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Navigating the Public-Private Partnership Investment Program

On March 23, 2009 the U.S. Department of Treasury ("Treasury"), in conjunction with the Federal Deposit Insurance Company (the "FDIC") and the Federal Reserve (the "Fed"), announced the latest piece of its Financial Stability Plan: the Public-Private Partnership Investment Program for Legacy Assets (the "Program"). The Program consists of two separate plans, addressing two distinct asset groups: the Legacy Loan Program and the Legacy Securities Program. Treasury explained that the exact requirements and structure of the Loan Program will be subject to notice and comment rulemaking, but announced no timetable. On the other hand, the Securities Program requires any interested asset manager to submit by April 10th, an extensive application to serve as a Fund Manager under the Securities Program. Treasury is expected to select five Fund Managers by May 1st. In addition, Treasury expanded the Term Asset-Backed Securities Loan Facility ("TALF") program to include Legacy Securities.

The Legacy Securities Program

The Securities Program, which will be administered by Treasury, involves the creation of public-private investment funds ("PPIFs") to target investments in eligible residential mortgage-backed securities ("RMBS") and commercial mortgage-backed securities ("CMBS") issued before 2009 that originally were rated AAA or the equivalent by two or more nationally recognized statistical rating organizations, without regard to rating enhancements (collectively, "Legacy Securities"). Legacy Securities must be directly secured by actual mortgage loans, leases or other assets, and may be purchased only from financial institutions that meet TARP eligibility requirements. Traditionally, "legacy" meant money or property handed down from an ancestor. Treasury is using the term to mean assets purchased by companies prior to the current economic crisis that are dragging down the earnings of those companies, yet are difficult to sell.

Fund Managers to be Selected

The PPIFs will be managed by private fund managers that are to be selected by Treasury. Prospective Fund Managers will be pre-qualified based on their ability to demonstrate:

- their capacity to raise at least $500 million of private capital,
- their investment experience with Legacy Securities, including thorough performance track records,
- that they have at least $10 billion (current market value) of Legacy Securities presently under management,
- their operational capacity to manage the Funds, and
- that they are headquartered in the United States.

Treasury notes that it plans to select five Fund Managers, or more depending on the quality of applications that are submitted, but Treasury may receive fewer applications than expected because of the requirements and restrictions. Although many asset managers may have $10 billion in assets under management, and some may have $10 billion in mortgage-related assets under management, relatively few have $10 billion of current value in Legacy Securities—that is, RMBS and CMBS that originally were rated AAA—under management. Thus, the field of potential asset managers is limited. Treasury announced that it would encourage small and veteran-, minority- and women-owned private asset managers to become partners with larger asset managers to apply jointly to act as Fund Managers.

Once an entity is selected as a Fund Manager, neither it, nor its affiliates, nor

any private investor that has committed 10% or more of the aggregate private capital raised by the Fund Manager may sell assets to any PPIF created under the Securities Program, including PPIFs created by other Fund Managers. In addition, Treasury's Frequently Asked Questions indicate that the executive compensation restrictions will not apply to *passive* private investors in Legacy Securities PPIFs, thereby implying that these restrictions will apply to Fund Managers. Thus, it remains to be seen how many asset managers will apply to act as Fund Managers under the Securities Program.

Capital Structure and Operation of PPIFs

In their applications to serve as Fund Managers, asset managers must provide a plan for raising funds for the PPIF. Treasury has indicated a desire to include retail investors, if possible. First, the Fund Managers would raise equity capital from private investors, and Treasury would match that equity contribution equally. Treasury's equity capital and the private investors' capital would be invested on a side-by-side basis. Fund Managers also will be permitted to obtain from Treasury secured senior debt in an amount up to 50% of the PPIF's total equity capital, or potentially in a greater amount up to 100%, subject to further restrictions. Moreover, Fund Managers will be able to access funds made available under TALF, which Treasury announced will be expanded to include RMBS and CMBS, though the haircuts, lending rates and other details have not been announced. The senior loans made available under the Securities Program would be subordinated to any TALF loans.

