

Client Alert

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New York Office

Emergency Economic Stabilization Act of 2008 - Key Elements for Non-US Banks

Introduction

President Bush signed the Emergency Economic Stabilization Act of 2008 (the "Act") into law on Friday, 3 October 2008. We summarize below the elements of the Act that will be of primary interest to non-US banks.

Although the Act has grown from 3 pages to 446 pages since it was first proposed on the 20th of September, the core of the Act remains the "Paulson Plan," now formally known as the "Troubled Assets Relief Program ("TARP"). Much of the Act's new bulk consists of unrelated "sweeteners" designed to attract Congressional votes.¹ The statutory text was drafted very quickly and under a great deal of pressure, so it would not be surprising if both conceptual mysteries and technical defects reveal themselves over time.

The goal of the Act is to give the Treasury more power to restore liquidity and stability to the U.S. (and world?) financial system by acting directly on troubled assets. The Act gives the Treasury two primary tools: (i) the ability to purchase, manage, and dispose of "troubled assets" and (ii) the ability to guarantee principal and interest on troubled assets in exchange for premiums. Although we have not described them here, the Act provides for multiple layers of executive branch, Congressional, and external oversight of these two programs.

¹ However, certain initial requests are not incorporated in the Act, such as the authority requested for judges to write down mortgage loan principals.



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1. PURCHASE, MANAGEMENT, AND SALE OF TROUBLED ASSETS

The TARP

The core of the Act is the TARP, which allows the Treasury to purchase “troubled assets” from “financial institutions.”

Troubled assets are:

- residential or commercial mortgages originated on or before March 14, 2008
- any securities, obligations, or other instruments that are based on or related to such mortgages and that were issued on or before March 14, 2008 (“Mortgage-Related Instruments”) if the Treasury determines that purchasing the Mortgage-Related Instruments promotes financial market stability
- any other financial instruments that the Treasury, in joint consultation with the Federal Reserve, determines is necessary to promote financial market stability (“Non-Mortgage Instruments”), but only after notifying Congress in writing of that determination.

The Treasury’s ability to purchase pre-March 14 mortgages and Mortgage-Related Instruments seems essentially unfettered. However, the involvement of the Federal Reserve, and the requirement that Congress be notified, may act as a meaningful constraint on purchase of Non-Mortgage Instruments.

Eligible financial institutions (“EFIs”) include—but are not limited to²—banks, savings associations, credit unions, securities brokers and dealers, and insurance companies that, in each case, (i) are established and regulated under US law (including that of US states and territories) and (ii) have significant operations in the US.

- Regulated US subsidiaries of foreign banks, such as their US broker-dealer subsidiaries, are EFIs.
- The EFI definition specifically excludes any central bank of, or institution owned by, a foreign government. However, in light of the Treasury’s desire to facilitate comparable market rescue interventions by non-US financial authorities and central banks, the Act specifically permits the Treasury to purchase troubled assets from foreign financial authorities and central banks if the assets were acquired as a result of a failed or defaulting borrower.
- US Branches of foreign banks. The Act does not permit the Treasury to purchase troubled assets directly from the home offices of foreign banks, but it may permit purchases from US branches of foreign banks (“US Branches”). The language used in the Act, when considered independently, seems to suggest that US Branches are not eligible. However, when read in light of certain bank regulatory rules that use the same phrase—but to which the Act does not specifically refer—the language would encompass US Branches. One wonders if the lack of clarity was intentional, in light of the conflict between (i) the Treasury’s reported desire to include US branches of foreign banks³ and (ii) the strongly held contrary views of many US Congressmen. We suspect that the Treasury will interpret the Act to include US Branches as EFIs (assuming that they have significant operations). However, whether our suspicion will prove to be correct remains to be seen.
- Conduit sales. Even if US Branches were not considered as EFIs, nothing in the Act prevents an EFI (such as a foreign bank’s US broker-dealer subsidiary) from selling to the Treasury a troubled asset acquired from a foreign bank. Consequently, whether or not US Branches are EFIs, we suspect that the Treasury would consider itself free to purchase troubled assets indirectly from foreign banks in conduit transactions.

² Domestic pension plans, although not obviously financial institutions are eligible to sell troubled assets under the TARP. Act sec. 103(8). The Treasury’s authority to extend the scope of EFIs could lead to the eventual inclusion of hedge funds and domestic securitization vehicles.

³ The Treasury’s objective to set a floor on the value of troubled assets is hindered if its access to those assets is limited.



