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Global Finance Group Client Alert

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Treasury Guidelines Expected to Answer Open Questions

Guidelines and interim final rules that will be released by the Treasury Department over the next days and weeks are expected to answer a number of critical open questions about the Troubled Assets Relief Program (“TARP”) that was authorized by the Emergency Economic Stabilization Act of 2008 (“EESA”). These questions include:

1. How will Treasury price the purchase of eligible assets. Treasury is authorized under TARP to purchase residential or commercial mortgages, and other instruments based on or related to such mortgages. TARP leaves considerable discretion to Treasury as to how such assets will be purchased: we know only that Treasury (i) must “make such purchases at the lowest price that the Secretary determines to be consistent with the purposes of this Act,” (ii) must pursue methods, in the case of a purchase directly from a financial institution, that ensure that “prices paid for assets are reasonable and reflect the underlying value of the asset,” and (iii) must “take such steps as are necessary to prevent unjust enrichment” of financial institutions participating in TARP, “including by preventing the sale of a troubled asset . . . at a higher price than what the seller paid to purchase the asset.” Treasury is directed to “maximize the efficiency of the use of taxpayer resources by using market mechanisms, including auctions or reverse auctions, where appropriate” (in reverse auctions, financial institutions would bid to sell assets to Treasury and Treasury would buy them at the lowest offered price).
 - a. What will be the scope and methodology of any auction alternative adopted by Treasury?
 - b. Will Treasury designate asset classes to be grouped together? Will it favor the purchase of mortgages over the purchase of securities based on those mortgages? Will direct sales be pursued only where an auction process is impractical?
 - c. Will third parties be authorized to participate as purchasers in auctions of troubled assets? EESA directs Treasury to “encourage the private sector to participate in purchases of troubled assets.”

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Structured Finance Group, whose names and contact information are provided herein.

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2. What institutions will qualify as eligible financial institutions? EESA's definition of financial institution -- the institutions eligible to participate in TARP -- is an illustrative one and includes "any bank, savings association, credit union, security broker or dealer, or insurance company" that is "established and regulated" under the laws of the United States or any state and that has "significant operations in the United States." The definition leaves room for Treasury to include other institutions not specified in the EESA. Open questions include:
 - a. Will non-bank institutions such as private investment funds and special-purpose vehicles, and non-bank subsidiaries of bank holding companies, be eligible to participate in TARP?
 - b. Will U.S. branches and agencies of foreign banks be eligible participants in TARP?
 - c. Will Cayman branches of U.S. and foreign banks be eligible participants where these branches are managed by a U.S. branch of the bank?
 - d. To what extent may an institution be owned by a foreign government without being disqualified as an eligible participant? Would an exception be made for an institution that has been the subject of a recent rescue effort by its home country government?
3. What assets will qualify as eligible assets? EESA authorizes the Treasury to purchase certain residential and commercial mortgages and "any securities, obligations or other instruments" that are "based on" or are "related to" such mortgages. In each case, the mortgage or other instrument must have been issued before March 14, 2008 and the purchase must be determined by the Secretary to "promote[] financial market stability." The Secretary is also authorized to purchase "any other financial instrument" based on the same determination.
 - a. To what extent might Treasury adopt a broad reading of "other instruments" based on or related to . . . mortgages" to include assets other than collateralized mortgage obligations, such as credit default swaps or other derivatives?
 - b. May eligible assets be moved from an ineligible affiliate to an eligible participating financial institution for sale to Treasury? Would it make a difference if the assets had been originated by an eligible participant and booked at the affiliate simply for tax or reserve reasons? Would it make a difference if the transfer were from a non-U.S. affiliate of a foreign bank to a eligible U.S. branch of that foreign bank? Does the requirement that Treasury adopt measures to prevent unjust enrichment of the participants suggest that any such transferred assets should be ineligible?
 - c. On the assumption that such transfers would otherwise be permitted by Treasury, would such transfers to U.S. bank participants be restricted by limits on purchases of assets by U.S. banks from affiliates in section 23A of the Federal Reserve Act, including prohibitions on transfers of low-quality assets (note that similar restrictions may not apply in the case of transfers to U.S. branches of foreign banks).
4. To what extent will Treasury promote TARP's guarantee program as an alternative to outright purchases of eligible assets? Treasury is directed to establish a program to guarantee up to 100 percent of the principal and interest of an eligible asset and is authorized to charge premiums for these guarantees. Because this provision was added at a late stage in the Congressional negotiations of the EESA it is unclear how the guarantee program will be integrated with other elements of TARP.
 - a. On what basis will premiums be charged to participants?

- b. Will participants in the guarantee program be subject to the executive-compensation provisions of EESA?
 - c. Will participants in the guarantee program be required to sell Treasury equity in their institutions?
5. How will curbs on executive compensation be applied in particular cases? EESA applies two types of restrictions on executive compensation to financial institutions that participate in direct sales of eligible assets to the Treasury under TARP. One limits and provides for “clawbacks” of the incentive compensation and golden parachutes received by senior executive offices of the participant. A second limits the extent to which the participant may deduct as a business expense the compensation of its senior executives. Treasury is in any case required to prohibit any institution from which it purchases more than \$300 million (including direct purchases) in assets in an auction from making golden parachutes available to its senior executives.
- a. If the participant is a subsidiary of a listed company, will the executive compensation limits be applied to the executive officers of the parent or of the participant?
 - b. Will the executive compensation limits be applied to the executive officers of the head offices of eligible branches and agencies of foreign banks or only to the senior executives of the branch or agency?
6. How will equity stakes be acquired by Treasury in participating institutions? EESA requires that Treasury acquire from any publicly listed institution that sells assets to TARP a warrant to acquire non-voting shares, preferred shares or voting shares that it agrees not to vote. In the case of a purchase from a non-publicly listed participant, Treasury may, in addition, acquire “a senior debt instrument.”
- a. If the participant is a subsidiary of a listed company, may or must the Treasury acquire its warrants from the listed parent?
 - b. If the participant is a subsidiary or branch of a foreign bank, will the requirement apply and, if so, will the warrant be issued by the foreign bank? What will be the effect if any of foreign law governing the issuance of such instruments?
 - c. What is intended by the reference to “a senior debt instrument.” If equity is permissible, why wouldn’t subordinated debt be permissible?
 - d. What factors will Treasury use to determine how much of an institution’s equity or debt will be subject to the warrants (e.g., price or amount of assets acquired, state of institution’s existing capital)?

Other provisions of EESA set in motion longer-term regulatory actions that could significantly affect the U.S. financial industry and which also pose questions that have yet to be answered. These provisions include a mandated report due by April 30, 2009 from Treasury on the effectiveness of the current regulatory system in overseeing participants in the financial markets, including the OTC swaps market. The Securities and Exchange Commission is charged with completing a study (together with recommendations) within 90 days of enactment of EESA on the application to financial institutions of mark-to-market accounting standards.

We will continue to keep track of the implementation of TARP and will distribute updates to this Client Alert periodically.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Global Finance Group, whose names and contact information are provided below.

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