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Public-Private Investment Funds Issues for Potential Investors

Yesterday the Treasury released highly anticipated details regarding the Public-Private Investment Fund ("PPIF") portion of the Financial Stability Plan. The PPIF plan is intended to address the "legacy" assets at the center of the global financial crisis. These assets include both residential and commercial real estate loans held directly on the balance sheets of banks ("legacy loans") and securities backed by real estate loan portfolios held by financial institutions ("legacy securities"). The announcement covered the creation of both a Legacy Loans Program and a Legacy Securities Program, the latter of which includes an expansion of the Term Asset-Backed Securities Loan Facility ("TALF") program to include both residential and commercial backed mortgage securities.

We summarize below the various programs announced today and then discuss several open issues to consider in connection with the programs. We note that the details of these programs are still preliminary and the specific requirements and structure of the programs will be subject to further clarifications from the government, including a specific notice and comment rulemaking process for the Legacy Loans Program.

Legacy Loans Program:

FDIC to Oversee Formation of Multiple Funds. Under this program the Federal Deposit Insurance Corporation ("FDIC") will oversee the formation and operation of multiple PPIFs to purchase legacy loans from insured banks and thrifts.

Auction Process to be Utilized. Private investors will bid for the opportunity to invest through an auction program run by the FDIC. Once asset pools are identified by eligible banks and their regulators, the FDIC will conduct diligence, prepare marketing materials and engage a third party firm to advise on appropriate leverage for the PPIF (not to exceed 6:1 debt to equity ratio) and to represent the government in structuring the auction.

Bid Procedures. Prior to submission of bids, private investors will be informed of the maximum leverage to be guaranteed by the FDIC and the terms of that debt (which is expected to be non-recourse and secured and to include debt service coverage escrows) and will be given access to due diligence information. Potential investors must be pre-qualified by the FDIC to participate. In the bid submissions, bidders will specify the total amount of equity to be contributed by private investors and the Treasury, respectively. While it is expected that the Treasury will fund up to 50% of the total equity contributions, a bidder can request in its bid that the Treasury provide less than 50% equity. The auction rules will require a refundable deposit from each bidder equal to 5% of the "bid value."

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Criteria for Successful Bids. The FDIC will then select the highest bid for the legacy assets based on the cash equivalent price of the loan pool implied by the bid. The seller will then be permitted to accept or reject the bid and, if accepted, the seller will receive a combination of cash and FDIC-guaranteed debt from the PPIFs.

Governance. The manager chosen by the private investors would manage the servicing of the asset pool and the timing of its disposition – subject to strict FDIC oversight.

Consideration for the Government. In addition to returns on debt and equity investments, the FDIC will receive annual guarantee fees, administrative fees and expense reimbursement. The Treasury will receive warrants in the PPIF consistent with those issued by other TARP recipients under the Emergency Economic Stabilization Act of 2008 ("EESA").

Legacy Securities Program:

Treasury to Oversee Formation of Multiple Funds. Under this program, to be administered by the Treasury, PPIFs will be formed and funded to target investments in eligible legacy securities. Eligible legacy securities will initially include only U.S. residential mortgage backed securities ("RMBS") and U.S. commercial mortgage backed securities ("CMBS") issued prior to 2009 that were originally rated AAA (or its equivalent) by two or more nationally recognized rating agencies without regard to ratings enhancement and that are secured by the actual mortgage loans, leases or other assets and not by other securities (with certain limited exceptions). The eligible assets may be purchased only from financial institutions from which the Treasury may purchase assets pursuant to EESA.

Five or More Private Fund Managers to be Selected. The capital structure of these PPIFs are to be determined by the Treasury working with five or more private fund managers to be selected based on announced criteria, including a demonstrated capacity to raise at least $500 million of private capital; experience and track record working "primarily" with eligible legacy securities; at least $10 billion of eligible legacy securities under management; operational capacity to manage in accordance with guidelines; and headquarters in the United States. Detailed application forms have been published and must be submitted by April 10. Treasury selections for preliminary approval are expected by May 1. Note that the Treasury will encourage small, veteran-, minority- and women-owned private asset managers to partner with larger asset managers

Capital Structure. The Treasury and a vehicle controlled by the applicable fund manager (the "Private Vehicle") would be the sole direct investors in each of these PPIFs and the Treasury would match equity contributions from the Private Vehicle. The Private Vehicle would have to agree to at least a three year lock up (though the Treasury may require longer periods and could structure a PPIF as a closed-end fund with no redemption rights). Debt financing would be available in the form of secured non-recourse loans from the Treasury equal to 50% of the PPIF's equity capital (provided that the private investors do not have any voluntary withdrawal rights). The leverage may be increased up to 100% of equity capital subject to restrictions to be determined regarding leverage, withdrawal rights, priorities and other factors negotiated by the Treasury. These senior loans will be structurally subordinated to any TALF financing obtained by the PPIFs (as described below). Note that the announcement did not address whether there would be any restrictions on the capital structure of the Private Vehicle. In particular, it is not clear whether the Private Vehicle will be permitted to utilize additional leverage.