Hiring EFIs As Financial Agents Of The Treasury

To carry out the vast task envisioned by the Act, the Treasury will engage EFIs to act as financial agents of the US government. The financial agents will have a fiduciary agent-principal relationship vis-à-vis the Treasury, with a responsibility to protect US government interests. Prospective financial agents will be solicited through the issuance of public notices, posted on the Treasury's website, requesting that interested EFIs submit a response. The selection process may involve extremely short deadlines for submitting information and for travelling to Washington, D.C. for meetings or interviews. The first solicitation was announced on October 6th and requires applications be submitted on October 8th.

- In general principle, any purchase of services by the Treasury under the Act would be subject to the Federal Acquisition Regulation ("FAR").⁴ However, the Act authorizes the Treasury to waive specific provisions of FAR upon determining that urgent and compelling circumstances make compliance contrary to the public interest, and one might expect waivers to be the norm at the outset because of the urgency of the task.

TARP Operations And Pricing Principles

The Treasury has broad powers to structure and facilitate the purchase of troubled assets, including the establishment of SPVs to purchase, hold, and sell the assets.

The Treasury has the authority to manage, lend, repo, sell, and enter into other financial transactions with regard to troubled assets purchased under the TARP.

In general, the Treasury may not pay a higher price for a troubled asset than the price paid by the selling EFI, unless the EFI acquired the asset from another EFI that is in receivership, conservatorship, or bankruptcy.

If the Treasury purchases a troubled asset in a negotiated transaction (rather than in a transaction in which market mechanisms set the price, such as a reverse auction), the Treasury must pursue measures to ensure that the price paid is reasonable and reflects the underlying value of the asset.

Within two days of the time the Treasury purchases its first troubled asset (and no later than November 8, 2008), the Treasury must publish guidelines for the TARP, including mechanisms for purchasing the assets, methods for pricing and valuing the assets, and criteria for identifying troubled assets for purchase. Given the urgency of the problem, we expect that the Treasury will produce at least a preliminary set of TARP guidelines very quickly.

Transparency Of The TARP

The terms (e.g., description, amounts, and pricing) of purchases under the TARP will be publicly disclosed within two business days of the transaction.

For each type of EFI selling assets under the TARP, the Treasury will establish whether existing public disclosure requirements with respect to off balance sheet transactions, derivative instruments, contingent liabilities, and other sources of potential exposure are adequate to provide the public with sufficient information regarding its "true financial position." If not, the Treasury is directed to make recommendations for additional disclosure to the relevant regulators.

- Given the high degree of oversight established under the Act and the amount of public funds at stake, one might expect these recommendations to carry a substantial amount of weight with the regulators.⁵

⁴ FAR contains many detailed government procurement rules that govern the process by which most federal agencies acquire supplies in services.

⁵ The reach of the regulators themselves is likely to expand in the future, for example into the credit derivatives and hedge fund markets. Section 105(c) of the Act requires the Treasury to submit a report by 30 April 2009 recommending improvements in the regulation of the financial markets, and those markets are specifically or implicitly mentioned.



Executive Compensation Limits On TARP Participants

In certain cases, an EFI selling troubled assets under the TARP must comply with senior executive compensation limits.

- Negotiated Purchases. If there is no market for the purchased troubled assets (e.g., no bidding process and no market prices available), and the Treasury takes a “meaningful” equity or debt position in the selling EFI, the EFI must (for so long as the Treasury holds the position):
 - limit incentives encouraging senior executives to take unnecessary and excessive risks
 - recapture bonuses or compensation based on EFI financial performance criteria later proved to be materially inaccurate
 - prohibit golden parachute payments to the EFI’s top five executives.
- Auction Purchases. If the troubled assets are bought at auction from an EFI that has sold, in the aggregate, more than \$300 million worth of assets under the TARP, the EFI may not create any new employment contract with a senior executive providing for a golden parachute in the event of involuntary termination, bankruptcy filing, insolvency or receivership.

2. TROUBLED ASSET GUARANTEE PROGRAM

Along with the TARP, the Treasury must establish a guarantee program (the “TAG Program”) for troubled assets.⁶ Under the TAG Program, an EFI can request a guarantee on the principal and interest of a troubled asset.

The premiums for the guarantees must be set, based on insurance principles, with the intent of covering the expected losses of the TAG Program. The Treasury has the authority to set premiums on the basis of asset classes, but (surprisingly) is not required to do so, as long as the total premiums received under the TAG Program are sufficient.

No foreign government owned institutions or central banks are eligible for the TAG Program.

Commitments under the TAG Program, less the premiums received (and earnings thereon), reduce the \$700 billion otherwise available for the TARP.

