January 16, 2009

From TARP to ARRP: Is 2009 the Year We Get Out from Under the TARP?

We begin 2009 hopeful that economists and policymakers are quicker to call an end to the recession than they were to declare the beginning of one. Our year started with the outgoing administration requesting the final $350 billion of the overall $700 billion in TARP funds. Upon taking office, we expect the incoming administration to submit to Congress a $825 billion American Recovery and Reinvestment Plan (ARRP or the Recovery Plan). These initiatives follow the unprecedented efforts in 2008 by the Secretary of the Treasury (Treasury), Federal Reserve Board (Federal Reserve), Federal Deposit Insurance Corporation (FDIC), Securities and Exchange Commission (SEC) and others to address the financial crisis that has gripped the country.

While observers, participants and policymakers have overwhelmingly come to the conclusion that no one factor is to blame for the current crisis, the precipitating event was the collapse of the mortgage market. Stagnant and falling home prices, and resetting adjustable-rate mortgages that couldn't be refinanced, triggered rising foreclosures and began a downward spiral of home values. The resulting impact to the mortgage-backed securities market turned an American mortgage crisis into a global financial crisis.

Below we take a look at the reactions of the Treasury and others to the growing crisis, beginning with a review of the TARP. As we look ahead, we consider the modernization of financial system regulation that is needed to prevent future crises. Our current regulatory structure was born out of crisis, but has not kept pace with the innovation and globalization of financial instruments or markets. We hope that as we consider the transformation of our regulatory system, we will be able to learn from history and build a comprehensive system for the future, not one that only addresses the issues of the present.

Please see our financial crisis related Client Alerts at http://www.mofo.com/news/updates/files/14605.html.

Part I: The TARP

How did we end up with a TARP over our heads?

In 2007, dozens of sub-prime mortgage originators filed for bankruptcy. By the end of 2007, financial institutions were reporting a steady stream of write-downs. By the beginning of 2008, we saw the cracks beginning to deepen and spread. The highlight of every discussion of the economy was the mortgage market, sub-prime lending and mortgage-backed securities. The American public was learning about CDOs-squared. The free market economy approach told us that investors and borrowers alike take risks and must bear the burden of their decisions. But with systemic implications, the tide began to turn. Main Street needed mortgages modified and Wall Street needed to stem the tide of eroding balance sheets or risk a lending freeze that could cripple the economy.

Traditional players, such as the Federal Reserve, took action, as described in more detail below and as outlined in our summary of federal programs in APPENDIX A. But by September 2008, Treasury, reportedly upon the urging of Chairman Bernanke, realized that unprecedented action was required, outside the scope of the current authority of the existing regulators.

In late September, Treasury presented Congress with a plan to spend $700 billion. The TARP was passed in a two-week whirlwind that saw a three-page Treasury proposal transformed into the 168-page Emergency Economic Stabilization Act of 2008 (Act) that was signed into law on October 3, 2008. The Act established the Office of Financial Stability within Treasury to run the TARP, and enact innumerable other related and unrelated laws. TARP was drafted, presented to Congress, and ultimately approved, as a balance sheet stabilization program for financial institutions. Treasury's plan was to buy mortgages and mortgage-related assets from financial institutions, stabilizing their balance sheets, and giving Treasury control over or ownership of an enormous portfolio of mortgages that could be modified.

As TARP was presented to Congress, the policy debate focused on the following:

- Size: Should Treasury be handed $700 billion to spend?
- Use of Funds: Why did Treasury propose bailing out Wall Street? Isn't Main Street at the crux of the crisis and shouldn't taxpayer dollars be returned to the taxpayers rather than given to the Wall Street executives who benefited from the risky decisions that contributed to the crisis?
- Accountability: Who will hold Treasury accountable for fulfilling the purpose of the Act and its use of taxpayer funds? Will recipients of the TARP funds receive a free ride, or will they be held accountable for leading their institutions into trouble?
- Troubled Asset Pricing: Will Treasury buy mortgage-related assets at cost—potentially overpaying with taxpayer dollars? Or will Treasury buy mortgage-related assets at current prices—potentially reducing the number of willing sellers? Can Treasury find a way to price assets slightly above their carrying value but below cost—and is Treasury qualified to do that?

The Act ultimately addressed some of these concerns:

- Size: The $700 billion will be released in stages, and Congress gave itself the authority to block the last $350 billion.
- Use of Funds: Numerous provisions were added, including a statement of purpose that use of the Act's programs must ensure protection of home values, college funds, retirement accounts and life savings, must preserve homeownership and must promote jobs and economic growth. Additionally, to the extent it acquired mortgages and mortgage-related securities, Treasury was required to implement a plan to maximize assistance to homeowners and prevent avoidable foreclosures.

- Accountability: The Act requires that Treasury comply with significant reporting obligations and a program of oversight was established. Participants are subject to executive compensation limits and any significant investment by Treasury using TARP funds requires that Treasury receive warrants or debt.
- Troubled Asset Pricing: The Act requires that Treasury may not purchase any asset at a price above cost, and premiums for the insurance program must create a sufficient reserve to cover expected losses, based on actuarial analysis. Additionally, within five years, if there is a shortfall under the TARP, the President must submit a plan to recoup the shortfall from the financial industry.

From Design to Implementation

On October 14, 2008, Treasury launched its first program under the TARP, the Capital Purchase Program. The announcement represented a shift from the proposal presented to Congress. The plan to purchase mortgage-related securities from financial institutions to provide balance sheet relief had been replaced with a program for Treasury to make capital investments directly in insured depository institutions and their holding companies. Under the program, healthy financial institutions receive capital injections and, in turn, agree to the executive compensation restrictions in the Act and additional corporate governance limitations.

The perceived shift in the use of the TARP funds from the description provided to Congress raised alarms immediately. Treasury explained in its October 14 announcement that the program was needed to restore confidence in the American banking system. This confidence was required to "ensure that the U.S. financial system performs its vital role of providing credit to households and businesses and protecting savings and investments in a manner that promotes strong economic growth in the U.S." Since that date Treasury continues to explain that, at the time, it feared the banking system was near collapse and immediate action was needed. Developing an effective asset-purchase program, including establishing a pricing mechanism, Treasury explained, would take too long to put in place. Recently, Treasury provided additional detail into its decision-making by disclosing its use of the LIBOR-OIS spread as a measurement of confidence in the banking sector. Typically at 5-10 basis points, by October 10th the spread had risen to 338 basis points.

Despite this information, Treasury's statements failed to quell the call for change in the methodology for allocating and managing TARP funds. Specifically, critics seek (1) additional transparency into use of taxpayer funds by recipients, (2) additional restrictions on the ability of recipients to deploy funds, including limitations on using these funds for compensation, dividends and mergers, (3) assurance that participants satisfy minimum lending requirements and (4) implementation of mortgage modification programs.

Subsequent allocations of TARP funds have only added fuel to the fire. Treasury next allocated TARP funds to AIG, the global insurance company that had received an earlier bailout from the Federal Reserve. At the time of the Federal Reserve bailout, the impact of the crisis on insurance companies, such as AIG, was not widely known. Despite explanations of the impact on AIG's financial condition of its portfolios of mortgage-related securities and credit default swaps (CDSs), and the potential systemic impact of AIG's failure, allocation of the TARP funds to AIG was not well received. The AIG investment was seen as another deviation from the original purpose of the TARP.

In the second bailout of AIG, Treasury imposed additional limitations upon AIG, including golden parachute prohibitions, a freeze on top executive bonuses, restrictions on expenses and lobbying and additional corporate governance requirements. Rather than embrace the additional restrictions as imposing accountability on a TARP funds recipient, critics questioned why similar limitations were not imposed upon earlier recipients of TARP funds and the Capital Purchase Program applicants that had yet to receive their allocations.

In addressing why the limitations under the Capital Purchase Program are not as stringent as those imposed on AIG (or those imposed by subsequent government programs), Treasury notes both that the Capital Purchase Program restrictions are those mandated by the Act and that, as a voluntary program, onerous restrictions could have a chilling effect on a financial institution's decision to apply. These positions have not been persuasive for two reasons. The first is that to describe as "voluntary" a $250 billion program to save the banking system from collapse, under the authority of an emergency stabilization act, seems disingenuous. The second is that, quite simply, Treasury said it was going to do one thing and then quickly did another. Treasury cannot overcome the burden of proof relating to this second claim, despite numerous and repeated explanations of its rationale.

On November 12, 2008, Secretary Paulson announced that other TARP programs were being evaluated but that it was unlikely any funds would be used to purchase mortgages or mortgage-related assets. Critics were quick to react, expressing their concern that taxpayer funds had been allocated for a program that wasn't being used. We suspect that, again, the primary issue is that Treasury was deviating from its stated plan. The probable validity of Treasury's findings in evaluating the market and the potential viability of various programs were irrelevant in the face of Treasury's unwillingness to execute the initial proposal that it had so forcefully pushed through Congress.

At the same time, questions were being asked about the foreclosure crisis. Although the Act requires that its funds be "used in a manner that . . . preserves homeownership," Treasury has not taken direct action under the TARP to address foreclosure and mortgage mitigation. In response to criticism, Treasury highlighted its establishment of the HOPE Now Alliance in 2007, a coalition of servicers and other market participants working toward mortgage modification and its early September investments in, and support for, Fannie Mae and Freddie Mac. These actions, however, were outside the TARP authority.

On November 23, 2008, following Citigroup's earlier participation in the Capital Purchase Program, Treasury announced a subsequent investment. Additionally, Treasury, the Federal Reserve and the FDIC agreed to protect Citigroup from losses arising from a portfolio of troubled assets. In exchange for the federal relief, Citigroup agreed to utilize the mortgage modification program developed by the FDIC. Critics asked why only Citigroup was being required to implement a mortgage modification program; why not all TARP recipients? Again responding to critics, Treasury highlighted the Capital Purchase Program's voluntary nature and the participation by only healthy institutions. It has been noted that Citigroup was approved for the initial capital injection, apparently upon a finding by Treasury that Citigroup was a healthy institution, but within weeks Citigroup required additional capital. The additional capital investment was made under the Treasury's Targeted Investment Program, a program that conditions allocation of TARP funds on such factors as the extent to which "destabilization of the institution could threaten the viability of creditors and counterparties exposed to the institution," the extent to which the "institution is at risk of a loss of confidence and the degree to which that stress is caused by a distressed or illiquid portfolio of assets." While the Targeted Investment Program does not require that a participant be found to be "unhealthy," the more stringent restrictions imposed upon Citigroup for the second investment led to questions regarding both its health as well as Treasury's judgment in approving the initial investment. Although Treasury's most recent TARP investment was conditioned on the recipient modifying mortgages—addressing a prime complaint—the need to give a second round of capital to an institution so quickly called into question the standards that Treasury was using to identify "healthy" institutions.

On November 25, 2008, Treasury announced a joint program with the Federal Reserve designed to increase lending to consumers. The Term Asset Backed Securities Loan Facility will make loans collateralized by newly-issued consumer and small business asset-backed securities, to restart the frozen securitization market. The program was designed to prevent further disruption in consumer and small business lending. By the time this latest program was announced, Treasury had made investments in healthy financial institutions, an investment in an unhealthy insurance holding company, an investment in a troubled financial institution and announced a program to improve consumer lending. Questions continued to arise, focused on whether these efforts were having the desired effect. Faced with another program designed to assist the credit markets, critics asked whether the Capital Purchase Program had improved lending; were recipients using the additional capital to extend credit and improve the economy? Treasury consistently responds that while the funds have been allocated, disbursements have been slower to come. Treasury also cites low confidence levels as impacting the extensions of credit, and has stated that "as confidence returns, Treasury expects to see more credit extended." Perhaps the most on-point response to these critiques was Treasury's recent statement distinguishing the expectations one can have from the TARP, a stabilization plan, from the increased spending that is expected to flow from a stimulus package. Nevertheless, Treasury's own statements regarding extensions of credit give credibility to the inquiries into when lending will resume.

When the automakers came, hat-in-hand, to Washington for bailout funds in late November, Congress insisted on more visibility into the use of taxpayer funds. Congress could not agree upon legislation to avoid the bankruptcy and collapse of the American automotive industry, and despite the initial contention that the TARP did not authorize an auto manufacturing bailout, Treasury ultimately allocated and dispersed TARP funds to GM and Chrysler. The package requires government approval of a restructuring plan and a labor agreement modification plan and imposes restrictions on executive compensation beyond those required under the Act. Again, although Treasury's bailout incorporated the additional restrictions critics had requested, the auto restrictions became the new standard that critics believed should apply to all TARP recipients.