New TALF Expansion. In addition, the PPIFs may utilize the newly expanded TALF program announced in connection with announcement of PPIF plans. This plan would expand the previously announced TALF program to include non-agency RMBS that were originally rated AAA as well as CMBS and consumer credit asset backed securities ("ABS") that are rated AAA. Permitted leverage ratios, haircuts, lending rates, minimum loan sizes and durations have yet to be determined. Through this expanded TALF program, non-recourse loans are made available to investors (such as the PPIFs) to fund purchases of legacy securities.

Governance. The PPIFs would be managed by the private managers subject to reporting and oversight by the Treasury.

Consideration for the Government. In addition to returns on debt and equity investments, the Treasury will receive warrants as required by EESA the terms of which will be determined in part based on the amount of debt issued by the government.

There is very little detailed guidance on how these PPIFs would actually work. Highlighted below are select issues to be considered by those interested in participating in either PPIF program. As additional details emerge, we will continue to update you.

Key open questions regarding the PPIF programs include:

- *Asset Pricing*. Will these PPIFs actually be able to bid prices high enough to interest the banks that have thus far been unwilling to sell these legacy assets at private market prices? Will regulators force a write-down of those assets (perhaps as a result of the Financial Stability Plan's mandatory "stress testing") or otherwise use influence to compel the banks to participate?

- *Political and Rule Change Risks*. Will private investors and fund managers have an appetite to participate in programs the rules of which could continue to change and develop as the political landscape shifts? Will they be interested in subjecting themselves to risks of potential future regulation as beneficiaries of the PPIF program "subsidies"? And will private fund managers be willing to subject themselves to enhanced public disclosures? In this regard note that the Legacy Securities Program application provides that "Treasury shall have an unlimited right to use, for any governmental purpose, any information submitted in connection with the application."

- *Executive Compensation Restrictions*. The FDIC and Treasury FAQ's indicate that the executive compensation restrictions will not apply to *passive* private investors. There is no guidance as to whether (and how) the restrictions would apply to fund managers or their employees and affiliates.

- *Manager Qualifications*. What qualifications for private fund managers will be applicable? No specific criteria have been announced with respect to the private fund managers under the Legacy Loans Program. With respect to the Legacy Securities Program, it is not clear whether the requirement for a track record "primarily" in eligible assets will exclude more diversified managers and narrow the field to more specialized players. Likewise, the application's requirements to provide detailed oversight standards may favor registered advisers.

- *Investor Qualifications*. What qualifications for private investor participation will be required? Will sovereign wealth funds or other quasi-governmental entities be allowed to participate? Will the restrictions contained in the stimulus bill on hiring H-1B Visa workers apply to investors participating in the PPIF program? No specific criteria for investors have been announced for either program. With respect to the Legacy Loans Program, private investors must be approved by the FDIC and cooperation between private investors will be prohibited once the auction process begins (to maintain fairness). In addition, the Treasury expects that the Private Vehicles will be structured to allow for pension plan investors, but it is not clear whether this means that the Private Vehicles may simply cap pension plan participation to less than 25% (as is commonly done by private funds wishing to remain exempt from ERISA) or whether the Treasury intends for each Private Fund to run as if it held pension plan assets, subjecting it to a much higher standard of care.

- *Investor Lock-Up.* What is the lock-up period for private investors? The Legacy Loans Program is completely silent on this issue or on life term of the funds. While the Legacy Securities Program suggests that voluntary withdrawal may be allowed after the first three years, a condition for participating in the debt financing is that there are no voluntary withdrawal rights. The Legacy Securities Program also suggests a maximum of 10 years for the life of the funds (subject to extension with the Treasury's consent). Until these points are clarified, it is not clear whether the program will attract some hybrid or relatively illiquid hedge fund investors in addition to traditional private equity investors.

- *Financing Commitments*. What will be the strength of equity commitments from private investors and the government? Note that under the Legacy Securities Program, the Treasury will expressly reserve the right to "cease funding of committed but undrawn Treasury equity capital and debt financing in its sole discretion." This optionality could seriously hamper private fundraising and begs the question of how firm the private investor commitments must be and what special remedies would be needed if the Treasury exercised this option. Also, with respect to the 5% deposits required under the Legacy Loans Program is "bid value" the equity components or the full amount of debt and equity capitalization?

- *Available Public Capital*. How much government equity capital will be made available to each of these two programs? The announcement indicates that $75 to $100 billion in TARP funds would be utilized for both programs. It is not clear how that will be split between the two programs. Also, note that there remains a total of only approximately $135 billion of unallocated TARP funds to fund the equity investments for these two programs, the Capital Assistance Program and any further assistance to the auto industry.