Treasury recognized that equity capital might be drawn down in tranches as the PPIF acquires Eligible Assets, and such a structure is permitted as long as Treasury equity is drawn down at the same time and in the same proportion as private capital. Debt financing, likewise, is intended to be funded concurrently with drawdowns of equity commitments. However, Treasury has reserved the right to cease funding committed but undrawn Treasury equity capital and debt financing in its sole discretion. Because of the pro rata requirements, the Treasury's refusal to fund committed equity capital would presumably release the private investors from their own commitments. Thus, Treasury's right to cease funding effectively provides Treasury with an unfettered ability to end the investment period of a Fund when it so desires.

Fund Managers are expected to follow long-term buy and hold strategies, although Treasury will consider other strategies involving limited trading. This requirement is notable given Treasury's stated objective to provide ongoing secondary market liquidity for these assets, which might otherwise lead to a program encouraging active trading of Legacy Securities. Fund Managers also must agree to waste, fraud and abuse protections, the details of which have not been provided.

Timetable and Application Details for Potential Fund Managers

Clearly, the government wants to move quickly to implement the Securities Program. Potential Fund Managers must submit applications by April 10th. Because of the breadth and scope of the questions in the application, preparing the application will be similar to preparing a private placement memorandum. Treasury is expected to pre-approve Fund Managers by May 1st, whereupon the Fund Managers will need to raise at least $500 million of private equity capital in a "limited amount of time." Prospective Fund Managers must include details of their anticipated timing for fundraising in their applications. Failure to demonstrate committed capital in this timeframe will lead Treasury to consider other applications.

Applicants must provide information showing their business entities, must provide particular details on entities that manage portfolios of Legacy Securities and must describe any structural or ownership changes over the past three years. Information regarding an applicant's personnel is also required, including their relevant expertise, specific details on personnel that currently manage portfolios of Legacy Securities and the names and experience of personnel who will be assigned to manage the Fund. Additionally, applications must contain detailed information regarding the number of funds, accounts or other investment vehicles managed by the applicants and the total assets they have under management, as well as the gross and net returns for these funds. The application also must describe the prospective Fund Manager's oversight framework, potentially giving registered investment advisors an advantage in the process.

Potential Fund Managers must explain their fundraising plans, including the planned amount of private capital to be raised, how long it will take to raise this capital and the expected composition

of the private investor base. Treasury encourages Fund Managers to structure the PPIFs to facilitate the participation of retail investors. This goal raises questions about how retail investors can purchase equity in a PPIF that is in the business of owning Legacy Securities without having to register the PPIF as an investment company under the Investment Company Act of 1940. Registering as an investment company would, among other things, limit the leverage that the PPIF could employ. Another requirement that may make it difficult to include retail investors in a PPIF is that no private investor may have the right to voluntarily withdraw from a PPIF prior to the third anniversary of the first investment (or at any time, if the PPIF uses the available debt financing). Retail investors are likely to be discouraged by such a lockup. The Treasury also expects PPIFs to be structured to accommodate ERISA benefit plan investors, but Treasury did not specify whether and how ERISA's plan assets regulations will apply to investments in the PPIF. Thus, it is not yet clear whether investments by benefit plan investors could be limited to less than 25% of the total value of the PPIF's interests in order to avoid the underlying assets of the PPIF being deemed to constitute plan assets of the benefit plan investor. Because this raises serious fiduciary and potential prohibited transaction issues, the application of ERISA's plan asset regulations will be critical to investments made by benefit plan investors. Moreover, the degree of interest of ERISA investors may be uncertain given the limitation on withdrawal rights. In addition, some cautious tax exempt investors may be reluctant to participate given that proposed legislation, the fate of which is uncertain, would eliminate the tax benefits of the customary offshore feeder fund structure and could subject such investors to "unrelated business taxable income."

