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CLIENT ADVISORY

IMPLEMENTATION BEGINS ON UNITED STATES EMERGENCY FINANCIAL RELIEF PROGRAM

OCTOBER 2008

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The Emergency Economic Stabilization Act of 2008 (Act) was signed into law by President Bush on October 3, 2008, immediately following its passage by Congress. The Act allocates up to US$700 billion towards purchasing and insuring troubled assets held by financial institutions in order to provide liquidity and stability to the US financial system; protect home values, college funds, retirement accounts, and life savings; preserve homeownership; and promote jobs and economic growth while maximizing overall returns to US taxpayers. The Act establishes the basic framework and policy goals of the so-called "bailout" effort, but vests in the Secretary of the Treasury (Secretary) largely unfettered authority to act within those broad parameters in carrying out the Act's purpose.

TROUBLED ASSET RELIEF PROGRAM

The centerpiece of the Act is the authorization of the Troubled Asset Relief Program (TARP), the purpose of which is to purchase troubled assets from eligible financial institutions. The TARP is to be administered by a newly created office within the US Department of the Treasury, the Office of Financial Stability. Secretary Paulson has designated Neel Kashkari, currently an Assistant Secretary for international affairs at the Treasury, as the Interim Assistant Secretary for the newly created Office of Financial Stability. Assets that the TARP may purchase include residential and commercial mortgages and related securities originated or issued on or before March 14, 2008, whose purchase the Secretary determines promotes financial market stability. Virtually all financial institutions established and supervised under US law, such as banks, savings associations, credit unions, securities brokers and dealers, and insurance companies, are eligible to sell assets into the program. Read broadly, the Act's definition of "financial institution" arguably gives the Secretary the authority to permit other investment vehicles, such as pension funds or hedge funds, to access the TARP as well.

Although foreign central banks and institutions owned by foreign governments are generally excluded from participation in the TARP, to the extent foreign financial authorities or central banks hold troubled assets as a result of extending financing to financial institutions that have failed or defaulted on such financing, those assets may be purchased by the TARP. The extent to which ownership by a foreign government will exclude participation in the TARP remains to be determined, however US

financial institution subsidiaries (including US branches) of non-governmental foreign entities, to the extent they have significant US operations, should be eligible to participate. In addition, the Act instructs the Secretary to coordinate with foreign financial authorities and central banks as appropriate in order to work towards the establishment of programs similar to the TARP in other countries.

The Secretary, in consultation with the Board of Governors of the Federal Reserve System (Board or Federal Reserve), the Comptroller of the Currency, the Director of the Office of Thrift Supervision, and the Secretary of Housing and Urban Development (HUD), has broad authority to set the terms and conditions of purchases made by the TARP, including the hiring of staff and outside advisors and firms[1] to assist with the TARP's operations. Within the earlier of two business days after the Secretary exercises his authority to purchase troubled assets or 45 days from enactment of the Act, the Secretary must publish program guidelines describing the 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. The Secretary must also issue guidelines regarding potential conflicts of interest arising out of the administration of the Act; interim regulations addressing this topic were released by the Secretary on October 6, 2008. The Secretary may also issue other regulations and guidance as deemed necessary in carrying out the purposes of this Act, but there is no timeline in the Act for the implementation of such additional regulations and guidance. The Secretary is authorized to make acquisitions under the program until December 31, 2009, although the Secretary may extend that period until October 3, 2010—two years from the passage of the Act—by certifying to Congress that it is necessary to do so. The TARP's power to hold, manage, and divest itself of the assets it acquires during this period, however, does not expire.

