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Clients&FriendsMemo

The Public-Private Investment Program; Treasury's Plan to Cleanse Legacy Assets from Banks' Balance Sheets

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Introduction

Earlier this week, the U.S. Department of the Treasury ("**Treasury**") released details on one of the key elements of the Obama Administration's Financial Stability Plan: the Public-Private Investment Program.[1] Building on a concept originally announced together with several other initiatives as part of the government's "full arsenal" approach to dealing with the financial crisis, the Public-Private Investment Program is designed to provide a means for banks and other financial institutions to cleanse their balance sheets of "legacy" assets and resume lending activity to bring much needed leverage to the credit-starved economy. The program is comprised of three components:

(i) the "**Legacy Securities Program**";

(ii) the expansion of the Federal Reserve's Term Asset-Backed Securities Loan Facility ("**TALF**") to permit financing of certain legacy residential mortgage-backed securities ("**RMBS**"), commercial mortgage-backed securities ("**CMBS**") and other qualifying asset-backed securities ("**ABS**"); and

(iii) the "**Legacy Loans Program**".

Contrary to the markets' negative reception for Treasury Secretary Geithner's announcement on February 10, 2008 of the general Financial Stability Plan (when the Dow Jones Industrial Average

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[1] For information on the Public-Private Investment Program, see http://www.financialstability.gov. For a fact sheet describing the Public-Private Investment Program, *see* http://www.treas.gov/press/releases/reports/ppip_fact_sheet.pdf. For a white paper on the Public-Private Investment Program, *see* http://www.treas.gov/press/releases/reports/ppip_whitepaper_032309.pdf. For the Legacy Securities Program Summary of Terms, *see* http://www.treas.gov/press/releases/reports/legacy_securities_terms.pdf. For the Legacy Securities Program FAQs, *see* http://www.treas.gov/press/releases/reports/legacy_securities_faqs.pdf. For the Legacy Securities Program Fund Manager Application, *see* http://www.treas.gov/press/releases/reports/legacy_securities_ppif_app.pdf. For the Legacy Loans Program Summary of Terms, *see* http://www.treas.gov/press/releases/reports/legacy_loans_terms.pdf. For the Legacy Loans FAQs, *see* http://www.treas.gov/press/releases/reports/legacy_loans_faqs.pdf.

fell over 380 points), the stock market's nearly 500 point rally following the release of details on the Public-Private Investment Program this week seems to indicate a higher level of optimism for the success of this particular program. However, important details of the program have yet to be disclosed, and those details may determine its success or failure. This memo will provide a brief summary of key elements of the Public-Private Investment Program, as well as some questions and concerns that need to be addressed in order for the program to fully achieve its goals.

Legacy Securities Program, Including Expansion of TALF to Legacy Securities

The Public-Private Investment Program contains two elements designed to help banks and other financial institutions sell certain legacy securities: (i) Treasury will co-invest with, and provide debt financing to, private investors to establish public-private investment funds to invest in certain legacy securities ("**Legacy Securities PPIFs**") and (ii) expansion of the TALF to permit certain legacy RMBS, CMBS and other qualifying ABS to be pledged as collateral for Federal Reserve financing.

Legacy Securities PPIFs

Legacy Securities PPIFs are investment funds established by private fund managers to invest in eligible legacy securities on behalf of Treasury and private investors. The Legacy Securities PPIFs will have two sources of capital: (i) equity capital to be contributed by Treasury and private investors and (ii) debt financing through Treasury, as well as access to loans available under the TALF (and potentially other private sources of leverage).

Pre-Qualification of Fund Managers. Treasury expects to approve approximately five private fund managers to establish and manage Legacy Securities PPIFs. Treasury will consider increasing the number of fund managers based on an evaluation of applications received and its determination of what is in the best interests of the taxpayers. Fund managers will be pre-qualified based upon criteria anticipated to include:

- 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 in a manner to generate attractive returns through predominantly a long-term buy-and-hold strategy; and
- Headquartered in the U.S.