Most recently, Chairman Bernanke stated that "with the worsening of the economy's growth prospects, continued credit losses and asset markdowns may maintain for a time the pressure on the capital and balance sheet capacities of financial institutions. Consequently, more capital injections and guarantees may become necessary to ensure stability and the normalization of credit markets." The Chairman discusses several options for improving financial institutions' balance sheets, but TARP funds are part of the solution. A resolution to the dispute between Treasury and lawmakers is needed to move the discussion forward toward a solution.

TARP Today and Tomorrow

Next we look at where the TARP is today, including the allocations that have been made and the recently announced Asset Guarantee Program, followed by a review of some of the extensive TARP reporting from oversight bodies, the proposal to amend the TARP presented by House Representative Barney Frank, and what is on the horizon for the TARP.

TARP Spending Recap

Treasury allocated the first $350 billion of the $700 billion authorized by the TARP. Treasury's recently submitted Section 115 report to Congress[1] outlining the plan for the final installment of TARP funds confirms our back-of-the-envelope calculation on TARP allocations to date. Our tally:

Initial Allocation:	$350.0 billion	
Less Commitments:		
Capital Purchase Program	$250.0 billion	(up to)
AIG Investment (Stage 2)	40.0 billion	
Citigroup Bailout	25.0 billion	(up to)
TALF	20.0 billion	
Auto Bailout	14.4 billion	
GMAC	5.0 billion	
Bank of America	20.0 billion	
Commitments Subtotal	$374.4 billion	
Excess over Initial Allocation	*$24.4 billion*	

Under the Act, the remaining $350 billion must be requested, and Congress has 15 days, subject to some statutory adjustments to that time frame, to reject the request. On January 12, 2009, at the incoming administration's request, the outgoing administration requested the additional TARP funds from Congress and Treasury submitted its plan for their use. Treasury's plan noted that any allocation of the next $350 billion will be undertaken by the

[1] Treasury's plan is available at: http://www.whitehouse.gov/news/releases/2009/01/20090112-7attachment.pdf.

next administration and referred Congress to the January 12, 2009 letter[2] from the Office of the President-elect broadly outlining the next administration's goals. That letter asks Congress to approve the request for additional funds and commits to increase transparency and accountability under the TARP.

On January 15, 2009, a Senate resolution of disapproval failed to obtain the necessary votes. A joint House and Senate resolution of disapproval being required to block the final $350 billion, failure by the Senate to disapprove the request will result in the additional funds being released to the Treasury. In addition to the January 12 letter, President-elect Obama reportedly committed to spending between $50 and $100 billion of the remaining funds on foreclosure prevention. By addressing one of Congress' critical concerns, TARP may be back on track.

Recent TARP Programs – Asset Guarantee Program

The Act requires that Treasury develop a program to provide insurance on troubled assets, in order to minimize their potential ongoing negative impact on financial institution balance sheets. On October 14, 2008, Treasury solicited public input on such a program and on December 31, 2008, Treasury issued its report, establishing the Asset Guarantee Program. Treasury is evaluating whether the loss protection provided to Citigroup in the transactions announced on November 23, 2008 will fall within the new program.

The Asset Guarantee Program will provide guarantees on troubled assets held by "systemically significant financial institutions that face a high risk of losing market confidence due in large part to a portfolio of distressed or illiquid assets." This is one of the factors used to evaluate whether an institution qualifies for the Targeted Investment Program, the program used for the follow-up Treasury investment in Citigroup. Treasury notes its expectation that the guarantee program will not be made widely available, and potential participants will be evaluated using the same five factors established for the Targeted Investment Program. (See APPENDIX A for a brief description of the Targeted Investment Program.)

To be eligible for the guarantee, the troubled asset must have been originated prior to March 14, 2008. Treasury will provide protection against specified losses on each asset. Such protection may be structured in a manner that is similar to the Citigroup transaction, with one party (e.g., Citigroup) assuming the first loss position, and Treasury assuming a secondary or other loss position, which may represent all or a portion of the losses in that position. The premium charged by Treasury for the loss protection may be paid using the institution's securities, as was the case with Citigroup. Additionally, the institution will be subject to portfolio management guidelines for the covered assets, to be established by Treasury.

The report on the program notes the unique accounting for the guarantee as mandated by the Act and outlines Treasury's considerations when evaluating how to structure a guarantee. The guaranteed troubled asset's full value reduces the funds available for use under the TARP, offset by the value of any cash premium received by Treasury. Non-cash premiums, such as preferred stock, will not offset the reduction of available TARP resources. As a result, Treasury will evaluate on a case-by-case basis the troubled assets to be covered by the program to minimize the impact to available funds.

Treasury's report also notes ongoing efforts to continue to evaluate the development of other insurance programs. In doing so, Treasury will be guided by two factors. The first is the TARP accounting for guarantees: that the impact to available TARP funds is the same for insuring an asset as for purchasing an asset. We expect Treasury will carefully evaluate whether it can maximize the use of those TARP funds through insurance, compared to the other available uses. Additionally, in order to determine the appropriate premium for a complex security, such as a asset-backed security, Treasury must undertake a detailed analysis of the related asset. As a result, broad-based auctions or other programs to offer insurance to large groups of troubled assets, even asset classes, would not properly price the related premiums, an outcome inconsistent with prudent allocation of TARP resources and protecting the taxpayers' investment.

[2] http://multimedia.nydailynews.com/pdf/2009/01/12/Summers_Letter_to_Congressional_Leadership.pdf.

We anticipate that the technical difficulties for pricing premiums and the challenging accounting of the insurance program will result in limited use of the program.

Reports of Oversight Bodies

Whether or not there is a lack of transparency related to the TARP, the Act's extensive reporting obligations have compelled the production of reams of paper. Treasury publishes special reports, transaction reports, monthly reports and periodic tranche reports. The Government Accountability Office (GAO) published its first TARP report[3] and will continue to issue reports every 60 days for so long as TARP investments are outstanding, with the next report due January 31st. The Congressional Oversight Panel (Panel), formed under the Act, issued the first two of its monthly reports[4] and will release its regulatory reform recommendations on January 20, 2009. The GAO report focused its recommendations on the development of internal controls, administrative matters and the development of tools to measure success under the TARP. The Panel reports focused on broader policy questions, looking into Treasury's strategy and plans as well as Treasury's adherence to the Act's stated purposes. All reports ask for additional transparency into recipients' use of TARP funds and discuss the lack of direct TARP spending in the mortgage industry or markets.

GAO Report: The GAO Report highlights some "critical issues" that Treasury has yet to address, including ensuring that the Capital Purchase Program will achieve its intended goals and that participants will comply with the program requirements. The GAO recommends that Treasury work with banking regulators to establish a system to monitor Capital Purchase Program participants. The report encourages Treasury to develop and document systems for internal controls, final conflict of interest standards, improved contractor management, communication strategies and transition plans.

Separately, the GAO reviewed TARP's Office of Financial Stability and testified as to its efforts related to the mortgage crisis. The GAO notes that Treasury is still developing its homeowner preservation efforts under the Office of Homeownership Preservation within the Office of Financial Stability. Initial reports have not made direct recommendations but indicate that the GAO will continue to monitor Treasury's progress in this area.

Congressional Oversight Panel: The Panel's goal is answering the following questions: (1) Who got the money? (2) What have they done with it? (3) How has it helped the country? and (4) How has it helped ordinary people?

In its first report on December 10, 2008, the Panel poses detailed questions to Treasury about the TARP. The Panel asks for information about Treasury's strategy, the TARP's policy goals, how Treasury will measure success, the measurements used by Treasury to assess the value of investments and what is being done about mortgage modification. The Panel sought Treasury's responses to inform the Panel's answers to its four primary questions. Although Treasury responded to the Panel in a December 30 letter, the January Panel report[5] directly criticizes the depth and breadth of Treasury's responses, going so far as to provide a chart that highlights the numerous questions for which the Panel received "No response" from Treasury.

TARP, as amended?

Chairman of the House Committee on Financial Services, Barney Frank, proposed amendments to the TARP[6] to clarify Treasury's authority under the TARP, to impose restrictions on the use of TARP funds by recipients, to increase transparency regarding the use of funds and to mandate mortgage foreclosure mitigation efforts. The proposal calls for quarterly reports by all program participants. The proposal also prohibits, without Treasury's

[3] The December 2008 GAO report is available at http://www.gao.gov/new.items/d09161.pdf.
[4] Reports of the Congressional Oversight Panel are available at http://cop.senate.gov/.
[5] The January 9, 2009 report is available at http://cop.senate.gov/documents/cop-010909-report.pdf.
[6] The proposed TARP Reform and Accountability Act of 2009 is available at: http://www.house.gov/apps/list/press/financialsvcs_dem/hr384.pdf.

prior consent, in consultation with the appropriate banking regulator, the merger of a participant in the Capital Purchase Program.

Executive compensation requirements would be extended as well. The proposal removes de minimis exemptions in the Act for imposing executive compensation limitations on smaller TARP recipients. In addition to the current restrictions in the Act, institutions would be subject to enhanced limitations, including a prohibition on any bonus or incentive compensation paid to the 25 most highly-compensated employees.

The proposed legislation would make the $250,000 deposit insurance limit permanent. If the insurance limit is not made permanent in connection with TARP legislation, we expect that this proposal will continue to be put forth throughout the year and will likely pass this year.

The FDIC's ability to recover a loss to the Deposit Insurance Fund through special assessments on depository institutions would be expanded to include special assessments on depository institution holding companies. For example, if there is a shortfall under the FDIC's TLGP program, a special assessment will be imposed on depository institutions. Smaller depository institutions have raised concerns that they would bear a disproportionate burden of any shortfall because the FDIC does not have the statutory authority to impose any such special assessment on holding companies participating in the TLGP. The FDIC tried to address these concerns by imposing an increased participation fee on holding companies whose primary business activities were outside their subsidiary depository institutions, but the fee would not necessarily be sufficient to cover any shortfall from the program.

As discussed, criticisms of the TARP have been sustained and consistent. Given the commitment of President-elect Obama to direct TARP funds to foreclosure prevention and Congress' need to focus on the Recovery Plan, the proposed amendments may lose some of their support. Nevertheless, we expect that what is left of the final $350 billion will be deployed differently than the initial TARP funds.

What's Next?

- Congress will continue to question and study the outgoing administration's programs. *Despite strong interest in Congress in continuing to follow up on the use of TARP funds, consideration of a stimulus package and monitoring mortgage modification efforts may take priority in the near-term. Additionally, a new Secretary of the Treasury may be given a small amount of breathing room to "prove himself" to Congress.*
- While Congress may grant the new Secretary of the Treasury some breathing room, he may be too busy staffing the Office of Financial Stability and providing leadership to the regulatory reform initiatives, a report on which is due on April 30, 2009, to effectively push a comprehensive plan for spending $350 billion. *Prioritizing will be challenging for both the administration and the Congress.*
- The new administration will test its relationship with Congress with a new stimulus package. *Will the President-elect be successful in passing an earmark-free stimulus package?*

  Given the impact of the financial crisis on states, municipalities, utilities and other industries, and the current focus on the financial sector, state elected officials will be highly motivated to ensure that funds are sent home.
- Treasury published Capital Purchase Program terms for S corporations on January 14, 2009. *Will the Capital Purchase Program ultimately include mutual institutions as well? What other changes are in store for Capital Purchase Program participants? What about the potential to expand the program to other financial institutions? Will Chairman Bernanke's statement on January 13, 2008 that more capital is needed prove true?*

- Additional information, in some form, will be requested of Capital Purchase Program participants. *Will Congress and the oversight bodies achieve the transparency they seek into the uses of the TARP funds?*

  Treasury is working with banking regulators to design a program to measure bank lending activity. Treasury will use both quarterly reporting to the banking regulators as well as a "selection of data [Treasury plans] to collect monthly from the largest banks we have invested in for a more frequent analysis." We expect they are focused on the largest banks in part to minimize the outcry from smaller program participants against any additional regulatory burden. But all institutions should expect additional scrutiny, whether directly from regulators and the Treasury, or from those questioning whether best practices are being followed.

  More broadly, Treasury releases transaction reports 48 hours after each investment, tranche reports after each $50 billion is spent and monthly reports as required under the Act. The Congressional Oversight Panel and the GAO are also releasing regular reports. Most of these routine reports are required until the last TARP asset has left Treasury. We can expect an ongoing flood of information from TARP, and more to follow under any additional stimulus packages.

- Treasury proposed one program under the insurance provisions of the Act and promised to consider more. *Will insurance, the Republicans' brain child, fade into history with the 110th Congress?*

  A program to insure or guarantee troubled assets has tremendous potential to provide support to financial institutions. However, as the insurance provisions are drafted in the Act, the accounting ties up a significant portion of TARP dollars. It isn't clear that a guarantee program will have a meaningful impact, unless made available to only significant institutions on the brink of failure. Perhaps a better proposal to amend the Act would have been to create a TARP insurance program using an insurance company model for allocating the TARP capital.