3. TAKING EQUITY PARTICIPATION RIGHTS

EFIs that sell troubled assets under the TARP generally must provide equity participation to the US government.

- Publicly Traded EFIs must provide the Treasury a warrant for the right to receive (i) nonvoting common stock or (ii) preferred stock or voting stock (with respect to which the Treasury agrees not to exercise voting power), as the Treasury determines appropriate.
 - The warrant must provide for a reasonable participation in equity appreciation.
- Private EFIs must provide the Treasury a warrant for common or preferred stock or a senior debt instrument.
 - The warrant must provide for reasonable participation in equity appreciation or, in the case of a senior debt instrument, must provide a reasonable interest rate premium.

⁶ Mortgage-backed securities are specifically mentioned in this provision, although it is not clear why, since as they already come within the definition of troubled assets. Possibly the intent was to insure that the Treasury treats them as a top priority



4. SEC AUTHORITY TO SUSPEND MARK-TO-MARKET ACCOUNTING

The Act gives the SEC authority to suspend mark-to-market accounting in the SEC's discretion. It also directs that, within 3 months, a study be completed regarding the advisability of modifying those rules and analyzing the role those rules played in the bank failures thus far in 2008.

- Note that the SEC already has the authority to suspend or modify such rules,⁷ and thus the inclusion of this authority under the Act apparently was a political maneuver. It is widely believed that the mark-to-market accounting guidance issued by the SEC on September 30, 2008 (the "SEC Guidance") was meant to pre-empt the anticipated inclusion of the provision in the Act. (If so, it failed.) FASB has since followed up on the SEC Guidance, issuing a proposed FASB Staff Position on October 3, 2008. The FASB position is consistent with the Guidance but provides more detail.
- The Guidance and the FASB position both effectively provide that when reporting the fair value of an asset in a "distressed market," reporting companies can put less emphasis on market trading prices and more emphasis on management's internal assessment of value.

Although some in Congress blame mark-to-market accounting for exacerbating the credit crisis and therefore want to repeal it, many investors and accounting professionals strongly oppose doing so. Thus, despite the SEC's authority to suspend the mark-to-market rules, it seems unlikely to do so before the study is complete.

5. RESERVE LEVELS AND INTEREST PAYMENTS AT THE FED

The Act authorizes the Federal Reserve to pay interest on reserve balances held by depository institutions in Federal Reserve Banks (which the Federal Reserve already has done) and grants the Federal Reserve more flexibility to set the level of reserves that depository institutions are required to maintain against their transaction accounts (even to set a 0% reserve ratio).

6. CONFLICTS OF INTEREST

Not surprisingly, the Act requires the Treasury to issue regulations or guidelines to address conflicts of interest that may arise in connection with implementing the Act, including:

- The selection or hiring of contractors or advisors, including asset managers
- The purchase of troubled assets
- The management of troubled assets held, and
- Post-employment restrictions on employees.

The Treasury issued Interim Guidelines on October 6, 2008 to this effect (the "Conflict of Interest Guidelines").

- The Conflict of Interest Guidelines provide that the Treasury may obtain non-disclosure agreements and conflict of interest agreements in advance of soliciting a potential contractor.
- The solicitation will instruct prospective offerors to disclose any actual or potential conflicts of interest that could arise from performance of contract.
- If any conflicts of interest are identified, a mitigation plan has to be submitted. If the contract is awarded, the mitigation plan will become a contractually binding obligation.

⁷ Under the Securities Exchange Act of 1934, the SEC has the authority and responsibility to establish standards for financial accounting and reporting for publicly held companies. The SEC designated the Financial Accounting Standards Board ("FASB"), a nonprofit organization established in 1973, as the authority responsible for setting such standards.



7. PHASE-IN OF SPENDING AUTHORITY

\$700 billion is available overall for the TARP and the TAG Program, but it is not all immediately accessible.

- The Treasury has \$250 billion available for immediate use.
- Upon a certification of need by the President, the Treasury can access an additional \$100 billion.
- The final \$350 billion will be available if the President provides a written report to Congress requesting the increase and Congress does not disapprove the request within 15 days.

8. TIME FRAME FOR THE TARP AND THE TAG PROGRAM

The TARP and TAG Program will terminate on December 31, 2009 unless the Treasury certifies to Congress that it is necessary to extend the life of those programs. Under the Act, the extensions cannot go beyond October 3, 2010.

9. TEMPORARY INCREASE IN FDIC DEPOSIT INSURANCE COVERAGE

From now until December 31, 2009, the FDIC and the National Credit Union Share Insurance Fund deposit insurance limits will increase from \$100,000 to \$250,000.

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