1 The Secretary has already posted solicitations for financial agents to perform, among other things, custodian, accounting, auction management, and securities and whole loan asset management services on behalf of the TARP. For further information, please refer to the Arnold & Porter LLP Client Advisory entitled "Issues in Contracting Under the Emergency Economic Stabilization Act of 2008," available on our website, http://arnoldporter.com/resources/documents/CA_IssuesInContractingUnderTheEmergency_100708.pdf

The Act allocates, in three tranches, US$700 billion for use by the Secretary to purchase troubled assets through the TARP. Initially, the Secretary is authorized to purchase up to US$250 billion in troubled assets, but by Presidential certification that amount may be increased to US$350 billion. To access the full US$700 billion authorized under the Act, the President must submit to Congress a written report detailing the Secretary's plan to use the additional funds, and Congress then has 15 days to refuse the request. These dollar limits on the TARP's purchase authority, moreover, apply only to the amount of expenditures outstanding at any one time. In order to avoid unjustly enriching parties that sell assets to the TARP, the Secretary may not purchase troubled assets at a price that is higher than the price paid by the seller to acquire the assets being sold. To the extent the activities conducted pursuant to the Act generate revenue, that revenue must be used to reduce the national debt. If, however, five years from the passage of the Act taxpayers are projected to suffer any losses as a result of the TARP, the President must submit to Congress a legislative proposal to recoup those losses from the financial services industry, thereby making the plan, at least facially, cost-neutral with respect to taxpayer funds. No specific guidance is provided in the Act as to how such a recoupment plan might be structured.

TROUBLED ASSETS INSURANCE FINANCING FUND

If the Secretary establishes the TARP, he must also create a Troubled Assets Insurance Financing Fund, the purpose of which shall be to guarantee troubled assets originated or issued prior to March 14, 2008, including mortgage-backed securities. Such a fund may guarantee the payment of up to 100% of the principal and interest due with respect to troubled assets. As with the TARP, the Secretary has broad power to structure this guaranty program as he sees fit, although the Act directs that premiums assessed on financial institutions participating in this program are to be risk-based and set such that the resulting reserves are sufficient to meet anticipated claims, thereby protecting taxpayers. The difference between the total amount of

outstanding obligations guaranteed by this insurance plan and the balance in the Troubled Assets Insurance Financing Fund is deducted from the funds authorized to be spent by the TARP. Although the Act contains no specific requirement that regulations be drafted with respect to the creation of this insurance fund, the Secretary will presumably use the Act's general authority to issue regulations, discussed above, to promulgate any necessary guidance. As with the TARP, the Secretary's authority to enter into guaranty agreements through this insurance fund expires at the end of 2009, unless the Secretary chooses to extend that period until October 3, 2010.

CONSIDERATIONS IN EXERCISING AUTHORITY UNDER THE ACT

In exercising his authority under the Act, the Secretary's primary goal is to inject liquidity into and provide stability to the financial system. Although the means of achieving these goals are left largely to the Secretary's discretion, the Act instructs him to take numerous factors into consideration in establishing and operating the programs authorized by the Act. These factors include protecting the interests of the taxpayers, protecting American jobs and savings, keeping families in their homes, assisting financial institutions of all types and sizes and those institutions that serve low- and moderate-income communities (while also considering such institutions' long-term viability), and safeguarding retirement assets, among other things.

In minimizing costs and maximizing returns to the taxpayers, the Secretary is instructed to obtain warrants or senior debt instruments from most financial institutions whose troubled assets are purchased in the TARP. In the case of a publicly traded financial institution, the Secretary may not purchase any troubled assets under the TARP unless the Secretary receives a warrant giving the government the right to receive nonvoting common stock or preferred stock, or voting stock if the Secretary agrees not to exercise voting power. In the case of a non-publicly traded financial institution, the Secretary must receive a warrant for common stock, preferred stock, or a senior debt instrument in exchange for the TARP's purchase of assets from the institution. Any warrant or debt instrument received by the Secretary must provide a reasonable opportunity for positive returns to the taxpayer through equity appreciation or interest payments. In addition, the debt and equity instruments received by the Secretary must include anti-dilution and other protective provisions in order to safeguard the value of the taxpayers' investment. In promulgating regulations governing the operation of the TARP, the Secretary must establish a *de minimis* exception to this warrant requirement such that institutions that sell assets to the TARP in an aggregate amount less than the *de minimis* amount, which may not exceed US$100 million, do not need to provide warrants or debt instruments to the Secretary. For entities that may be prohibited by applicable law from issuing warrants or debt instruments as required by the Act, the Secretary is instructed to establish alternative arrangements designed to provide similar protections to the taxpayers.