Part II: Other Federal Actions

In addition to Treasury's efforts to address the financial crisis, action was taken by the Federal Reserve, FDIC, SEC, the Financial Accounting Standards Board and other industry participants. We outline some key recent efforts below.

Federal Reserve and Section 13(3)

The Federal Reserve had quite a year in 2008: expansion of the Term Auction Facility; establishment of the Term Securities Lending Facility, ABCP Money Market Fund Liquidity Facility, Commercial Paper Funding Facility, Term Asset Backed Securities Loan Facility and the GSE MBS purchase program, not to mention bailouts for AIG and Citigroup and rate cuts. While all eyes were focused on the $700 billion requested by Treasury, the Federal Reserve injected trillions of dollars into the financial system, often utilizing its authority under Section 13(3) of the Federal Reserve Act, which is available only in "unusual and exigent circumstances." We are pretty confident Congress won't need to hold hearings on whether we are currently experiencing unusual and exigent circumstances.

Please see APPENDIX A for a brief description of these Federal Reserve Programs. Our chart summarizing the Federal Reserve Lending and Liquidity Programs is available at http://www.mofo.com/docs/pdf/081031FedReserveCheatSheet.pdf.

What's New?

Money Market Investor Funding Facility: The program, designed to ensure the availability of liquidity to money market funds sufficient to satisfy redemption requests, was expanded this month to a broader class of investment funds and vehicles. Illiquid markets have hampered the ability of fund managers to meet redemption requests in a timely fashion. Reports of liquidity concerns have raised the specter of a "run on the funds." Fearing an inability to timely redeem money market funds, investors request redemptions, requiring liquidations of fund assets that raise concerns regarding access to cash, leading to more redemption requests. Ultimately, the concern is that this spiral of redemption requests and asset liquidations, in dislocated markets, could also result in asset sales at reduced values, potentially causing funds to "break the buck." Given the importance of money market funds and other investment vehicles, the Federal Reserve announced this program in late October and funding began November 24th. Money market funds can sell their securities to the Federal Reserve Bank of New York (New York Fed), rather than risk lack of market appetite, a particularly useful resource when raising cash for redemptions.

Beginning in January 2009, additional categories of funds may sell securities to the New York Fed under the program, including funds that are managed or owned by a U.S. bank, insurance company, pension fund, trust company, SEC-registered investment advisor or a U.S. state or local government entity. To be eligible for the program, a fund is required to (1) maintain a dollar-weighted average portfolio maturity of 90 days or less, (2) hold the fund's assets until maturity under usual circumstances and (3) hold only assets that, at the time of purchase, are rated by a nationally recognized statistical rating organization in one of the top three long-term investment-grade rating categories or the top two short-term investment-grade rating categories, or that are the credit equivalent thereof.

Additionally, any U.S. dollar-denominated cash collateral reinvestment fund, account or portfolio associated with securities lending transactions that is managed or owned by a U.S. bank, insurance company, pension fund, trust company or SEC-registered advisor will be able to use the program.

Each of the Treasury, FDIC and Federal Reserve have taken action or designed programs to ensure continued stability in money markets funds. These actions and policy decisions highlight the significance of these investment vehicles in the financial system. We expect that the policy decision to support these investment vehicles and retain investor confidence in the safety of money market funds raises the possibility of additional regulatory oversight as the regulatory modernization debate commences. If the Federal Reserve or others in the bank regulatory system are effectively charged with providing a safety net for money market mutual fund investments, they may seek corresponding regulatory authority.

FDIC's TLGP

The Temporary Liquidity Guarantee Program (TLGP) was announced by the FDIC on October 14, 2008. Under the TLGP, the FDIC has two programs designed to increase market confidence in the banking system and improve inter-bank lending. Inter-bank lending had come to a standstill by early October. The first is a Debt Guarantee Program to provide an FDIC-guarantee of timely payments of principal and interest on newly-issued senior unsecured debt of participating financial institutions. The second is a Transaction Account Guarantee Program under which noninterest-bearing transaction account deposits held in participating institutions receive unlimited FDIC insurance. Please see our Client Alerts on the TLGP at http://www.mofo.com/news/updates/files/081016NewLiquidity.pdf and http://www.mofo.com/news/updates/files/081123FDIC.pdf.

What's New?

The FDIC launched the TLGP with immediate and free coverage for all eligible institutions. Once rules for the programs were finalized on November 21, 2008, eligible institutions had an opportunity to opt out prior to fees being assessed. Since publication of the final rule, over $75 billion of registered FDIC-guaranteed debt has been issued by participants in the program.

The final TLGP rule provides that the Debt Guarantee Program will provide for the timely payment of principal and interest upon issuer default. To administer the guarantee of timely payment of principal and interest, participants in the program were required to enter into a master agreement with the FDIC, pursuant to which the participants made several commitments regarding provisions of the debt instruments covered by the guarantee, appointment of an authorized representative to act on behalf of holders of the guaranteed debt, and reporting obligations.

On January 16, 2009, the FDIC announced that it will soon propose TLGP rule changes to extend the maturity of the FDIC-guarantee under the Debt Guarantee Program from three to up to 10 years where the debt is supported by collateral and the issuance supports new consumer lending. Depending on the requirements for consumer lending, the collateral required and whether the debt issuance limits for the program are revised upward, the new program could provide significant liquidity to on balance sheet asset-backed funding.

- Debt Reporting Under TLGP: On January 12, 2009, the FDIC issued Financial Institution Letter FIL-2-2009, Guidance to Periodic Debt Balance Reporting. Participants in the program are required to submit to the FDIC monthly reports of all outstanding FDIC-guaranteed debt, regardless of outstanding balance. Balances as of the end of each calendar month must be reported within 30 calendar days. When electing to participate in the Debt Guarantee Program, eligible institutions had the opportunity to elect to participate in the long-term non-guaranteed debt program through which they are permitted to issue long-term senior unsecured debt free from the FDIC-guarantee. Each of these entities must also report to the FDIC whether the entity had issued any non-guaranteed debt within the prior calendar month. As with other reporting under the program, monthly reports are required to be certified as to their accuracy. Reporting is to be submitted through FDIC*connect*.
- Monitoring Use of Federal Capital: On January 12, 2009, the FDIC issued Financial Institution Letter FIL-1-2009, requiring that state nonmember institutions implement a process to monitor their use of capital injections, liquidity support and financial guarantees received through the various federal stability programs established by the Treasury, FDIC and Federal Reserve. Those institutions are encouraged to include summary information in public filings and reports. As noted above, there has been significant criticism of program sponsors, particularly Treasury, regarding its lack of systematic review of the use of fund received by financial institutions from crisis-related programs. Treasury announced ongoing discussions with the banking regulators to gather information from TARP participants, and we expect other banking regulators will be similarly seeking reporting.

Treasury's non-TARP Programs

Prior to the TARP, Treasury entered into preferred stock purchase agreements structured to provide capital support for Fannie Mae and Freddie Mac. Additionally, facing unprecedented stresses in the money market business, Treasury launched a guarantee program for money market funds. The Treasury guarantee program, described below, complements the efforts of the Federal Reserve to support money market funds.

Temporary Guarantee Program for Money Market Funds

Following the bankruptcy filing by Lehman Brothers in September 2008, a money market mutual fund reported that its share value fell below $1.00 due to the losses the fund's portfolio suffered as a result of the significant decline in market value of the fund's holdings of Lehman Brothers commercial paper. Money market mutual funds began reporting a significant increase in redemptions.

In response to this market activity, on September 19, 2008, Treasury announced the establishment of a Temporary Guarantee Program for Money Market Funds (Guarantee Program) for the U.S. money market mutual fund industry. Under the Guarantee Program, all money market funds that are regulated under Rule 2a-7 of the Investment Company Act of 1940, are publicly offered, are registered with the SEC and maintain a stable net asset value or share price of $1.00 were eligible to participate in the Guarantee Program for a fee. Eligible funds include retail and institutional money market funds, as well as taxable and tax-exempt money market funds. With respect to tax-exempt money market funds, Treasury and the Internal Revenue Service issued guidance that confirmed that participation in the Guarantee Program would not be treated as a federal guarantee that jeopardizes the tax-exempt treatment of payments by tax-exempt money market funds.

On September 29, 2008, Treasury opened the Guarantee Program, providing coverage, subject to certain conditions and limitations, to share amounts held by investors in participating money market funds as of the close of business on September 19, 2008 in the event the market-based net asset value per share of a participating fund is less than $0.995 (i.e., does not round to $1.00, a "guarantee event") and the fund subsequently liquidates. The Guarantee Program only covers the amount a shareholder held in a fund as of the close of business on September 19, 2008 or the amount a shareholder holds if and when a guarantee event occurs, whichever is less. Treasury made $50 billion available from the assets of the Exchange Stabilization Fund to guarantee the payment to investors of participating money market funds. Funds were required to apply to participate in the Guarantee Program by October 8, 2008. Funds with a net asset value below $0.995 as of the close of business on September 19, 2008, were not eligible to participate in the Guarantee Program. The Guarantee Program was for an initial three-month term. Following the initial three-month term, Treasury had the option to renew the Guarantee Program up to the close of business on September 18, 2009. As discussed below, on November 24, 2008, Treasury extended the Guarantee Program.

On October 8, 2008, Treasury announced that money market funds that have a policy of maintaining a stable net asset value or share price that is greater than $1.00, and had such a policy on September 19, 2008, were eligible to participate in the Guarantee Program, provided the funds met all of the other original requirements. The enrollment deadline for these funds that were eligible as a result of this technical correction was October 10, 2008.

As of October 12, 2008, reports indicated that most of the large money market fund managers had entered the Guarantee Program.

On November 24, 2008, Treasury announced an extension of the Guarantee Program until April 30, 2009. All money market funds that already were participating in the Guarantee Program and that met the extension requirements were eligible to continue to participate in the Guarantee Program. Funds that choose not to participate in the Guarantee Program during its initial enrollment in early October 2008 were not eligible to now enter the Guarantee Program. Funds that were eligible to and wanted to participate in the Guarantee Program during the extended period were required to make a Guarantee Program extension payment and submit the extension notice by December 5, 2008. Any fund that participated in the Guarantee Program for its initial three-month term, but decided not to participate in the Guarantee Program for the extended term, is not eligible to participate in any potential further extension of the Guarantee Program. As of November 24, 2008, the Guarantee Program covered over $3 trillion of assets.

Treasury may extend the Guarantee Program until September 18, 2009; however, no decision has been made to extend the Guarantee Program beyond April 30, 2009. If Treasury chooses not to renew the Guarantee Program at the end of the current extension, the Guarantee Program will terminate.

While the Temporary Guarantee Program was initially authorized under the Exchange Stabilization Act, as noted above, the Act requires that any costs associated with the Guarantee Program be reimbursed from authorized amounts under the Act.

Securities and Derivatives Developments

What's New?

- Executive compensation has been a central issue in the crisis and in the criticism of the TARP, with an emphasis on disclosure. We expect ongoing focus on compensation disclosure by the SEC and market participants in the year ahead.
- Short selling emergency actions expired in October and new rules were promulgated permanently eliminating naked short selling.

- The SEC promulgated credit rating agency reforms initially proposed in mid-2008, re-proposed reforms and left open the possibility of future action.
- Mary Shapiro's confirmation hearings for appointment as the Commissioner of the SEC are scheduled for Thursday, January 15, 2009. If confirmed, she faces such challenges as identifying how the SEC failed to detect the Madoff fraud and how the SEC can prevent another massive Ponzi scheme from going undetected by regulators in the future.
- The SEC published its Act-mandated study of mark-to-market accounting and recommended that fair value accounting not be suspended, but that additional guidance be issued on its interpretation and use.
- CDSs were in the firing line throughout 2008; the inability of any regulator or independent body to quantify CDS exposure was seen by many as a notable shortcoming of the current regulatory system.

Executive Compensation

The financial crisis and the economic downturn fomented public anger over executive compensation in 2008, as policymakers and investors questioned the payment of bonuses and the use of corporate jets. As a result of the attention, calls for increasing shareholder involvement in pay decisions have accelerated.

Significant momentum now appears to exist for federal legislation that would mandate a shareholder advisory vote on executive compensation, so-called "Say on Pay" legislation. This legislation was introduced in the last Congress by Representative Frank in the House and then-Senator Obama in the Senate. During his presidential campaign, President-elect Obama indicated that Congress needed to act quickly to pass the legislation to change "a system where bad behavior is rewarded." As with the past two proxy seasons, shareholder proponents are advancing shareholder proposals asking companies to implement advisory votes on executive compensation, so even in the unlikely event that the legislation is not enacted, shareholders will continue to press for this reform.