Prospective fund managers must submit applications[2] to Treasury by April 10, 2009. Treasury expects to inform an applicant of its preliminary approval on or prior to May 1, 2009. Applicants will be asked to describe the amount of time they anticipate needing, and their plan, to raise private capital. Applicants will have a limited time from preliminary approval to raise at least $500 million and demonstrate committed capital before receiving final approval from Treasury.

Eligible Assets. Securities eligible to be purchased by Legacy Securities PPIFs are initially limited to CMBS and RMBS:

- issued prior to 2009;
- originally rated "AAA" or the equivalent, without giving effect to ratings enhancement, by two or more rating agencies;
- secured directly by mortgage loans, leases or other assets, but *NOT* other securities (other than certain swap positions, as determined by Treasury) – thus, CDOs, resecuritizations and synthetic RMBS and CMBS are not eligible; and
- the underlying assets of which must be situated predominantly in the United States (which limitation is subject to further clarification by Treasury).

Eligible Sellers. Eligible securities may be purchased solely from:

- "financial institutions"[3] from whom Treasury may purchase troubled assets under the Emergency Economic Stabilization Act of 2008 ("**EESA**"); and
- sellers that are not (i) affiliates of the fund manager of the related Legacy Securities PPIF or any private investor that has committed at least 10% of the aggregate private capital raised by such fund manager, or (ii) fund managers for other Legacy Securities PPIFs, or their respective affiliates.

Legacy Securities PPIF Structure Generally. Treasury will consider suggestions on specific structures received from fund managers. Generally, Treasury and a vehicle (a "**Private Vehicle**") controlled by the fund manager will be the sole equity investors in Legacy Securities PPIF. Private investors will indirectly invest in the Legacy Securities PPIF through investments in the Private Vehicle.

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2 Application is available at http://www.treas.gov/press/releases/reports/legacy_securities_ppif_app.pdf.

3 "Financial institutions" under EESA means any institution, including, but not limited to, any bank, savings association, credit union, security broker or dealer, or insurance company, established and regulated under the laws of the United States or any State, territory, or possession of the United States, the District of Columbia, Commonwealth of Puerto Rico, Commonwealth of Northern Mariana Islands, Guam, American Samoa, or the United States Virgin Islands, and having significant operations in the United States, but excluding any central bank of, or institution owned by, a foreign government.

Term of Legacy Securities PPIF. Fund managers will make proposals for the term of the Legacy Securities PPIF, which cannot be longer than 10 years, subject to extension by Treasury.

Eligible Private Investors. Based on the materials released by Treasury, there do not appear to be any restrictions on who may be a private investor in the Private Vehicles. Treasury anticipates that Private Vehicles will be structured so that ERISA plan investors will be eligible to invest. Treasury also indicated that it would consider suggestions from fund managers to raise equity capital, through the Private Vehicles, from retail investors.

Equity Investments. Fund managers will raise equity capital from private investors and Treasury will match such equity capital raised. Treasury and the Private Vehicle will invest in and divest the eligible assets of the related Legacy Securities PPIF proportionately at the same time and on the same terms and conditions. Treasury and the Private Vehicle will generally share any profits or losses in the related Legacy Securities PPIF on a *pro rata* basis, in accordance with equity capital investments, subject to Treasury's right to receive warrants.[4]

Debt Financing. Each fund manager will have the option to obtain for each Legacy Securities PPIF non-recourse loans from Treasury secured by the eligible assets in an aggregate amount up to 50% of the Legacy Securities PPIF's total equity capital, provided that the private investors in the Private Vehicle do not have voluntary withdrawal rights. Treasury will consider requests for additional financing of up to 100% of total equity capital, subject to restrictions on asset level leverage, withdrawal rights, disposition priorities and other factors Treasury deems relevant.

Treasury loans will:

- have the same term as the Legacy Securities PPIF;
- be repaid on a *pro rata* basis as principal repayments or disposition proceeds are realized by the Legacy Securities PPIF;
- accrue interest at an annual rate to be determined by the Treasury;
- be payable in full upon termination of the Legacy Securities PPIF; and
- be structurally subordinated to any financing extended by the Federal Reserve to the Legacy Securities PPIF via the TALF.