The Secretary is also directed to encourage the private sector to participate in purchasing troubled assets and to invest in financial institutions, in furtherance of the Act's goals of minimizing long-term costs and maximizing benefits for taxpayers.

Although the Act, in many respects, instructs the Secretary to manage the TARP as if it were a for-profit enterprise, it also uses the opportunity of direct government ownership of subprime assets to accomplish what many in Congress have felt has not been adequately addressed by the private sector--namely, mortgage foreclosure mitigation efforts. The Act strengthens and expands eligibility in the "HOPE for Homeowners Program" and directs the Secretary to "maximize assistance for homeowners" and to encourage private servicers to take advantage of the HOPE and similar programs. In addition to working with servicers, the Secretary is encouraged to consent to reasonable loan modification requests, such as term extensions, rate reductions, and principal write-downs with respect to assets owned by the TARP. The Secretary is also instructed to coordinate his efforts with other government entities that hold troubled

assets, such as the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve, the Federal Housing Finance Agency (FHFA), and HUD. In turn, the FHFA (in its capacity as conservator for Freddie Mac and Fannie Mae), the FDIC (with respect to any bridge banks it creates in its capacity as receiver of a failed bank), and the Federal Reserve (with respect to mortgage backed securities or similar assets held by it) are directed to take many of these same homeowner-assistance steps in their own right and to consult with each other in doing so.

To ensure market transparency, the Secretary is required to make available to the public details of the types, amounts, and pricing of assets acquired under the Act within two business days of purchase, trade, or other disposition. Although the Act is not clear on this point, presumably these disclosures will include the identity of the parties to the transactions. The Secretary also must determine whether the public disclosure required of each financial institution that sells troubled assets to the TARP provides the public with sufficient information as to the true financial position of the institution, and the Secretary must recommend additional disclosure requirements as appropriate.

OVERSIGHT AND REPORTING

To ensure effective supervision and oversight, the Act establishes a number of oversight boards. First, the Financial Stability Oversight Board ("FSOB") is created and charged with making certain that the policies implemented under the Act protect taxpayers and are in the economic interests of the United States. The FSOB is comprised of the Chairman of the Federal Reserve, the FHFA Director, the Chairman of the US Securities and Exchange Commission (SEC), the Secretary of HUD, and the Secretary. Second, a Congressional Oversight Panel (Oversight Panel) is established to review the state of the financial markets, the regulatory system, and the Secretary's use of authority under the Act. The Oversight Panel is required to report to Congress every 30 days and to submit a special report on regulatory reform prior to January 20, 2009. Third, an Office of the Special Inspector General for the TARP is created to conduct, supervise, and coordinate audits and investigations of the actions undertaken by the Secretary pursuant to the Act.

The Act imposes various reporting requirements on the Secretary, including periodic reports of the Secretary's actions under the TARP. In particular, the Secretary must begin making monthly reports to Congress on the TARP's activities within 60 days of first exercising authority under the Act. In addition, the Secretary must provide to Congress a detailed accounting and explanation of TARP transactions following each US$50 billion of assets purchased. The Secretary must make available to the Congressional Budget Office (CBO) information on the activities conducted pursuant to the Act to facilitate the preparation by the CBO of periodic reports to Congress mandated under the Act. The Act also requires the Comptroller General of the United States to conduct ongoing oversight of the activities of the TARP, to provide a report every 60 days to Congress, and to conduct an annual audit of the TARP, as well as to undertake a study to determine the extent to which leverage and sudden deleveraging of financial institutions was a factor behind the current financial crisis.

The Secretary's actions are subject to limited judicial review to ensure that the Secretary's actions are not arbitrary, capricious, or an abuse of discretion, and to ensure that the Secretary's actions are in accordance with the law. The scope of this judicial review is restricted by various provisions in the Act, including limitations on the availability of injunctive relief and the timing of temporary restraining orders against the Secretary pursuant to the Secretary's actions taken under to the Act. In addition, any participant who sells assets to the TARP may not bring claims or actions against the Secretary unless the Secretary's actions are unlawful and are set aside because they are arbitrary or capricious, unless such claim or action is expressly authorized in a written contract between the participant and the Secretary.