The TARP executive compensation provisions—in particular the provision compelling compensation committees to consider the extent to which compensation may lead to unnecessary and excessive risks—may have broader applicability to practices and disclosures of companies other than financial institutions. Shortly after the legislation was enacted, John White, the former Director of the SEC's Division of Corporation Finance, stated: "Would it be prudent for compensation committees, when establishing targets and creating incentives, not only to discuss how hard or how easy it is to meet the incentives, but also to consider the particular risks an executive might be incentivized to take to meet the target—with risk, in this case, being viewed in the context of the enterprise as a whole?" As a result, many companies will be addressing the relationship between risk and executive compensation in their Compensation Discussion and Analysis this year.

In Treasury's recent bailout of GM, Chrysler and GMAC, under their new Automotive Industry Finance Program (as opposed to the Capital Purchase Program), additional compensation conditions were imposed under the terms of the agreement, including restrictions on the ability to pay or accrue any bonus or incentive compensation to the 25 most highly-compensated employees, unless approved by Treasury; a prohibition on adopting or maintaining any compensation plan that would encourage manipulation of its reported earnings to enhance the compensation of any of its employees; and the maintenance of all suspensions and other restrictions of contributions to benefit plans that are in place or initiated as of the closing date of the funding transaction. Treasury also maintained the ability to claw back any bonuses or other compensation, including golden parachutes, paid to the 25 highest-paid employees in violation of any of the restrictions.

Many are beginning to wonder if the compensation reforms contemplated under the TARP will be extended, either through legislation or through the efforts of shareholders seeking changes through shareholder proposals. Any combination of these reforms could significantly alter the executive compensation landscape in 2009 and beyond.

Short Selling

In 2008, the SEC took a series of dramatic actions aimed at restoring investor confidence in the financial markets and to curb perceived improper shorting activities. Between July and October 2008, the SEC issued a series of emergency orders prohibiting naked short selling in the stocks of financial institutions, and requiring disclosure of short sales by institutional investment managers. The emergency orders were issued in response to a perception that excessive shorting might trigger a market stampede away from the securities of financial institutions. The last of the emergency orders prohibiting short selling in specific stocks expired in October 2008. The SEC is actively monitoring short selling activities and is seeking to reduce abusive short selling practices through a combination of regulations and enforcement actions.

Permanent Prohibitions on Naked Shorting

On September 17, 2008, the SEC adopted, under its emergency authority, three rules that permanently prohibit naked short selling.[7]

Accelerated Closeout Requirement. First, the SEC adopted a new rule, Rule 204T pursuant to Reg SHO, dramatically reducing the amount of time a broker has to close out a short position. The rule requires that short sellers and their broker-dealers deliver securities by the close of business on the settlement date (three days after the sale transaction date, or T+3) and imposes penalties for a failure to do so. Pursuant to Rule 204T(b), if a short sale violates this closeout requirement, any broker-dealer acting on the short seller's behalf will be prohibited from making further short sales in the same security unless the shares are not only located but also are pre-borrowed. The prohibition on the broker-dealer's activity applies not only to short sales for the particular naked short seller, but to all short sales in that security for any customer. Rule 204T became effective on September 18th and the interim final temporary rule is effective through July 31, 2009.[8] Comments were due by December 16, 2008 and the SEC expects to follow with further rulemaking. The SEC released non-binding interpretive guidance in the form of Frequently Asked Questions, or FAQs, regarding the application of Rule 204T.[9]

Exceptions to the Closeout Requirement. Second, the SEC adopted proposed amendments to Reg SHO eliminating the "options market maker exception" and on October 17, 2008 these rules became final.[10] The options market maker exception excepted from the closeout requirement any fail-to-deliver position in a threshold security attributable to short sales by a registered options market maker if, and to the extent that, the short sales were effected by the registered market maker to establish or maintain a hedge on options positions created before the security was designated a threshold security. As a result, options market makers will be treated in the same way as all other market participants, and are required to abide by the new hard T+3 closeout requirements. Any market maker to which a fail-to-deliver position at a registered clearing agency is attributable must provide a written attestation to the market on which it is registered stating that the fail-to-deliver position at issue was established solely for the purpose of meeting its bona fide market making obligations and describing the steps the market maker has taken to deliver securities to its registered clearing agency.

Rule 10b-21 Relating to Naked Short Selling. Finally, the SEC's adopted Rule 10b-21.[11] Rule 10b-21 is aimed at short sellers, including broker-dealers acting for their own accounts, who deceive specified persons, such as a broker or dealer, about their intention or ability to deliver securities in time for settlement and that fail to make delivery by the settlement date. The new rule addresses the SEC's concern that some short sellers have made deliberate misrepresentations to broker-dealers, who are permitted to reasonably rely on customer assurances regarding identified borrow, that they have obtained a legitimate source of shares, about their ownership of shares, or that their sales are long sales (when they are in fact short). Rule 10b-21 is intended to highlight the specific liability of persons that engage in abusive short selling as part of a manipulative scheme.

[7] SEC Release No. 34-58572 (September 17, 2008) is available at http://www.sec.gov/rules/other/2008/34-58572.pdf.
[8] SEC Release No. 34-58773 (October 17, 2008) is available at http://www.sec.gov/rules/final/2008/34-58773.pdf.
[9] Guidance Regarding Temporary Rule 204T (September 23, 2008) is available at http://www.sec.gov/divisions/marketreg/204tfaq.htm.
[10] SE Release No. 34-58775 (October 17, 2008) is available at http://www.sec.gov/rules/final/2008/34-58775.pdf.
[11] SEC Release No. 34-58774 (October 17, 2008) is available at http://www.sec.gov/rules/final/2008/34-58774.pdf.

Position Reporting

On September 18, 2008, the SEC issued an emergency order temporarily requiring that certain institutional money managers report their new short sales of certain publicly traded securities under specified circumstances.[12] The order was amended on September 21, 2008 to require electronic reporting of the information on Form SH, and on October 18, 2008, the SEC issued an interim final temporary rule extending the reporting requirement through August 31, 2009.[13] On September 24, 2008 the SEC issued FAQs[14] to provide guidance on the preparation and filing of Form SH. The FAQs clarified that for purposes of reporting under the order, managers are required to aggregate gross short sales across all accounts, strategies and funds. Any manager subject to the order is required to provide the reports on the first business day of every calendar week immediately following a week in which it effected short sales.[15]

Credit Rating Agency Reform

Actions of nationally recognized statistical ratings (NRSROs) were identified as a contributing factor in the financial crisis in the July 2008 SEC *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies.*[16] The report found that ratings assigned to mortgage-backed and mortgage-related securities backed by sub-prime loans were based on limited diligence of the underlying assets and over-reliance on statistical models, without adequate disclosure to investors regarding the assumptions underlying ratings, the stress-testing incorporated in the statistical models or the risks inherent in the structures. As a result, the SEC proposed a series of rules designed to enhance the regulatory framework for NRSROs and to remove references to ratings throughout the its rules.

On December 3, 2008, the SEC approved final rules relating to NRSROs and proposed additional NRSRO rules, but did not take action on the rule proposals relating to removal of references to credit ratings in SEC rules and forms. The new rules include new prohibited conflicts of interest, new disclosure obligations and new reporting and recordkeeping requirements. Please see our Client Alert at http://www.mofo.com/news/updates/files/081204SECCredit.pdf.

In addition to the pending rulemaking proposals, we expect additional rulemaking from the SEC as it continues to develop its NRSRO examination and oversight responsibilities.

New Rules

The following new conflicts of interest restrictions apply to NRSROs:

- An NRSRO cannot issue a rating on an obligor or a security if NRSRO personnel, including affiliates, have made recommendations to a transaction party about the corporate or legal structure, assets, liabilities or obligations of that obligor or issuer of the security.
- An NRSRO cannot issue a rating if the personnel responsible for participating in determining the credit rating or credit rating methodology have participated in fee discussions, negotiations or arrangements with the related issuer.
- An NRSRO credit analyst that participated in determining or monitoring the credit rating cannot receive gifts, including entertainment, from a transaction party. There is a $25 de minimis exception for normal business activities.

[12] SEC Release No. 34-58591 (September 18, 2008) is available at http://www.sec.gov/rules/other/2008/34-58572.pdf.
[13] SEC Release No. 34-58785 (October 18, 2008) is available at http://www.sec.gov/rules/final/2008/34-58785.pdf/
[14] Guidance Regarding the Commission's Emergency Order Concerning Disclosure of Short Selling (September 24, 2008) is available at http://www.sec.gov/divisions/marketreg/shortsaledisclosurefaq.htm.
[15] SEC Release No. 34-58591A (September 21, 2008) is available at http://www.sec.gov/rules/other/2008/34-58591a.pdf.
[16] A copy of the report is available at http://www.sec.gov/news/studies/2008/craexamination070808.pdf.

NRSROs are now required to maintain the following records:

- All rating actions, including initial ratings, upgrades, downgrades and placements on watch lists for upgrades or downgrades.
- Any communications relating to complaints about the performance of a credit analyst in rating or monitoring a credit rating and the NRSRO response to the complaint.
- The rationale for any material difference between the credit rating implied by a quantitative model and the final credit rating issued if the quantitative model is a substantial component in the process of determining a structured finance product's rating.
- Communications related to monitoring of ratings.

The rules impose additional disclosure obligations on NRSROs in their annual reports, on Form NRSRO and on the websites of issuer-paid NRSROs, including:

- Disclosure on the website of each issuer-paid NRSROs of a random sample of 10% of its ratings. Ratings must be post within six months and disclosed in extensible business reporting language (XBRL).
- Form NRSRO disclosure is required of transition statistics for each asset class of credit ratings for which an NRSRO is registered, broken out over 1, 3 and 10-year periods, including all ratings transitions, as well as default statistics, in each case relative to the initial rating.
- Form NRSRO disclosure of (1) the verification of underlying or referenced assets and the reliance by the NRSRO, (2) how assessments of the quality of originators were used in determining the credit rating and (3) a description of the credit ratings surveillance process.
- Annual reports disclosing the number of credit rating actions that occurred during the fiscal year in each ratings class for which the NRSRO is registered.

Rule Proposals

The SEC proposed requiring that issuer-paid NRSROs disclose ratings history information for all credit ratings determined after June 25, 2007, no later than 12 months after ratings action is taken, and in an XBRL format.

The SEC also proposed a rule making it a prohibited conflict of interest for an NRSRO to rate a structured finance product whose rating is paid for by the product's issuer, sponsor, or underwriter, unless information about the product provided to the NRSRO to determine and monitor the rating is made available to NRSROs not retained to issue a credit rating. The proposal is intended to provide transparency in the ratings process and to encourage competition from subscriber-paid NRSROs.

Also pending are the proposed rules to eliminate references to ratings of NRSROs within the SEC's rules and forms.

New Leadership

New incoming leadership for the SEC (Mary Shapiro) and Commodities Futures Trading Commission (Gary Gensler) will face some interesting challenges. The new SEC Commissioner will be assuming responsibility for an agency that received significant criticism throughout 2008. And at some point this year, someone is likely to pull up Treasury's *Blueprint for a Modernized Financial Regulatory Structure*, including the proposal that the SEC and CFTC be merged.

Accounting for the Crisis

Accounting issues were an important part of the debate in 2008, most notably the impact of fair value and mark-to-market accounting on the balance sheets of financial institutions. As numerous financial instruments began losing market value and the financial institutions holding them began making write-downs, a vicious spiral of write-downs, fire sales establishing lower market values and further write-downs began. The IMF recently estimated total global losses in securitizations of approximately $1.4 trillion, with only half having been written down as of December. The clamor resulted in the Act giving the SEC authority to suspend mark-to-market accounting and mandating an SEC study of the issue. The year also saw continuation of the ongoing debate on accounting for securitizations, updated disclosure requirements for derivatives and the need for global convergence of accounting standards. Some of the highlights are discussed below.

Fair Value Accounting

The debate over fair value and mark-to-market accounting resulted in Congress mandating a study and report by the SEC which was released on December 30, 2008.[17] The focus of the debate was Financial Accounting Statement 157, *Fair Value Measurements* (FAS 157). Fair value and mark-to-market accounting, however, are not new and FAS 157 was adopted to address inconsistent, and sometimes conflicting, guidance for defining and implementing fair value measurements across existing fair value pronouncements by creating a uniform definition of fair value and providing a framework for implementing it. FAS 157 became effective for the first financial reporting period after November 15, 2007, and the timing of the change during the crisis threw it into the spotlight.