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4 The materials released by Treasury state that Treasury will take warrants as required by EESA, but no further details are provided.

In addition to the Treasury loans, Legacy Securities PPIFs may also finance the purchase of eligible assets through the TALF (as discussed below), any other Treasury program or debt financing raised from private sources, provided that the Treasury equity capital and the Private Vehicle equity capital must be leveraged proportionately from such private debt financing sources.

Drawdowns. Legacy Securities PPIFs may draw down Treasury equity capital in tranches to provide for anticipated investments (subject to limitations to be agreed with Treasury). Treasury equity capital may only be drawn down at the same time and in the same proportion as private capital is drawn down. In addition, debt financing must also be funded concurrently with drawdowns of equity commitments.

Treasury will have the right, in its sole discretion, to cease funding of committed but undrawn Treasury equity capital and debt financing.

Withdrawal Rights of Private Investors. Private investors may be given voluntary withdrawal rights at the Private Vehicle level, subject to certain limitations to be agreed with Treasury, including that no voluntary withdrawal is permitted prior to three years after the first investment by the Private Vehicle in the Legacy Securities PPIF.

Fees. Fund managers may charge private investors in the Private Vehicle fees in their discretion. Treasury will accept proposals to be charged fixed management fees, which must be based on a percentage of the equity capital contributions invested in the Legacy Securities PPIF by the Treasury. Management fees payable by Treasury, as well as Treasury's share of the Legacy Securities PPIF's expenses will be paid solely out of distributions on the Treasury's equity capital.

Any fees paid to a fund manager or its affiliates in connection with a Legacy Securities PPIF, other than management fees payable by Treasury and management or incentive fees charged to private investors, must accrue to the benefit of Treasury and private investors on a pari passu basis based on their equity capital commitments.

<u>Governance and Management</u>. The Legacy Securities PPIFs will be managed by the fund managers, not Treasury. Fund managers will have control of asset selection, pricing, and asset liquidation, trading and disposition responsibilities, although fund managers are expected to follow a predominantly long-term buy-and-hold strategy. Treasury expects to define the final terms and conditions for specific Legacy Securities PPIFs prior to fundraising.

Fund managers must:

- provide monthly reports to Treasury detailing eligible assets bought and sold, current valuations of eligible assets and profits/losses on eligible assets;
- determine asset prices of eligible assets using third-party sources;
- have annual audited valuations performed by a nationally recognized accounting firm;
- not inform private investors of potential acquisitions of specific eligible assets prior to acquisition;
- agree to waste, fraud and abuse protections to be defined by Treasury; and
- agree to provide access to relevant books and records of the Legacy Securities PPIF to Treasury, the Government Accountability Office and their respective advisors and representatives.

Executive Compensation Restrictions. Based on the materials provided by Treasury describing the Legacy Securities PPIF program, the executive compensation restrictions set forth in Section 111(b) of the EESA will not apply to "passive" private investors.[5]

[5] *See* Legacy Securities Public-Private Investment Funds ("PPIFs") Frequently Asked Questions, at 3, available at http://www.treas.gov/press/releases/reports/legacy_securities_faqs.pdf.

In its release, Treasury provided the following example of a sample investment in a Legacy Securities PPIF[6]:

Sample Investment Under the Legacy Securities Program

Step 1: Treasury will launch the application process for managers interested in the Legacy Securities Program.

Step 2: A fund manager submits a proposal and is pre-qualified to raise private capital to participate in joint investment programs with Treasury.

Step 3: The Government agrees to provide a one-for-one match for every dollar of private capital that the fund manager raises and to provide fund-level leverage for the proposed Legacy Securities PPIF.

Step 4: The fund manager commences the sales process for the investment fund and is able to raise $100 of private capital for the fund. Treasury provides $100 equity co-investment on a side-by-side basis with private capital and will provide a $100 loan to the Legacy Securities PPIF. Treasury will also consider requests from the fund manager for an additional loan of up to $100 to the fund.

Step 5: As a result, the fund manager has $300 (or, in some cases, up to $400) in total capital and commences a purchase program for targeted securities.