OTHER PROVISIONS AFFECTING FINANCIAL INSTITUTIONS

Executive Compensation and Corporate Governance. The Secretary is required to issue rules governing executive compensation and corporate governance at financial institutions whose assets are purchased by the TARP. These rules must address and limit senior executive compensation incentives, including golden parachute payments. Additionally, financial institutions that sell assets in the TARP above certain thresholds face less favorable tax treatment of certain executive compensation payments.

Gain or Loss from Sale or Exchange of Government Sponsored Enterprise Preferred Stock. The Act enhances the ability of financial institutions to recognize losses on the sale of preferred stock issued by Fannie Mae and Freddie Mac by recharacterizing such losses as ordinary, rather than capital, losses.

Tax Treatment of Cancelled Mortgage Debt. The Act extends the current forgiveness for tax-law purposes of cancelled mortgage debt on primary residences.

FDIC Insurance Enhancement. The Act raises the standard maximum federal deposit insurance amount from US$100,000 to US$250,000 for banks, thrifts, and credit unions through December 31, 2009, temporarily matching the insurance level of individual retirement accounts under the Federal Deposit Insurance Act. To ensure this additional coverage, the Act temporarily raises the borrowing limits at the Treasury for the FDIC and the National Credit Union Administration (NCUA). This temporary increase in the standard maximum deposit insurance amount may not be used by the FDIC or the NCUA to increase insurance assessments charged to depository institutions.

Federal Deposit Insurance Act Enforcement Enhancement. The Act amends the Federal Deposit Insurance Act to prohibit false advertising and misuse of the FDIC's name and to prohibit misrepresentations of insured status. The Act grants enforcement authority to the appropriate Federal banking agency for each violation. If the appropriate Federal banking agency fails to take an enforcement action within 30 days of a recommendation by the FDIC, the FDIC may take the recommended enforcement action itself.

Federal Reserve Report on Exercise of Loan Authority. The Act requires the Federal Reserve to provide a detailed report to Congress promptly after exercising its emergency lending authority under Section 13(3) of the Federal Reserve Act. Under that section, in unusual and exigent circumstances, the Board may authorize any Federal Reserve Bank to make loans to any individual, partnership, or corporation that demonstrates to the Federal Reserve Bank's satisfaction that it is unable to secure adequate credit elsewhere. The report to Congress must include the Board's justification for exercising its authority under Section 13(3) and the specific terms of the actions, including the size and duration of the lending, available information concerning the value of any collateral held with respect to such a loan, the receipt of warrants or any other potential equity in exchange for the loan, and any expected cost to the taxpayers. Every 60 days that a loan is outstanding, the Board must update Congress on the status of the loan, the value of the collateral, and the projected cost to the taxpayers.

Reimbursement of Exchange Stabilization Fund. The Secretary is required to reimburse the Exchange Stabilization Fund established under Section 5302 of Title 31 to protect it from losses due to the recently extended temporary money market fund guaranty that the President authorized on September 19, 2008. Moreover, the Secretary is prohibited from using the fund in order to establish any future similar guaranty programs for the money market fund industry.

Treatment of Mark-to-Market Accounting. The Act restates the SEC's authority to suspend mark-to-market accounting as provided in Statement Number 157 (FAS 157) of the Financial Accounting Standards Board (FASB) if the SEC determines that to do so is in the public interest and protects investors. The Act also requires the SEC, in consultation with the Federal Reserve and the Secretary, to conduct a study on mark-to-market accounting standards as

provided in FAS 157 and to report its findings to Congress within 90 days of the enactment of the Act. The report must include the effects of mark-to-market accounting on balance sheets, its impact on the quality of financial information, the process used by FASB in developing accounting standards, the advisability and feasibility of modification to such standards, and alternatives to the mark-to-market accounting standard.

We hope that you have found this client advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

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