Fair value is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." FAS 157 establishes a fair value hierarchy for financial statement preparers to use to measure value. Assets and liabilities subject to fair value accounting that are actively traded can be valued at their trading, or market, price. Assets and liabilities subject to fair value accounting where no active market exists are valued based on management assumptions and internal models for determining the exit price of such assets and liabilities. Although it does not require reporting entities to use distressed sales as a basis for fair value reporting in an otherwise inactive market, FAS 157 does not define what constitutes a distressed sale, or an inactive market. Many financial institutions facing large scale write-downs if fair value were to be based on market prices in illiquid markets disagreed with auditors who believed that write-downs should reflect the prices at which the securities were bought or sold, as those prices reflected objective price measurements. Because there is no objective standard for determining when a market price does not reflect fair value, i.e., when a market is sufficiently illiquid that the financial statement preparer can use the next hierarchy level of FAS 157 to determine fair value, many auditors and financial statement preparers were unwilling to deviate from relying on market prices as the measure of fair value. The lack of guidance under FAS 157 compelled financial institutions holding mortgage-backed securities or auction rate securities to write down the value of such assets or liabilities to less than the present value of the principal and interest amounts owed, even when such payments were current and management had no expectation or belief that the credit of the issuer had deteriorated.

The SEC report on fair value concluded that neither FAS 157, nor fair value accounting generally, was the cause of U.S. bank failures in 2008. The report provided recommendations for improvements to existing accounting practices, but did not call for the suspension of FAS 157 or fair value accounting generally. Additionally, in a joint statement released on September 30, 2008, the SEC and the FASB issued guidance to assist reporting entities in determining the fair value of assets and liabilities in inactive markets, accounting for the effect of disorderly, or distressed transactions, and determining if losses are other than temporary impairment (OTTI) or the result of a temporary impairment. The OTTI guidance related to reviewing the decline in the value of assets and liabilities,

[17] The SEC's *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting* is available at: http://www.sec.gov/news/studies/2008/marktomarket123008.pdf.

the period of time for which the decline existed, the period of time until anticipated recovery, and whether or not the holder of the asset or liability has the ability to retain its investment until the anticipated recovery.

The FASB is also working closely with the IASB to ensure that any guidance relating to fair value is consistent with fair value guidance under IFRS, including a recent proposal released on December 24, 2008 to revise fair value disclosure requirements under Financial Accounting Standard 107, *Disclosures About Fair Value of Financial Instruments* (FAS 107), to bring FAS 107 in line with recent guidance provided by the IASB for IFRS 7, *Financial Instrument Disclosures*.[18] The FASB and the IASB are also working on a broader convergence plan for accounting principles generally, which they hope to have completed by 2011. This plan is in line with the convergence goals of the SEC and its IFRS roadmap. The FASB is also working to align impairment models, not only to simplify existing U.S. GAAP impairment models, but also to achieve its goal of global convergence.

For additional background on Fair Value please see our Client Alert at http://www.mofo.com/news/updates/files/081013FairValue.pdf, and for a detailed discussion of the SEC's report to Congress, please see our Client Alert at http://www.mofo.com/news/updates/files/090107SECStudy.pdf.

Other Than Temporary Impairment

An issue raised in connection with FAS 157 in distressed markets is the determination of whether or not an OTTI has occurred. An OTTI occurs if it is probable that a reporting entity will be unable to collect all amounts due or obtain par value on a sale of an asset or liability, regardless of whether any actual credit loss was sustained. On January 12, 2009, the FASB issued *Amendments to the Impairment and Interest Income Measurement Guidance of EITF Issue No. 99-20* (FSP EITF 99-20-1). FSP EITF 99-20-1 revises EITF Issue No. 99-20, which generally applies to securitized financial assets that are rated below "AA" at the time of origination, to provide for the use of judgment in assessing whether an impairment loss is expected to be temporary.[19] The amendment eliminates the requirement that impairment is determined by market participant assumptions regarding future cash flows without consideration of the probability that all cash flows will be collected. Reporting entities may rely on such guidance for financial reporting periods ending after December 15, 2008. The guidance will be prospective and will address a concern raised by reporting entities by bringing impairment guidance more in line with those under Financial Accounting Statement 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), and with IFRS, which are based on a reasonable judgment of the probability that the holder will be unable to collect all amounts due. Financial institutions holding securitization assets falling under the EITF will only have OTTI where cash flows are not expected to remain current, consistent with the application of OTTI for other assets.

Derivative Instruments and Hedging Activities Disclosures

In March 2008, the FASB issued Statement No. 161,[20] which requires increased disclosures regarding derivative and hedging activities. The Statement was issued to enhance the transparency of financial reporting and to better convey the purpose of derivatives use in terms of the risk that the entity intends to manage through the use of such instruments.

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, establishes disclosure requirements related to derivative instruments and hedging activities. Statement 161 expands these disclosure requirements to provide users of financial information with an understanding of: (i) the reasons an entity uses derivative instruments, and how these instruments are used; (ii) the accounting for derivative instruments and related hedged items under Statement 133 and related interpretations; and (iii) the effect that derivative instruments and related hedged items have on an entity's financial position, financial performance and cash flows.

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[18] FASB Staff Position FAS 107-a (posted for comment on December 24, 2008).
[19] FASB Staff Position EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue No. 99-20* (January 12, 2009).
[20] FASB Statement of Financial Accounting Standards No. 161, Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133 (March 2008) is available at http://www.fasb.org/pdf/fas161.pdf.

Statement 161 applies to all entities and all derivative instruments and related hedged items accounted for under Statement 133.

An entity is now required, at a minimum, to disclose its primary purposes and strategies for using derivatives by the underlying risk, including, but not limited to, interest rate, credit, foreign exchange rate or overall price risk. If the derivatives are not used to manage risk, then this required disclosure should adequately convey this. Entities have the option of disclosing additional information regarding derivatives and hedging activities, such as the different types of derivative instruments used to manage each type of primary risk, or the entity's particular exposure within each risk category. Statement 161 requires that the location and fair values of derivative instruments, and the location and amount of gains and losses on derivative instruments be disclosed in tabular format in the statement of financial position and the statement of financial performance, respectively. The fair value of derivatives is to be disclosed in the statement of financial position on a gross basis rather than on a net basis, to help users of financial information understand the risks and how those risks are being managed. The Statement also requires that an entity now provide some information that enables users to understand the entity's overall volume of derivative activity.

Also required is disclosure of the existence and nature of contingent features in derivative instruments, the aggregate fair value amount of such features and the aggregate fair value amount of assets that would be required to be posted as collateral or transferred under the provisions about triggering of the contingent features. This disclosure requirement is intended to provide information about the timing or likelihood of certain contingencies related to derivatives being triggered, as well as the effect on the liquidity of the entity if the contingencies were triggered.

Credit Derivatives and Certain Guarantees

In September 2008, the FASB issued FASB Staff Position No. FAS 133-1 and FIN 45-4,[21] which (i) amends Statement 133 to require certain disclosures by sellers of credit derivatives and guarantees, (ii) amends FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*,[22] to require an additional disclosure about the current status of the payment/performance risk of a guarantee, and (iii) clarifies the effective date of Statement 161. Over the past few years, CDSs have become a major focus of attention due to a large number of sellers facing defaults under their CDSs in light of current market conditions. This FSP aims to require entities to disclose the risks related to credit derivatives in order to provide users of financial information with a clearer picture of the entity's financial position.

This FSP applies to credit derivatives within the scope of Statement 133 as well as to hybrid instruments that contain embedded credit derivatives and guarantees within the scope of FIN 45. Statement 133 requires that a seller of credit derivatives (the party that assumes the credit risk in any credit derivative contract) provide the following types of information in its statement of financial position regarding the credit derivative: (a) its nature, including the term, events requiring performance of the seller and current status of its payment/performance risk; (b) the maximum potential amount of future payments (non-discounted) the seller could be required to make; (c) its fair value as of the date of the statement of financial position; and (d) the nature of (1) any provisions enabling the seller to recover from third parties any amounts paid under the credit derivative and (2) any assets held as collateral by third parties that, upon the occurrence of specific events or conditions, the seller can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative. These additional disclosures are intended to help users of financial statements in assessing the potential effect of a credit derivative on an entity's financial position, financial performance and cash flows. The disclosures are required for each credit derivative, or each group of similar credit derivatives, even if the probability of the seller having to make payment

[21] FASB Staff Position, No. FAS 133-1 and FIN 45-4, Disclosures About Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161 (September 12, 2008) are available at http://www.fasb.org/pdf/fsp_fas133&fin45-4.pdf.
[22] FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (November, 2002) is available at http://www.fasb.org/pdf/fin%2045.pdf.

obligations under the derivative is low. In addition, a seller of a hybrid instrument with an embedded credit derivative must make the required disclosures with respect to the entire instrument, not only to the embedded credit derivative.

FIN 45 was also amended by requiring the current status of the payment/performance risk of a guarantee to be disclosed (and what such risk is based on), to bring the required disclosures related to guarantees in line with those required for credit derivatives under Statement 133. This amendment was implemented due to the fact that guarantees and credit derivatives are similar instruments with similar risks and rewards and the FASB's desire to provide adequate information to users of financial information. The amendments are applicable for financial reporting periods ending after November 15, 2008; however, earlier application is encouraged.

This FSP also clarifies that the effective date of Statement 161 is for financial statements for periods ending after November 15, 2008.

Financial Guarantee Insurance Contracts

In May 2008, the FASB issued Statement No. 163[23] to eliminate diversity in practice in accounting for financial guarantee insurance contracts (often referred to as "monoline insurance") by insurance enterprises under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*.[24] The diversity in practice resulted in inconsistencies in the timing of the recognition and measurement of claim liabilities related to financial guarantee insurance contracts.

Statement 163 applies to financial guarantee insurance and reinsurance contracts, which are not accounted for as derivatives and are issued by insurance enterprises within the scope of Statement 60. A financial guarantee insurance contract is a contract that is issued by an insurance enterprise to provide protection to the holder of a financial obligation from a financial loss in the event of a default related to such obligation. Upon the occurrence of an event of default, such as non-payment of interest or principal on the underlying financial obligation, the insurance enterprise is required to pay a claim. Many securitization structures involved the use of financial guarantee insurance contracts as a form of credit enhancement. During 2007 and 2008, monoline insurance companies experienced unprecedented losses as a result of defaults in the sub-prime mortgages underlying mortgage-backed securitizations.

As a result of the potential liability associated with a financial guarantee insurance contract and the inconsistency of financial reporting related thereto, Statement 163 requires that an insurance enterprise recognize a liability for any unearned premium revenue on the financial guarantee insurance contract at its inception, with subsequent adjustments to be made based on any changes in assumptions or prepayment of any unearned premiums. In addition, Statement 163 requires an insurance enterprise to recognize the premium from a financial guarantee insurance or reinsurance contract as revenue over the term of the contract in proportion to the amount of insurance protection provided, with adjustments to be made based on changes in prepayment assumptions and the early retirement or replacement of a contract. As the premium revenue is recognized, the unearned premium revenue shall be decreased accordingly. The insurance enterprise must also recognize a claim liability on a financial guarantee insurance or reinsurance contract if the likelihood of an event of default occurring increases such that the enterprise expects that the present value of expected net cash outflows to be paid under the insurance contract will exceed the unearned premium revenue for that contract.

The measurement and disclosure requirements of Statement 163 are intended to increase the comparability in financial reporting by insurance enterprises issuing financial guarantee insurance or reinsurance contracts by requiring one form of accounting for premium revenues and claim liabilities. The Statement also expands the

[23] FASB Statement of Financial Accounting Standards No. 163, Accounting for Financial Guarantee Insurance Contracts, an interpretation of FASB Statement No. 60 (May 2008) is available at http://www.fasb.org/pdf/fas163.pdf.
[24] Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No. 60, Accounting and Reporting by Insurance Enterprises (June 1982) is available at http://www.fasb.org/pdf/fas60.pdf.

amount and quality of information provided to users of financial information regarding financial guarantee insurance contracts.

Statement 163 is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those years. In addition, it should be applied to existing and future financial guarantee insurance contracts issued by an insurance enterprise as of the beginning of the fiscal year in which Statement 163 is initially applied, and an insurance enterprise shall disclose any cumulative effect of the change on retained earnings in the statement of financial position in the first interim period of the fiscal year in which the Statement is initially applied.

Asset-Backed and Securitization Accounting

Financial Accounting Statement 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), and related FASB staff interpretation 46(R) (FIN 46(R)), govern the deconsolidation of assets in transactions including the plain vanilla and more complex securitization transactions that have been at the epicenter of the financial crisis.[25] FASB proposed significant changes to both FAS 140 and FIN 46(R), as well as additional disclosures.