Step 6: The fund manager has full discretion in investment decisions, although it will predominately follow a long-term buy-and-hold strategy. The Legacy Securities PPIF, if the fund manager so determines, would also be eligible to take advantage of the expanded TALF program for legacy securities when it is launched.

6 *See* Public-Private Investment Program Fact Sheet, at 5, available at http://www.treas.gov/press/releases/reports/ppip_fact_sheet.pdf.

Expansion of the TALF to Legacy Securities

Under the current version of the TALF, the Federal Reserve provides non-recourse financing to investors in certain types of ABS backed by newly and recently originated loans and receivables.[7] However, in order to address the "broken" market for legacy securitization assets tied to residential real estate, commercial real estate, and consumer credit, the Federal Reserve and Treasury are expanding the availability of the TALF to include such legacy assets.

The expanded list of eligible assets is expected to include certain:

- non-agency RMBS that were originally rated AAA;
- CMBS currently rated AAA; and
- ABS currently rated AAA.

Specific terms for the new TALF loans, such as haircuts, lending rates, minimum loan sizes and loan durations, have not been released yet. However, it is expected that the duration of TALF loans for the legacy eligible assets will take into account the duration of the underlying assets.

As discussed above, a fund manager under a Legacy Securities PPIF may elect to finance the purchase of eligible assets through the TALF and thereby increase the leverage available to such Legacy Securities PPIF.

Executive compensation restrictions set forth in Section 111(b) of the EESA do not apply under the TALF program.

[7] For information on the TALF, see *Understanding the Term Asset-Backed Securities Loan Facility ("TALF")*, available at, http://www.cwt.com/assets/client_friend/032709UnderstandingTALF_Update.pdf.

Legacy Loans Program

Under the Legacy Loans Program, the FDIC will oversee the formation, funding and operation of multiple public-private investment funds ("**Legacy Loans PPIFs**") that will purchase pools of certain eligible loans and other assets from insured U.S. banks and U.S. savings associations. The Legacy Loans PPIFs will be funded by equity co-investments from private investors and the Treasury, and will obtain additional funding by issuing debt guaranteed by the FDIC.

Eligible Sellers. Sellers eligible to sell loans to Legacy Loans PPIFs are limited to any insured U.S. bank or U.S. savings association, as determined by the FDIC and Treasury.[8] Banks or savings associations owned or controlled by foreign banks or companies are not eligible.

Eligible Assets. Eligible assets include pools of loans and other assets situated predominantly in the United States. The FDIC has said that the initial focus of the Legacy Loans Program will be residential and commercial mortgage loans, but they will explore expanding eligibility to include consumer loans and possibly REO properties.

Eligible Private Investors. Private investors eligible to invest in Legacy Loans PPIFs are expected to include financial institutions, individuals, insurance companies, mutual funds, publicly managed investment funds and pension funds.

- Private investors may not participate in any Legacy Loans PPIF that purchases assets from sellers that are affiliates of such investors or that represent 10% or more of the aggregate private capital in the Legacy Loans PPIF.
- Groups of private investors must be approved by the FDIC, and cooperation between private investor groups will be prohibited once the auction process begins.

Asset Purchases and Pricing. Banks interested in participating in the program must identify a pool of eligible assets to sell and then contact the FDIC. The contemplated pool must meet certain minimum requirements to be determined by the FDIC and Treasury. The FDIC will oversee initial due diligence of the eligible assets and preparation of required marketing materials. The FDIC will then obtain a third-party valuation of the pool of eligible assets, establish and disclose financing terms and leverage ratios to potential investors and conduct the auction. The FDIC will review the received bids and select the winning bid. Bids from private investors must be accompanied by a refundable cash deposit of 5% of the bid value. Once a bid is selected, the selling bank will have the option of accepting or rejecting the bid within a pre-established timeframe.

8 For purposes of this program, "U.S. bank" and "U.S. savings association" mean banks or savings associations organized under the laws of the United States or any State of the United States, the District of Columbia, any territory or possession of the United States, Puerto Rico, Northern Mariana Islands, Guam, American Samoa, or the Virgin Islands.