Applicants also must provide reference contacts for their three largest limited partners, in the aggregate, that invest in their funds, including names, titles, organizations and phone numbers. This requirement may be problematic for some applicants, particularly if side letters or other fund documents limit the Fund Manager's ability to disclose information about their investors. In what manner Treasury intends to use this information remains to be seen. The application suggests that Treasury may use any information submitted for "any governmental purpose." Additionally, Fund Managers must agree to provide access to relevant books and Fund records for the advisors or representatives of a number of federal entities. Although Treasury is expecting a high degree of transparency from Fund Managers, the reverse does not hold true, at least as far as the application process is concerned. Information provided to an applicant by Treasury may not be disclosed to any third party outside the applicant's corporate organization without prior written consent. Whether this restriction applies to an applicant's outside accounting and legal counsel remains to be seen. These provisions, in addition to the other enhanced reporting requirements, raise questions about whether Fund Managers or their traditional investor base will be interested in participating in the Securities Program.

Fund Managers have the discretion to charge private investors fees, including management and incentive fees, and those proposed fees must be disclosed in the Fund Managers' applications and will be reviewed. It is unclear whether Treasury will consider the fee structure in deciding whether to approve an entity as a Fund Manager. Fund Managers may propose a fixed management fee that Treasury would pay based upon Treasury's invested, not committed, capital. It appears that Treasury may not be charged incentive fees, and an additional consideration is that Treasury fees and its share of a Fund's expenses will be paid solely out of distributions with respect to Treasury equity capital. Treasury will consider all proposed fees when evaluating applications.

Although private investors may be charged higher fees than those charged to Treasury, fund proceeds will be divided between Treasury and the applicable private investors based on equity contributions. Treasury also will take warrants as required by the Emergency Economic Stabilization Act ("EESA"), an element not customarily included in private investment fund structures. Little detail was provided by the Treasury regarding the warrants. How the presence of Treasury's warrants and their dilutive effect and other complicating factors may impact PPIF fundraising remains to be seen. This combination places private investors, which may include retail investors, at a disadvantage as compared to Treasury, which seems to run counter to Treasury's expectation that the applicants include proposals to align the interests of private and public investors.

Expansion of TALF to Legacy Securities

Importantly, in its press release regarding the Legacy Securities Program and the Legacy Loan Program, Treasury also announced an expansion of TALF. Through TALF, non-recourse loans are made to investors who purchase eligible assets. Eligible assets initially included securities backed by consumer assets other than mortgage loans. On March 19th, the Federal Reserve Bank of New York expanded the list of collateral eligible to be pledged under the TALF program to include, among other things, mortgage servicing advance receivables.

And now, the program is available for eligible borrowers who purchase certain Legacy Securities. It appears that not all Legacy Securities will qualify for TALF. Treasury indicated that "certain" RMBS that were originally rated AAA, and outstanding CMBS that *are* rated AAA would be eligible. Borrowers will need to meet eligibility criteria, and it is not clear whether that criteria will be same as the criteria for other assets eligible for TALF funding. Haircuts, lending rates, minimum loan sizes and loan durations will be announced at a later date.

Funding under this expanded TALF program could be used in conjunction with the Securities Program or on its own. Treasury hopes that the program will give investors greater confidence to purchase Legacy Securities, thereby increasing market liquidity.

The Legacy Loan Program

As the name implies, the Loan Program's primary purpose is to facilitate the sale of troubled mortgage loans ("Legacy Loans") by eligible institutions, which include FDIC insured banks and savings associations ("Banks") organized under U.S. laws or the laws of any state or territory of the U.S. Eligible assets may not be strictly limited to loans; however, what constitutes an eligible asset will be determined by participating Banks, their primary regulators, the FDIC and Treasury. Additionally, the Loan Program's requirements and structure will be subject to notice and comment rulemaking, which may take some time to complete.