FAS 140 provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. After a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. One of the major issues surrounding FAS 140 is determining control. In general, the greater the degree of control a seller continues to exercise over assets, the less likely it will be able to derecognize the assets and remove them from its balance sheet. Based on the FASB's recent exposure draft, industry participants are concerned that a servicer could be deemed to control assets or liabilities despite having limited power over them. There are also concerns that the exposure draft fails to address issues relating to shared control, which can impact kick-back rights and the governing of special purpose vehicles where there are numerous servicers. Proposals to eliminate the qualified special purpose entity provisions of FAS 140, which provide for deconsolidation of assets transferred to such an entity, raise specific concerns for the credit card industry that utilizes such structures for the majority of its securitization funding.

FIN 46(R) provides guidance to a reporting entity when it has a controlling financial interest in a variable interest entity (VIE). Financial institutions that sponsor VIEs, but were not required to include them on their balance sheets, nevertheless experienced losses when the VIEs required additional funds or were consolidated as a result of dislocations in the market. Given concerns that financial institutions' potential exposure to VIEs was not appropriately addressed by current accounting literature, there has been significant pressure to amend FIN 46(R). FIN 46(R) requires that the entity that is the primary beneficiary of a VIE—the party that absorbs a majority of the VIE's expected losses, receives a majority of its expected residual returns, or both, as a result of holding "variable interests"—is the entity that should consolidate the VIE's results in its financial statements. "Variable interests" are the ownership, contractual, or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets excluding variable interests. The exposure draft of FIN 46(R) requires ongoing assessments to determine whether an entity is a variable interest entity and whether an enterprise is the primary beneficiary of a variable interest entity, rather than just making an assessment upon the occurrence of certain specified events. The revisions are being proposed as a companion to the proposed elimination of the qualified special purpose entity concept from FAS 140.

While broader changes to FAS 140 and FIN 46(R) are being debated, the FASB has proposed substantial additional disclosures. Rather than restructure existing disclosure standards, the securitization industry has proposed utilization of "linked" financial statement reporting whereby financial statement entries are linked to additional disclosures that provide details of off-balance sheet arrangements and clarify which assets are linked to

[25] FASB Staff Position FAS 140-4 and FIN 46(R)-8

the repayment of identified liabilities. Linked presentations have been used effectively outside the United States and are being considered in connection with convergence discussions with the IASB.

What's Next?

In 2009, the SEC and the FASB will focus on simplifying accounting principles and on harmonizing global accounting standards. Both entities appreciate the need for greater transparency in financial reporting and for enhanced financial reporting as a means of bolstering investor confidence. This was a theme that surfaced throughout the SEC report to Congress on fair value accounting and throughout the recently released FASB guidance.

Additionally, in August 2008, the Advisory Committee on Improvements to Financial Reporting issued its Final Report.[26] The Advisory Committee's dual mandate was to examine the U.S. financial reporting system in order to make recommendations intended to increase the usefulness of financial information to investors, while reducing the complexity of the financial reporting system. The Final Report makes 25 recommendations, in five areas: (1) increasing the usefulness of information in SEC reports, (2) enhancing the accounting standards-setting process, (3) improving the substantive design of new accounting standards, (4) delineating authoritative interpretive guidance and (5) clarifying guidance on financial restatements and accounting judgments. We expect the 2009 priorities in this area to be shaped both by the Final Report and those areas of financial accounting implicated in the financial crisis.

Credit Derivatives

A popular belief echoed by politicians, regulators, and financial pundits throughout 2008 is that credit derivatives– and, in particular, CDSs– were major contributors to the current global financial crises.[27] A consequence of this negative, whether or not justified, is that we expect that the U.S. credit derivatives markets will undergo substantial regulatory and operational changes in 2009.

Establishment of Central Counterparties for Credit Default Swaps is a Top Priority

On November 14, 2008, the President's Working Group on Financial Markets (PWG), which includes the Treasury Secretary and the Chairs of the Federal Reserve, the SEC and the Commodity Futures Trading Commission (CFTC), announced a series of initiatives to strengthen oversight and the infrastructure of the over-the-counter derivatives market. Among those initiatives, the PWG stated that its top near-term OTC derivatives priority is "to oversee the successful implementation of central counterparty services for credit default swaps." In furtherance of that priority, the FRB, the CFTC, and the SEC entered into a Memorandum of Understanding on November 14, 2008 that establishes a framework for cooperation, coordination, and information sharing on issues relating to central counterparties (CCPs) for CDSs.

CCPs, as regulated entities, address a fundamental concern with credit derivatives: counterparty credit risk that contributes to systemic risk. More specifically, if credit exposures are concentrated in a specific market participant and that market participant fails, such failure could have a disproportionate effect on the overall market. In a CCP arrangement, the buyer and seller of a CDS novate their respective trades to the CCP promptly after entering into the contract through a clearing system. As a result, the CCP becomes the counterparty to all parties of CDSs that it clears, thereby substituting its creditworthiness and liquidity for the creditworthiness and liquidity of those parties. The use of CCPs also would facilitate greater market transparency and provide regulators with access to trade and position information for the purpose of monitoring market trends and preventing market manipulation and insider trading.

[26] The Final Report is available at http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf.
[27] For a general description of CDSs, please see our Client Alert "Credit Default Swaps as Insurance: One Regulator or Many?" at http://www.mofo.com/news/updates/files/081006CreditDefault.pdf (CDS Client Alert).

To date, competing efforts to create CCPs have been launched by (i) CME Group, which is the parent of the Chicago Mercantile Exchange, and Citadel Investment Group, (ii) the Intercontinental Exchange, through The Clearing Corp., (iii) a joint effort between NYSE Euronext's subsidiary, Liffe, and LCH.Clearnet and (iv) Eurex. On December 23, 2008, the CFTC announced that the Chicago Mercantile Exchange certified that its plans to provide clearing services for certain CDSs through its clearinghouse will comply with the derivatives clearing organization core principles enumerated in the Commodity Exchange Act. Separately, on December 24, 2008, the SEC granted temporary exemptions from certain requirements under the Securities Exchange Act of 1934 (Exchange Act), such as the requirement to register as a clearing agency under Section 17A of the Exchange Act, for LCH.Clearnet relating to its proposed activities in clearing and settling certain index-based CDSs. On that same date, the SEC issued an order that provides a temporary exemption from Sections 5 and 6 of the Exchange Act for exchanges and broker-dealers effecting transactions in CDSs. In addition, on January 14, 2009, the SEC published interim final temporary rules that provide exemptions under the Securities Act of 1933, the Exchange Act, and the Trust Indenture Act of 1939 for certain CDSs in order to facilitate the operation of one or more CCPs for those CDSs. The interim final temporary rules are effective from January 22, 2009 until September 25, 2009. Given the high priority that the PWG and its members have assigned to establishing CCPs for CDSs, it is likely that regulatory approval of the four proposals should be forthcoming in 2009.

The development of CCPs will require standardization of the CDSs that are cleared by those CCPs. However, this does not mean that customized CDSs will not be allowed or that all CDSs must be cleared through a CCP. As part of its policy objectives for the OTC derivatives market that the PWG announced on November 14, 2008, the PWG stated that market participants "should also be able to bilaterally negotiate customized contracts where there are benefits in doing so, *subject to continued oversight by their prudential supervisors*." Another policy objective of the PWG is that details of all CDSs that are *not* cleared through a CCP should be retained in a central contract repository.

Expanded Regulatory Jurisdiction over Credit Default Swaps is Sought

Commissioners of both the CFTC and SEC have called for federal regulation of CDSs. As discussed in our CDS Client Alert, based on statements made by New York's Governor Paterson on September 22, 2008, it also appeared that New York would reverse its prior position and, effective January 1, 2009, regulate CDSs as financial guarantee insurance, but only to the extent that the buyer of a CDS owns the underlying security for which the CDS provides protection. However, citing the PWG's initiatives that were announced on November 14, 2008, including the accelerated development of CCPs, and the progress made toward comprehensive federal regulation of CDSs, the New York Insurance Department announced on November 20, 2008 that it would delay indefinitely its application of New York Insurance Law to CDSs.

Auction Supplement to the 2003 ISDA Credit Derivatives Definitions

An Auction Supplement to the 2003 ISDA Credit Derivatives Definitions is expected to be completed by the International Swaps and Derivatives Association, Inc. (ISDA) by mid-March 2009. In response to regulators' request to "hardwire" auction terms into the settlement process for credit derivatives, the Auction Supplement will amend the Credit Derivatives Definitions to include the settlement auction terms that are currently found in ISDA's Auction Protocols relating to the settlement of credit derivatives. Interestingly, the Auction Protocol also is expected to provide for an entirely new element, the "ISDA Determination Committee," which will make binding determinations for issues relating to credit derivatives and is expected to play a central role in the credit derivatives market. Those issues may include, for example, whether a "Credit Event" has occurred under the Credit Derivatives Definitions or whether a particular obligation is deliverable in settlement of a credit derivative.

Part III: From Stabilization to Stimulus and Regulatory Re-engineering

The 111th Congress will have two key crisis-related matters on its agenda. The first is the incoming administration's stimulus package. Information about the new stimulus package is being released daily. Second, numerous studies have been requested on proposed changes to the financial regulatory system, and Congress will be asked to ensure that the regulatory structural limitations and gaps that failed to prevent or curtail the current crisis are addressed.

AARP: Transition from Stabilization to Stimulus

The President-elect's Recovery Plan, or ARRP, is a stimulus package. In setting forth his broader economic plan and in recent public statements, President-elect Obama proposed a combination of spending plans, tax cuts and mortgage modification programs. It isn't clear yet how much he will ask for at once. Notwithstanding the severity of the crisis, the new administration's proposed combination of reducing federal government income through tax cuts, increasing expenditures through spending programs and a stated goal of no earmarks, is a combination destined to be the subject of a hearty, and potentially lengthy, debate.

President-elect Obama's Recovery Plan, estimated at $825 billion, including $550 billion in new spending and $275 billion in tax relief, includes the following:

- Substantial investments in infrastructure, education, health and energy, including:
  - Moving forward with "well planned" infrastructure projects, including bridges, roads and schools;
  - Updating the power grid system, developing a delivery system for alternative forms of energy, home weatherization and modernizing over 75% of federal buildings to improve energy efficiency;
  - Expanding broadband throughout the country;
  - Investing in science, research and technology;
  - Education investments, including equipping schools, community colleges and universities with new computers, technology and training for teachers;
  - Investments in healthcare to move toward a nationwide system of electronic healthcare records;
- Temporary increases in programs such as job training, food stamps, extending heath care for the unemployed and unemployment insurance;
- Fiscal relief for states to prevent cuts in state healthcare programs, social services and education and to prevent increases in state taxes;
- Business investment incentives, particularly in the areas of renewable energy sources; and
- A $1,000 tax cut for 95% of working families.

Notably, recipients of TARP funds will not be eligible for many of the business tax savings included in the proposal.

Notwithstanding the incoming administration's efforts to pave the way for the stimulus package, Congress will be influenced by its recent TARP experience. As a result, we anticipate that Congress will closely consider the limits imposed on spending plans, and provisions for accountability and transparency. Anticipating such concerns, the ARRP proposes to make state spending conditional on personal certifications by governors and mayors that all expenditures within their jurisdictions are appropriate. Transparency will be provided through program managers identified on a website that is accessible to the public.

Additionally, because ARRP is a more traditional spending/tax-cut program, the biggest hurdle for the program may relate to the administration's stated goal of no earmarks. While Congress may welcome, and be more receptive to, a more traditional stimulus package, Chairman Bernanke recently commented that additional capital is required to stabilize a fragile financial system and that spending programs "are unlikely to promote a lasting recovery unless they are accompanied by strong measures to further stabilize and strengthen the financial system." We agree that while the stimulus package is likely to provide some immediate relief, ultimately financial institutions must resume lending in order for the financial system to function independent of government aid. As a result, despite the challenges and detractors, we expect that both the TARP and the ARRP will be needed, particularly in the short term.

Regulatory Modernization

On Tuesday, January 20, 2009, the Congressional Oversight Panel is scheduled to release its report on recommended reforms to the financial regulatory structure. This will be the latest, but not the last, outline for a new and improved regulatory regime. While a complete overhaul of U.S. financial system regulation, encompassing domestic, global and central banking, investment banking, securities markets and participants, mortgage, consumer and specialty finance lending, governmental and quasi-governmental bodies, futures and derivatives and insurance is needed, such sweeping change faces an uphill battle. Despite numerous impediments to modernization of financial system regulation, Congress will have the benefit of a wealth of reports and proposals and a healthy policy debate. Energized by the need to prevent such devastating crises in the future, we expect Congress to propose and implement significant changes in the months and years ahead.