Legacy Loans PPIF Structure Generally.

Equity Investments. It is initially contemplated that private investors and Treasury will each contribute 50% of the equity in a Legacy Loans PPIF. Alternatives for Treasury capital may be adopted so long as such alternatives do not diminish the collateral protection securing the FDIC guarantee (discussed below) and are capital neutral compared with the currently contemplated investment. Investors can choose to take less Treasury equity subject to a minimum to be determined. Private investors and the Treasury will share profits and losses in proportion to the equity invested, subject to Treasury's right to receive warrants.[9]

Debt Financing. The Legacy Loans PPIF will issue debt guaranteed by the FDIC to fund the acquisition of the eligible assets. The debt will initially be placed with the selling bank. The FDIC guarantee will be collateralized by the assets purchased by each Legacy Loans PPIF. Leverage will be determined on a pool-by-pool basis at the FDIC's sole discretion, with input from a third-party valuation firm. The third-party valuation firm will assess the supportable leverage of the asset pool based on the expected cash flows, type of interest rates, risk of the underlying assets, expected lifetime losses, geographic exposures, maturity profiles and other relevant factors. It is anticipated that the debt to equity ratio will not exceed 6-to-1.

The FDIC is considering the merits of an alternative debt structure. In its request for comment on the Legacy Loans Program issued on March 26, 2009,[10] the FDIC seeks comments from the public on, among other things, what would be the advantages and disadvantages of structuring the program so that instead of issuing a note guaranteed by the FDIC back to the selling bank, the Legacy Loans PPIF issues debt (presumably guaranteed by the FDIC) publicly in order to pay cash to the selling bank. The FDIC also seeks comments on whether a public issuance of debt by the Legacy Loans PPIF would limit its flexibility compared to the issuance of a note to the selling bank.

The Legacy Loans PPIF will be required to maintain a Debt Service Coverage Account ("**DSCA**") to ensure that working capital for each Legacy Loans PPIF is sufficient to meet anticipated debt service obligations, interest expenses and operating expenses. A portion of cash proceeds from the sale of the eligible assets will be retained until cash flow from the eligible assets has fully funded the DSCA, at which point the escrowed cash will be released to the selling bank.

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[9] The materials released by Treasury state that Treasury will take warrants as required by EESA, but no further details are provided.

[10] To view the FDIC's request for comment, *see* http://www.fdic.gov/llp/progdesc.html.

FDIC Fees and Expenses. The FDIC will be reimbursed for all expenses related to auctioning pools of eligible assets. The Legacy Loans PPIFs will pay ongoing administration fees to the FDIC for oversight functions performed by the FDIC.

In exchange for the debt guarantee, the Legacy Loans PPIFs will pay the FDIC an annual guarantee fee based on the outstanding debt balances upon each anniversary of the transaction closing date. A portion of the guarantee fee will be allocated to the FDIC's Deposit Insurance Fund.

Governance and Management. The Legacy Loans PPIFs will be managed by asset managers within parameters pre-established by the FDIC and Treasury and will report to, and be overseen by, the FDIC. Treasury will have no control rights in the Legacy Loans PPIF. Treasury will be responsible for overseeing and managing its equity contributions to the Legacy Loans PPIF. The FDIC will be responsible for overseeing and managing its debt guarantees to the Legacy Loans PPIF.

Sales of loans to Legacy Loans PPIFs will be on a servicing-released basis, but it is contemplated that interim servicing will initially be provided by the selling bank, unless otherwise specified. The Legacy Loans PPIF will retain control of servicing throughout operations, subject to relevant agreements.

It is expected that owner-occupied residential mortgage loans purchased by Legacy Loans PPIFs will become subject to Treasury's Home Affordable Modification Program under the Homeowner Affordability and Stability Plan.[11] If the criteria specified in the Home Affordable Modification Program guidelines are satisfied with respect to a residential mortgage loan purchased by the Legacy Loans PPIF, the servicer will be required to modify such mortgage loan in accordance with the terms of such modification program.