- *Governance/Oversight*. How much management power and oversight over the PPIFs will be retained by the government? While the announcement indicates that private sector managers will control and manage the legacy assets, the legacy loan PPIFs will be subject to "strict FDIC oversight" and we should expect similar government oversight to be applied to the legacy securities PPIFs. All of the PPIFs will be subject to waste, fraud and abuse protections, each to be defined. It is not clear what additional protections are contemplated beyond those already provided in the anti-fraud provisions of the Investment Advisers Act to which all fund managers (whether or not registered) are subject. In addition the PPIFs will be subject to enhanced reporting requirements and access to books and records must be provided to various government agencies. Each PPIF will be a restricted from purchasing legacy assets from affiliates of the fund managers or 10% or larger private investors in such PPIF and, under the Legacy Securities Program, a PPIF will also be restricted from purchasing assets from any of the other four (or more) fund managers in the program or any of their affiliates. It is unclear what additional affiliate restrictions will apply or if they will be more restrictive than the cross trade and principal transaction provisions of the Investment Advisers Act applicable to all fund managers.

- *Management and Incentive Fees*. Will the private fund managers be entitled to a management fee on committed capital and a carry on profits? The Legacy Loans Program is silent on the ability of the fund managers to receive any management or

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incentive fees. The Legacy Securities Program expressly permits a fixed management fee based on invested (not committed) capital by the Treasury; does not address incentive fees with respect to Treasury profits; and suggests that management and incentive fees with respect to the private capital will be allowed in the manager's discretion (but subject to Treasury review in the application process). It is unclear whether this government review in the auction or application processes will have any impact on the fee structures adopted in this market.

- *Transaction Fees*. Will the fund managers be entitled to participate in transaction fees? The summary of terms for the Legacy Securities Program indicates only that the government and the private investors share those fees on a *pari passu* basis. It is unclear if the fund managers will be able to participate in these fees based on the typical 80/20 fee sharing arrangements that are standard for private equity funds.

- *Government Fees/Expenses*. Unlike the Legacy Loans Program, there is no express fee and expense reimbursement provision in the Treasury's Legacy Securities Program.

- *Asset Dispositions/Investments*. When and how will the PPIFs be able to hedge and/or sell the acquired assets? What restrictions will apply to future investments by the PPIFs?

- *Warrants.* How will the warrants work in the fund structures and how will this dilution affect a private sponsor's ability to raise capital? Until further details including the debt terms and pricing are announced, as well as the expected pricing of legacy assets, it will be difficult to assess whether private investors will determine that the added dilution from the warrants is a reasonable trade-off in their rate of return calculations.

- *Eligible Legacy Assets*. How long must a financial institution have held the legacy assets before selling them to a PPIF? Could a bank purchase such loans or securities out of a CDO and immediately sell it to a PPIF? Will the Legacy Loan Program allow for a PPIF to bid on multiple pools of legacy loans? Will the programs be expanded to include purchases of distressed assets held by non-financial institutions impacted by the financial crisis, including pension and mutual funds? Will the categories of eligible assets be broadened to include other asset classes?

- *Timing of Fundraising Relative to Asset Purchases*. What is the expected timing of the private fundraising relative to legacy asset purchases? Under the Legacy Securities Program, the selected fund managers will have a period of time (not yet identified) to raise private capital and, only if the target private amount is raised, would the manager be entitled to request the government equity and debt funding. Once the fund is formed and the funds committed, the fund would begin to make investments in the eligible legacy securities. The Legacy Loans Program, on the other hand, provides investors an opportunity to make targeted investments in specific pools of loans identified upfront in the auction process, subject to the 5% deposit requirement. It remains unclear how much lead time private managers wishing to participate in the Legacy Loans Program will have to conduct diligence and fundraise prior to initial bid submission. While not addressed, presumably the 5% deposit is forfeited if the manager is unable to raise the private equity in a winning bid accepted by a bank. Additionally, because one or both programs may contemplate hedge fund structures, it is not clear how the fundraising requirement would apply to hedge funds. For example, would a hedge fund be eligible for Treasury equity as soon as it raises a certain amount or would it need to maintain a certain amount of capital (or net asset value) in the fund on an ongoing basis (even after the expiration of the lock-up period and despite redemptions made from the fund)?

- *Timing of Program Relative to CAP*. How will the PPIFs purchasing of distressed assets be timed relative to other parts of the Financial Stability Plan, especially investments under the Capital Assistance Program (CAP)? The Treasury has already begun the "stress-testing" component of CAP. If new CAP investments are made in the financial institutions before the PPIFs processes are in place, how will this effect the incentives of the financial institutions to participate?

- *Diligence/Rating Agency Reform*. How will due diligence and rating agency reform be timed relative to the PPIFs purchases?

- *Timing Relative to Loan Modifications*. How will the timing of the Housing Affordability and Stability Plan operate in relation to the PPIF's purchasing and will potential loan modifications be factored into private sector pricing of the troubled assets?

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We have been following these issues closely and have spoken with many of you about them. We will continue to provide you with further updates as details emerge about the PPIF program and other related U.S. Government programs.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. If you have any questions, or would like to discuss any of the foregoing in further detail, please feel free to call any of the following Paul, Weiss lawyers:

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