Our current regulatory system was also borne out of crisis. While cautious comparisons have been made to the Great Depression, cautious in large part to avoid spreading panic, it is important to note that our current model was reaction to that crisis and the environment, beliefs and assumptions of that era. Wholesale shifts in philosophy and approach rarely come about in times of peace and prosperity. We expect that regulatory reform will be shaped by the specific forces, events and failures that led to the current crisis.

The decisions of the last century to provide a safety net for banking, did not provide flexibility or adaptability to adjust based on ongoing innovation in financial products and the blurring of lines across products and services. Efforts by the Federal Reserve, Treasury and the FDIC to secure money market mutual funds, a key savings tool for individuals and businesses, highlights one of the shortcomings in the current system. Americans, by relying on money market mutual funds as a safe and secure alternative to bank deposits, created a sector of the financial system that was "too big to fail." The government-sponsored enterprises are another example of where a government safety net, once applied, will be hard to remove.

In addition to the Congressional Oversight Panel's upcoming report, we look ahead to the Treasury's report on regulatory reform, due April 30, 2009. Treasury's prior effort was outlined in the March 2008 *Blueprint for a Modernized Financial Regulatory Structure*[28] (Blueprint). The Blueprint's views and proposals can be expected to shape and influence reform proposal development when policymakers move from stabilization and stimulus to reform. However, the recent events will shape priorities and the speed with which proposals are put forth and evaluated.

The Blueprint takes a three-step approach, proposing short-term and intermediate-term recommendations that could be implemented under the current regulatory system, as well as a framework for an "optimal" regulatory system.

<u>Short-term Recommendations</u>. The short-term recommendations were highlighted for immediate action based on the events as they stood in the first quarter of 2008. The impact and scope of the credit and financial crisis are still undetermined, but given its expansion since the Blueprint's publication, and the need for significant and dramatic change, we expect that a first look at regulatory reform will reach well beyond these short-term measures. Recommendations:

- Expand the President's Working Group on Financial Markets (1) to include banking regulators, (2) beyond financial markets, to cover financial policy for the entire financial sector and (3) to coordinate efforts on mitigating systemic risk, enhancing market integrity, promoting consumer and investor protection and supporting market efficiency and competitiveness.

[28] Treasury's Blueprint is available at http://www.ustreas.gov/press/releases/reports/Blueprint.pdf.

- Establish a federal Mortgage Origination Commission (MOC), with a board comprised of representatives from the Federal Reserve, OCC, OTS, FDIC, National Credit Union Administration and the Conference of State Bank Supervisors.
- Establish federal qualification and enforcement requirements for mortgage market participants, clarify authority for enforcement of laws and retain with the Federal Reserve the responsibility for national mortgage lending laws.
- The Federal Reserve, as the last source of liquidity to financial market participants through its discount window activities, should have authority as systemic risk regulator, to regulate institutions that utilize its programs.

Intermediate-term Recommendations. The intermediate-term recommendations cover areas not identified as immediately critical to the crisis as it was understood at the beginning of 2008 and were designed to increase the efficiency of financial regulation. Recommendations:

- Merge the thrift charter into the national bank charter.
- Rationalize federal oversight for state chartered banks with one regulator.
- Subject systemically significant payment and settlement systems to federal charter and regulation.
- Create an optional federal insurance regulatory system.
- Merge the SEC and the Commodities Futures Trading Commission and modernize SEC regulation prior to the merger to facilitate a smoother transition.

Given the worsening of the economy following the Blueprint's publication, we expect the scope of regulatory reform efforts will focus on reshaping the system, rather than making incremental changes as proposed in the intermediate-term recommendations.

Optimal Framework. The Blueprint notes the market developments since the establishment of our current framework, including capital market globalization, improvements in information technology and information exchange, development of more sophisticated risk diversification products, including securitization, increased use of leverage, development of innovative financial products with insurance, banking, securities and futures components and the convergence of financial services providers and products. Functional regulation based on lines of business is seen as (1) preventing one regulator from having the information necessary to develop a perspective on systemic risk, (2) leading to jurisdictional conflicts between regulators, impeding the adoption of timely regulatory changes and (3) creating redundancies and inefficiencies.

To address these concerns, the Blueprint proposes replacing functional regulation with objectives-based regulation. The primary regulatory functions would be market stability regulation, prudential financial, or safety and soundness, regulation, and business conduct regulation.

To assist Congress in the development and evaluation of plans for regulatory reform, on January 8, 2009, the GAO published *A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*[29] (Framework). The Framework reviews the historical underpinnings of the current structure and outlines the reasons significant and holistic reform is critical to prevent future crises. It then offers the following nine elements that can be used to develop or evaluate alternatives:

1. *Clearly defined regulatory goals*. Clearly articulated and relevant goals permit regulators to effectively conduct activities to implement their missions.

[29] The GAO Framework is available at http://www.gao.gov/new.items/d09216.pdf.

2. *Appropriately comprehensive*. Financial institutions and activities should be regulated in a way that ensures regulatory goals are fully met. Activities that pose risks to consumer protection, financial stability, or other goals should be comprehensively regulated, while recognizing that not all activities will require the same level of regulation.

3. *Systemwide focus*. The regulatory system should include a mechanism for identifying, monitoring and managing risks to the financial system regardless of the source of the risk or the institutions in which it is created.

4. *Flexible and adaptable*. Regulators should be able to readily adapt to market innovations and changes and include a mechanism for evaluating potential new risks to the system.

5. *Efficient and effective*. Efficient oversight of financial services should be provided by eliminating overlapping federal regulatory missions, where appropriate, and minimizing regulatory burden while effectively achieving the goals of regulation.

6. *Consistent consumer and investor protection*. Include consumer and investor protection to ensure that market participants receive consistent, useful information, as well as legal protections for similar financial products and services, including disclosures, sales practice standards and suitability requirements.

7. *Regulators provided with independence, prominence, authority, and accountability*. Regulators should have independence from inappropriate influence; have sufficient resources, clout, and authority to carry out and enforce statutory missions; and be clearly accountable for meeting regulatory goals.

8. *Consistent financial oversight*. Similar institutions, products, risks and services should be subject to consistent regulation, oversight and transparency, which should help minimize negative competitive outcomes while harmonizing oversight, both within the United States and internationally.

9. *Minimal taxpayer exposure*. Adequate safeguards should be in place to allow financial institution failures to occur while limiting taxpayers' exposure to financial risk.

Perspectives

The Blueprint lays out proposed changes in stages, primarily, we believe, to reflect the perceived uphill battle to regulatory system modernization. The impact of the events of the last several months, however, may have opened the door to more dramatic and holistic proposals being considered in the short-term. While the Blueprint proposes the merger and transformation of individual agencies, Congress may alternatively propose a new umbrella agency or agencies to achieve the objectives-based regulatory approach. Adding, rather than subtracting, may be an easier pill to swallow. Any proposal offered will be evaluated by the GAO against its framework, and we should expect their reports to provide comprehensive analysis of any proposed regulatory changes.

Conclusion

We have never been more certain that the coming year will present new and unprecedented changes and challenges. Financial services regulation overhaul proposals will be shaped by the current crisis. The safety net for banking, having been extended by necessity through patchwork programs and initiatives, will be formally re-established in a new regulatory structure. Consumer regulatory initiatives will be balanced with the need to be competitive, domestically and globally, but many of the voices traditionally calling for that balance have been distracted or tarnished, or have disappeared as a result of the crisis. The need to both restart and restructure the mortgage industry in America creates conflicting policy goals that will need to be addressed. Lawmakers will need to balance short-term and long-term goals—a challenging mandate.

Whatever the outcome, the debate will be lengthy and complex. Please consult our financial crisis website at http:///www.mofo.com/news/updates/files/14605.html for updates and developments.

Contacts

Contact your Morrison & Foerster lawyer with any questions.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

Appendix A

Federal Crisis Programs

Sponsor	Program	Date Announced	Description and Information
Treasury	Fannie Mae / Freddie Mac Bailout	Sept 7, 2008	1. Treasury announces plan to begin making open-market purchases of mortgage-backed securities issued by Fannie and Freddie in September. The purchase program is scheduled to expire in December 2009. 2. Treasury established a secured lending credit facility for use by Fannie and Freddie and the Federal Home Loan Banks. The facility, intended as a liquidity backstop, is scheduled to expire in December 2009. 3. Treasury entered into preferred stock purchase agreements with each of Fannie and Freddie and committed to purchase preferred stock as and when either of Fannie or Freddie needed additional capital. The preferred stock was senior to all existing equity holders and accompanied by warrants. The agreements are infinite in duration and represent a $100 billion commitment to each of Fannie and Freddie. These actions were authorized by the Housing and Economic Recovery Act of 2008 and were announced the same day that the Federal Housing Finance Agency was appointed conservator of Fannie and Freddie.
Treasury	Money Market Guarantee		SEC registered money market funds were eligible to purchase a guarantee from Treasury that, in the event their net asset value fell below $1.00, Treasury would make payable to investors any shortfall. Only amounts outstanding as of September 19, 2008 are guaranteed, and to be eligible for the guarantee, the fund's net asset value could not be below $0.995 when it enrolled in the program. In November 2008, Treasury extended the program through April 30, 2009. Further extension through December 2009 is possible. The Guarantee Program was initially funded under the Exchange Stabilization Act, but the Emergency Economic Stabilization Act requires any disbursements under the program come from TARP funds. As of November 2008, the program covered $3 trillion of money market assets.
	Programs under the Emergency Economic Stabilization Act		
Treasury	1. Purchase of mortgage-related assets	On hold	TARP was originally proposed as a program to purchase mortgages and mortgage-related securities (troubled assets) to ease pressure on the balance sheets of financial institutions. Complexity of developing a purchase program and the freeze in inter-bank lending led Treasury to develop other programs and announce in November 2008 an abandonment of the mortgage-related asset purchase program.
Treasury	2. Capital Purchase Program (publicly held)	Oct 14, 2008	Treasury will make investments in healthy U.S. depository institutions and their holding companies through a purchase of preferred stock. Participants are also required to grant warrants to Treasury.

Sponsor	Program	Date Announced	Description and Information
			In exchange for the new capital, participants agree to executive compensation restrictions and limitations on their ability to pay dividends or repurchase shares without Treasury approval. Executive compensation restrictions apply to the CEO, CFO, and the three most highly compensated executive officers and include limitations on golden parachute payments, clawback of incentive compensation under certain circumstances, limited deductibility of compensation, restrictions on certain types of incentive compensation structures, and the imposition of requirements and disclosure obligations on the compensation committee.
Treasury	3. Capital Purchase Program (privately held)	Nov 17, 2008	Treasury structured the primary Capital Purchase Program for publicly held eligible entities, including many of the corporate governance requirements and transfer requirements for the securities it acquired. For privately-held participants, the terms of the securities being acquired were adjusted.
Treasury	4. Capital Purchase Program (S corporations and mutual organizations)	Jan 14, 2009	For S corporations, Treasury will receive subordinated debentures and warrants. The alternative structure of the investment was necessary to preserve the tax status of these organizations. Modifications were made to the terms of the Treasury securities to provide parity to the other programs.
Treasury	5. Capital Purchase Program (mutual organizations and other institutions)	Under consideration	
Treasury	6. Systemically Significant Failing Institutions (SSFI)	Nov 10, 2008	Treasury to evaluate on a case-by-case basis the need to make an investment in a systemically significant failing institution based on the following factors: 1. The extent to which the failure of an institution could threaten the viability of its creditors and counterparties because of their direct exposures to the institution; 2. The number and size of financial institutions that are seen by investors or counterparties as similarly situated to the failing institution, or that would otherwise be likely to experience indirect contagion effects from the failure of the institution; 3. Whether the institution is sufficiently important to the nation's financial and economic system so that a disorderly failure would, with a high probability, cause major disruptions to credit markets or payments and settlement systems, seriously destabilize key asset prices, and significantly increase uncertainty or loss of confidence, thereby materially weakening overall economic performance; or 4. The extent and probability of the institution's ability to access alternative sources of capital and liquidity, whether from the private sector or from other sources of U.S. government funds. Used on November 10, 2008 for Treasury's investment in AIG (AIG II). AIG was required to comply with the