Each Legacy Loans PPIF must agree to waste, fraud and abuse protections in order to protect taxpayers. Each Legacy Loans PPIF must also agree to provide access to information required by the Special Inspector General of the TARP and the Government Accountability Office.

Reservation of Rights. The FDIC and Treasury reserve all rights to modify or withdraw the Legacy Loans Program at any time. The exact requirements and structure of the Legacy Loans Program will be subject to notice and comment rulemaking.

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[11] For information on the Homeowner Affordability and Stability Plan, *see Obama Administration Releases Details of the Homeowner Affordability and Stability Act*, available at, http://www.cwt.com/assets/client_friend/031009HomeownerAffordablityStabilityPlan.pdf.

Executive Compensation Restrictions. Based on the materials provided by the Treasury describing the Legacy Loans Program, the executive compensation restrictions set forth in Section 111(b) of the EESA will not apply to "passive" private investors.[12]

In its release, Treasury provided the following example of a sample investment in a Legacy Loans PPIF[13]:

Sample Investment Under the Legacy Loans Program

Step 1: If a bank has a pool of residential mortgages with $100 face value that it is seeking to divest, the bank would approach the FDIC.

Step 2: The FDIC would determine, according to the above process, that they would be willing to leverage the pool at a 6-to-1 debt-to-equity ratio.

Step 3: The pool would then be auctioned by the FDIC, with several private sector bidders submitting bids. The highest bid from the private sector – in this example, $84 – would be the winner and would form a Legacy Loans PPIF to purchase the pool of mortgages.

Step 4: Of this $84 purchase price, the FDIC would provide guarantees for $72 of financing, leaving $12 of equity.

Step 5: Treasury would then provide 50% of the equity funding required on a side-by-side basis with the investor. In this example, Treasury would invest approximately $6, with the private investor contributing $6.

Step 6: The private investor would then manage the servicing of the asset pool and the timing of its disposition on an ongoing basis – using asset managers approved and subject to oversight by the FDIC.

12 *See* Public-Private Investment Program for Legacy Loans Frequently Asked Questions, at 3, available at, http://www.treas.gov/press/releases/reports/legacy_loans_faqs.pdf.

13 *See* Public-Private Investment Program Fact Sheet, at 4, available at, http://www.treas.gov/press/releases/reports/ppip_fact_sheet.pdf.

Comparison of Public-Private Investment Programs

Structural Feature	Legacy Loans Program	Legacy Securities Program	TALF For Legacy Securities
Type of Investment Vehicle	Legacy Loans PPIF	Legacy Securities PPIF	No specific vehicle required
Eligible Assets	Loans meeting criteria to be established by FDIC	RMBS and CMBS issued prior to 2009 originally rated AAA	RMBS issued prior to 2009 that was originally rated AAA and CMBS and ABS issued prior to 2009 currently rated AAA
Eligible Asset Sellers	Eligible banks (excluding foreign bank subsidiaries)	Eligible financial institutions having significant operations in the U.S. (excluding institutions owned by foreign governments)	Eligible financial institutions having significant operations in the U.S. (excluding institutions owned by foreign governments)
Nature of Treasury's Equity Investment	50% *pari passu* co-investment	50% *pari passu* co-investment	None
Eligible Private Sector Equity Investors	Private sector equity investors may not be affiliated with sellers of legacy securities	No restriction	Not applicable[14]
Nature of Government Debt Financing	FDIC to guarantee vehicle leverage up to 6-to-1 debt-to-equity ratio	U.S. Treasury to provide debt financing equal to 50% (perhaps up to 100%) of total equity capital. Fund may also access TALF for Legacy Securities	Financing available from Federal Reserve under TALF program. Advance rate, term and pricing to be determined
Asset Management	Legacy Loans PPIF managed by private sector manager, subject to FDIC parameters. Loan servicing by selling bank, unless otherwise agreed	Legacy Securities PPIF required to be managed by pre-qualified fund managers selected by Treasury	No specific requirements
Applicability of Executive Compensation Limits	Not applicable to passive investors in Legacy Loans PPIF. Other parties unclear	Not applicable to passive investors in Legacy Securities PPIF. Other parties unclear	Executive Compensation Limits not applicable

[14] There are specific requirements that must be satisfied to be an eligible borrower under the TALF. For information on the TALF, see *Understanding the Term Asset-Backed Securities Loan Facility ("TALF")*, available at, http://www.cwt.com/assets/client_friend/032709UnderstandingTALF_Update.pdf.