The Loan Program's basic design, as announced, is to match privately raised equity capital with public equity capital (TARP funds) on a 1:1 basis and to use those funds to purchase Legacy Loans from Banks through PPIFs created by the FDIC for this purpose. Once a Bank or other seller identifies assets to be sold, the FDIC will prepare marketing materials, conduct due diligence, engage a firm to advise about the appropriate leverage (expected not to exceed 6:1 debt-to-equity ratio) and structure the auction. The FDIC will guarantee the debt issued by the PPIFs.

Thus, the FDIC's agent will conduct a bid procedure, pursuant to which pre-qualified investors may bid for the assets identified in the marketing materials. Although Treasury is expected to fund 50% of the equity capital, the bidder may specify a lower percentage. The FDIC selects the highest bid from those who submitted bids in the auction, after which the seller may choose to accept or reject the bid. If the bid is accepted, the transaction is closed. The servicing is managed by an entity identified by the private investors, subject to "rigorous oversight from the FDIC."

To date, Banks and others who own Legacy Loans have been reluctant to sell the Legacy Loans at prevailing market prices, believing that the intrinsic values in the Legacy Loans exceed the market prices. The goal of the Loan Program is to change that dynamic, so that Banks will be willing to sell their assets at prices offered pursuant to these auctions. Before offering assets for sale, a Bank will want to consider what accounting implications might ensue from a low bid that the Bank rejects.

It will be interesting to see whether qualified investors expend the necessary resources to submit bids when selling Banks may reject bids they perceive as too low. Similarly, it will be interesting to see how much pressure the FDIC applies to encourage Banks to accept low bids—particularly bids that are lower than the values the Banks have assigned to those loans on their books—in return for disposing of troublesome assets and improving their capital position.

The requirements of the Loan Program will be subject to notice and comment rulemaking. Whether Banks, private investors, private fund managers and servicers will be able to benefit by participating in the Loan Program will depend in large part on how a number of issues are addressed. Issues include:

- *Eligible Assets*: what assets will be eligible under the Loan Program,
- *Executive Compensation Restrictions:* whether executive compensation restrictions apply

to servicers, managers, and other participants, in that the announcement provided that these restrictions will not apply to *passive* private investors, but was silent regarding other participants,

- *Asset Valuation and Pricing*: what is the process by which third party evaluation firms will determine the value and risk of Legacy Loan pools for purposes of establishing permitted debt- to-equity ratios, and what are the accounting implications of rejecting an offered price,
- *Eligibility Requirements for Investors*: what are the eligibility requirements and approval procedures for private investors,
- *Eligibility Requirements for Asset Managers*: what are the eligibility requirements and approval procedures for asset managers,
- *Financing Terms*: what the debt financing terms will be,
- *Oversight*: how intrusive will "rigorous oversight by the FDIC" of servicers be, and to what waste, fraud and abuse protections must PPIFs agree,
- *Reporting*: what the financial and operational reporting will be required,
- *Governance*: what governance procedures will be established,
- *Due Diligence*: under what timetable and procedures will due diligence be conducted,
- *Servicing Standards and Parameters*: what mortgage loan servicing parameters will be imposed, and
- *Retroactive Regulation:* what changes to the program might be implemented after entities agree to participate?

The Securities Program and the Loan Program seem to offer solutions for the problem posed by Legacy Assets and an exciting opportunity for private investors, banks, asset managers and mortgage loan servicers. As with most things, however, the devil is in the details. It will be very interesting indeed to see what the next several weeks bring. Additional information regarding these programs is available at http://www.fdic.gov/llp/index.html and http://www.financialstability.gov/. Moreover, as the government provides more details, we will post those details and analysis at www.huntonfinancialindustryrecovery.com. If you need assistance, please feel free to contact us.

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A Resource for Clients and Colleagues Concerning the Financial Crisis

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