revise regulatory structures or subject currently unregulated entities to regulatory requirements?*

A. The Act requires the Secretary to submit a report to Congress by April 30, 2009, analyzing the current state of the regulatory system and its effectiveness at overseeing participants in the financial markets, including the over-the-counter swaps market and government-sponsored enterprises (such as Fannie Mae and Freddie Mac). This report will include recommendations regarding, among other things, (i) whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system and (ii) the enhancement of the clearing and settlement of over-the-counter swaps. In addition, the Act establishes a congressional oversight panel that will submit to Congress a special report on regulatory reform by January 20, 2009, that will consider similar subject matter.

The Secretary also is required to determine whether the public disclosure required for each type of financial institution that sells assets to the Secretary is adequate to provide sufficient information as to the "true financial position" of the institutions with respect to off-balance sheet

transactions, derivatives, contingent liabilities, and similar sources of potential exposure. If such disclosure is not adequate for that purpose, the Secretary may make recommendations for additional disclosure requirements to the relevant regulators.

The Comptroller General is required to study and report to Congress concerning the role of leverage as a factor behind the current financial crisis. The report, due by June 1, 2009, will include an analysis of the authority of the FRB to regulate leverage, including by setting margin requirements.

15. Q. *Will the federal government be able to recoup losses incurred in the TARP?*

A. Four years after the Act’s enactment, a report will be submitted to Congress concerning the net results of the TARP at that time. If there is a shortfall, the President is required to submit proposed legislation to Congress to recoup the shortfall from the “financial industry” – not just TARP participants.

16. Q. *What foreclosure mitigation efforts are required?*

A. The Secretary must, with respect to mortgages, mortgage-backed securities, and other assets secured by residential real estate (including multifamily housing) acquired by the Secretary, maximize assistance to homeowners and encourage mortgage servicers – considering net present value to taxpayers – to take advantage of available programs (including the HOPE for Homeowners Program) to minimize foreclosures. The Secretary is authorized to use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures.

In addition, the Act provides that federal property managers (including Fannie Mae, Freddie Mac, the FDIC, and the FRB) undertake certain foreclosure mitigation efforts.

17. Q. *How does the Act affect mark-to-market accounting standards?*

A. The Act authorizes the SEC to suspend the application of the mark-to-market accounting standards in Statement Number 157 of the Financial Accounting Standards Board for any issuer or class or category of transaction if the SEC determines that such suspension is in the public interest and is consistent with the protection of investors. In addition, within 90 days of the Act’s passage, the SEC must complete a study of the application of mark-to-market accounting standards to financial institutions and provide Congress a report that includes administrative and legislative recommendations.

18. Q. *How does the Act change federal deposit insurance?*

A. Upon enactment through December 31, 2009, the Act increases the basic limit for federal insurance of deposits of banks, thrifts and credit unions from \$100,000 to \$250,000 per depositor, per bank. The FDIC also is authorized to borrow from the U.S. Treasury to cover the additional insured amounts as needed.

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If you have any questions about the Act, please call any of your regular contacts at Cleary Gottlieb or one of the Firm's senior lawyers in the Financial Institutions Group: Kenneth Bachman, Jack Murphy, Linda Soldo or Derek Bush in the Firm's Washington Office at +1 202 974 1500, or Robert Tortoriello or Paul Glotzer in the New York Office at +1 212 225 2000.

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