Program Limitations and Unresolved Questions

While much thought has been put into the initial release of the Public Private Investment Programs, there are some issues and questions that need to be addressed in order to ensure that the programs will accomplish their stated goals, including the following:

Political Risk. Many potential sellers and managers have expressed concern about the risk of retroactive changes to the rules of the programs. It would be helpful if Treasury and/or FDIC provided some level of comfort to address this risk.

Executive Compensation Limits. The term sheets for both PPIF programs provide that executive compensation restrictions set forth in Section 111(b) of the EESA will not apply to "passive" private investors. Although the Treasury is justifiably concerned about potential abuse and public outcry, this provision will need to be clarified so that managers and asset sellers are clearly aware of the full nature of restrictions that could apply, as certain fund managers could be discouraged from participating if the restrictions were to apply to them. In addition, it is not clear when an investor will be considered "passive" and what the consequences will be for a manager that is also an investor in a PPIF.

Treasury Warrants. The term sheets for both PPIF programs provide that, as required by EESA, Treasury is required to take warrants to protect the interests of taxpayers. The term sheets are silent as to which entity will issue the warrants (although presumably it will be the PPIF) and what the terms and conditions for these warrants will be.

Limitation on the Number of Participating Fund Managers. The Legacy Securities Program is expected to initially involve only five fund managers that are pre-qualified by the Treasury. Although the release provides some guidance as to what the pre-qualification criteria will be, some market participants have questioned whether restricting participation to such a small universe will hinder the stated objective of price discovery.

Treasury Right to Terminate Funding Commitment to Legacy Securities PPIF. Treasury retains the right, in its sole discretion, to cease funding of a committed but yet undrawn portion of its equity capital and debt financing with respect to any Legacy Securities PPIF. This feature will be of concern to fund managers since it can add an element of uncertainty with respect to their ability to meet the target size of a fund and realize the necessary economies of scale to make their involvement profitable. Additional details are necessary to understand under what circumstances Treasury would exercise this discretion.

Private Investor Groups in Legacy Loans Program to be Approved by FDIC. Private investors in the Legacy Loans Program are expected to include financial institutions, insurance companies, mutual funds, pension funds and foreign investors with a headquarters in the United States. However, each private investor group that desires to purchase a pool of loans under the Legacy Loans Program will need to be approved by the FDIC. It remains to be clarified (i) the type of approval process the FDIC will implement in this regard and (ii) whether it is too restrictive to limit private investors to have "headquarters in the United States", to the exclusion of major foreign investors and sovereign wealth funds.

Legacy Loans Program Limited to Sellers that are U.S. Banks. The Legacy Loans Program contemplates the establishment of vehicles to purchase pools of loans from insured U.S. depository institutions, excluding any institutions controlled by foreign banks or companies. Based on the Treasury's materials, it is unclear whether a depository institution can purchase loans from financial institutions or financial companies and then turn around and sell those assets into a Legacy Loans PPIF.

Will Managers Be Able to Sell/Trade? The term sheets for both PPIF programs indicate that the investment strategy to be utilized is predominantly a long-term by-and-hold strategy. Fund managers will likely seek clarification on how limited they will be in their ability to trade. Considering that most of the assets acquired by a PPIF will be at a discount, a slight improvement in market outlook or performance may create opportunities to lock-in a profit.

Restrictions on Withdrawal of Capital. The Legacy Securities Program provides that the availability of Treasury debt financing will be contingent, in part, on a prohibition on the private investors from making withdrawals from the related Private Vehicle. Such a limitation would restrict an investor's liquidity in its investment, which could discourage certain investors from participating in the program. We would expect Treasury to provide more detail on how this restriction will be implemented.

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Please feel free to contact any of the following if you have any questions about this memorandum.

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