Sponsor	Program	Date Announced	Description and Information
			executive compensation limitations imposed on participants in the Capital Purchase Program, as well as limits on its annual bonus pool, additional golden parachute restrictions, new corporate governance requirements including the establishment of a Board level risk committee, and restrictions on expenses and lobbying. Restrictions on participating institutions will be determined on a case-by-case basis. Treasury will also require any institution participating in the program to comply with the limitations on executive compensation applicable to SSFIs as set forth in Treasury Notice 2008-PSSFI.
Treasury	7. Targeted Investment Program (TIP)	Nov 23, 2008	The program will evaluate potential participants using the following five factors: 1. The extent to which destabilization of the institution could threaten the viability of creditors and counterparties exposed to the institution, whether directly or indirectly; 2. The extent to which an institution is at risk of a loss of confidence and the degree to which that stress is caused by a distressed or illiquid portfolio assets; 3. The number and size of financial institutions that are similarly situated, or that would likely be affected by destabilization of the institution being considered for the program; 4. Whether the institution is sufficiently important to the nation's financial and economic system so that a loss of confidence in the firm's financial position could potentially cause major disruptions to credit markets or payments and settlement systems, destabilize asset prices, significantly increase uncertainty, or lead to similar losses of confidence or financial market stability which could materially weaken overall economic performance; and The extent to which the institution has access to alternative sources of capital and liquidity, whether from the private sector or from other sources of U.S. government funds. Used on November 23, 2008 for the Citigroup investment and program guidelines were published on January 2, 2009. This program is distinguished from the Systemically Significant Failing Institutions Program by requiring only that the participant be facing "destabilization" rather than failure. Terms of Treasury's investment and the conditions and restrictions imposed on participants, which are expected to be stricter than the Capital Purchase Program, will be on a case-by-case basis. Treasury purchased an additional $20 billion of preferred stock from Citigroup, and Treasury, the Federal Reserve, and the FDIC provided loss protection on a portfolio of mortgage-related assets. Treasury is evaluating whether the loss protection portion of the transaction may be part of the Asset Guarantee Program. Used on January 15, 2009 for the Bank of America investment in connection with a purchase of $20 billion of preferred stock. Treasury, the Federal Reserve, and the FDIC provided protection against large losses from a portfolio of assets acquired from Merrill Lynch. Bank of America will comply with enhanced executive

Sponsor	Program	Date Announced	Description and Information
			compensation restrictions and implement a mortgage loan modification program.
Treasury	8. Term Asset-Backed Securities Loan Facility (TALF)	Nov 25, 2008	Joint Federal Reserve– Treasury program. The New York Fed (FRBNY) will make three-year loans to fund the purchase of consumer and small business asset-backed paper. The ABS must be backed by newly originated assets and will be pledged to the New York Fed to secure the loans. The program was designed to increase liquidity in the consumer and small business securitization market, which should increase, or prevent further decrease in, the extension of credit to consumers and small businesses. Treasury will absorb $20 billion in losses on the collateral through a subordinated debt investment in the vehicle that will hold the collateral. Please see our Client Alert at http://www.mofo.com/news/updates/files/081126TermAsset.pdf.
Treasury	9. Automotive Industry Financing Program (AIFP)	Dec 19, 2008	Treasury will evaluate making investments in the American automotive industry to prevent significant disruption that poses a systemic risk to financial market stability and has a negative effect on the real economy. The Treasury will consider the following factors: 1. The importance of the institution to production by, or financing of, the American automotive industry; 2. Whether a major disruption of the institution's operations would likely have a materially adverse effect on employment and thereby produce negative spillover effects on overall economic performance; 3. Whether the institution is sufficiently important to the nation's financial and economic system so that a major disruption of its operations would, with a high probability, cause major disruptions to credit markets and significantly increase uncertainty or loss of confidence, thereby materially weakening overall economic performance; and 4. The extent and probability of the institution's ability to access alternative sources of capital and liquidity, whether from the private sector or from other sources of U.S. government funds. The terms and conditions of each investment will be made on a case-by-case basis. The program was used to make secured loans to each of GM, Chrysler, and an investment in GMAC, and to extend a loan to GM in connection with the GMAC rights offering. The objective of the AIFP is to prevent any significant disruption of the American automotive industry, which would pose a systemic risk to financial market stability and have a negative effect on the economy of the United States. Each of GM and Chrysler's loans are conditioned on government approval of restructuring and other plans, extensive compensation, and governance restrictions.
Treasury	10. Asset Guarantee Program	Dec 31, 2008	Guarantees for assets held by systemically significant financial institutions that face a high risk of losing market confidence due in large part to a portfolio of distressed or illiquid assets. Each financial institution and troubled

Sponsor	Program	Date Announced	Description and Information
			asset will be individually evaluated. Institutions will be evaluated using the factors employed for the Targeted Investment Program. Not to be widely available. Treasury continues to evaluate and consider alternative insurance programs.
Treasury	Bank of America	Jan 15, 2009	Treasury, the Federal Reserve, and the FDIC provided a package of guarantees, liquidity access, and capital to Bank of America. Treasury and the FDIC will provide protection against the possibility of unusually large losses on an asset pool of approximately $118 billion of loans, securities backed by residential and commercial real estate loans, and other such assets, all of which have been marked to current market value. These assets were assumed by Bank of America as a result of its acquisition of Merrill Lynch. Bank of America will issue preferred shares to Treasury and the FDIC. In addition and if necessary, the Federal Reserve stands ready to backstop residual risk in the asset pool through a non-recourse loan. In addition, Treasury will invest $20 billion in Bank of America from the Troubled Asset Relief Program's Targeted Investment Program in exchange for preferred stock with an 8 percent dividend to Treasury. Bank of America will comply with enhanced executive compensation restrictions and implement a mortgage loan modification program.
Federal Reserve	Single Tranche Open Market Operations Program	Mar 7, 2007	Primary dealers can borrow against Treasuries, Agencies, and Agency-MBS for 28-day terms in weekly auctions. Expansion of the regular open market operations of the Federal Reserve.
Federal Reserve	Term Auction Facility	Dec 12, 2007	The Federal Reserve will auction term funds to depository institutions against the wide variety of collateral that can be used to secure loans at the discount window. All depository institutions that are judged to be in generally sound financial condition by their local Reserve Bank and that are eligible to borrow under the primary credit discount window program will be eligible to participate in TAF auctions. All advances must be fully collateralized. Each TAF auction will be for a fixed amount, with the rate determined by the auction process (subject to a minimum bid rate). Depositories will submit bids through their local Reserve Bank. The minimum bid rate for the auctions will be established at the overnight indexed swap (OIS) rate corresponding to the maturity of the credit being auctioned.
Federal Reserve	Term Securities Lending Facility (TSLF)	March 11, 2008	The Federal Reserve will lend up to $200 billion of Treasury securities to primary dealers secured for a term of 28 days (rather than overnight, as in the existing program) by a pledge of other securities, including federal agency debt, federal agency residential-mortgage-backed securities (MBS), and non-agency AAA/Aaa-rated private-label residential MBS. The TSLF is intended to promote liquidity in the financing markets for Treasury and other collateral and thus foster the functioning of financial markets more generally.

Sponsor	Program	Date Announced	Description and Information
Federal Reserve	Primary Dealer Credit Facility	March 16, 2008	The Federal Reserve authorized the New York Fed to create a lending facility to improve the ability of primary dealers to provide financing to participants in securitization markets. Credit extended to primary dealers under this facility may be collateralized by a broad range of investment-grade debt securities. The interest rate charged on such credit will be the same as the primary credit rate, or discount rate, at the Federal Reserve Bank of New York. Initially, the program had a six-month term. It was extended twice.
Federal Reserve	Primary Dealer Credit Facility Extension	July 30, 2008	Program extended through January 30, 2009.
Federal Reserve	Term Auction Facility expanded	July 30, 2008	The Federal Reserve will auction 84-day TAF loans while continuing to auction 28-day TAF funds. Specifically, the Federal Reserve will conduct biweekly TAF auctions, alternating between auctions of $75 billion of 28-day credit and auctions of $25 billion of 84-day credit. Under the TAF, the Federal Reserve auctions term funds to depository institutions, secured by a wide variety of collateral. All depository institutions that are judged to be in generally sound financial condition by their local Reserve Bank are eligible to participate in TAF auctions.
Federal Reserve	Term Securities Lending Facility Options Program	July 30, 2008	Extension of the Term Securities Lending Facility (TSLF) through January 30, 2009. The introduction of auctions of options on $50 billion of draws on the TSLF. The Federal Reserve authorized the New York Fed to auction options for primary dealers to borrow Treasury securities from the TSLF. The Federal Reserve intends to offer such options for exercise in advance of periods that are typically characterized by elevated stress in financial markets, such as quarter ends. Under the options program, up to $50 billion of draws on the TSLF using options may be outstanding at any time. This amount is in addition to the $200 billion of Treasury securities that may be offered through the regular TSLF auctions. Draws on the TSLF through exercise of these options may be collateralized by the full range of TSLF Schedule 2 collateral. (Schedule 2 collateral includes Treasury securities, federal agency debt securities, mortgage-backed securities issued or guaranteed by federal agencies, and AAA/Aaa-rated private-label residential mortgage-backed, commercial mortgage-backed, and asset-backed securities.) Additional details of this program will be announced once consultations with the primary dealer community have been completed.
Federal Reserve	AIG I	Sept 16, 2008	The Federal Reserve authorized the New York Fed to lend up to $85 billion to the AIG. The secured loan has terms and conditions designed to protect the interests of the U.S. government and taxpayers. The purpose of this liquidity facility is to assist AIG in meeting its obligations as they come due. This loan will facilitate a process under which AIG will sell certain of its businesses in an orderly manner, with the least possible disruption to the overall economy.

Sponsor	Program	Date Announced	Description and Information
			The AIG facility has a 24-month term. Interest will accrue on the outstanding balance at a rate of three-month Libor plus 850 basis points. AIG will be permitted to draw up to $85 billion under the facility. The loan is collateralized by all the assets of AIG, and of its primary non-regulated subsidiaries. These assets include the stock of substantially all of the regulated subsidiaries. The loan is expected to be repaid from the proceeds of the sale of the firm's assets. The U.S. government will receive a 79.9 percent equity interest in AIG and has the right to veto the payment of dividends to common and preferred shareholders.
Federal Reserve	ABCP Money Market Fund Liquidity Facility	Sept 19, 2008	The Federal Reserve will extend non-recourse loans at the primary credit rate to U.S. depository institutions and bank holding companies to finance their purchases of high-quality asset-backed commercial paper (ABCP) from money market mutual funds. This should assist money funds that hold such paper to meet demands for redemption by investors and to foster liquidity in the ABCP markets and broader money markets.
Federal Reserve	Transitional Credit Extensions	Sept 21, 2008	The Federal Reserve Board on Sunday approved, pending a statutory five-day antitrust waiting period, the applications of Goldman Sachs and Morgan Stanley to become bank holding companies. To provide increased liquidity support to these firms as they transition to managing their funding within a bank holding company structure, the Federal Reserve Board authorized the Federal Reserve Bank of New York to extend credit to the U.S. broker-dealer subsidiaries of Goldman Sachs and Morgan Stanley against all types of collateral that may be pledged at the Federal Reserve's primary credit facility for depository institutions or at the existing Primary Dealer Credit Facility (PDCF); the Federal Reserve also made these collateral arrangements available to the broker-dealer subsidiary of Merrill Lynch. In addition, the Board also authorized the Federal Reserve Bank of New York to extend credit to the London-based broker-dealer subsidiaries of Goldman Sachs, Morgan Stanley, and Merrill Lynch against collateral that would be eligible to be pledged at the PDCF.
Federal Reserve	Interest Paid on Excess Deposit Balances	Oct 6, 2008	The Federal Reserve will pay interest on depository institutions' required and excess reserve balances. The payment of interest on excess reserve balances will give the Federal Reserve greater scope to use its lending programs to address conditions in credit markets while also maintaining the federal funds rate close to the target established by the Federal Open Market Committee. Employing the accelerated authority, the Federal Reserve approved a rule to amend its Regulation D (Reserve Requirements of Depository Institutions) to direct the Federal Reserve Banks to pay interest on required reserve balances (that is, balances held to satisfy depository institutions' reserve requirements) and on excess balances (balances held in excess of required reserve balances and clearing balances). The interest rate paid on required reserve balances will be the average targeted federal funds rate established by the Federal Open Market Committee over each reserve maintenance period less 10 basis points. Paying interest on required reserve balances should essentially eliminate the opportunity cost of holding required reserves, promoting efficiency in the banking sector. The rate paid on excess balances will be set initially as the lowest targeted federal funds rate for each reserve maintenance period less 75 basis points. Paying interest on excess balances should help to establish a lower bound on the federal funds rate. The formula for the interest rate on

Sponsor	Program	Date Announced	Description and Information
			excess balances may be adjusted subsequently in light of experience and evolving market conditions. The Federal Reserve approved other related revisions to Regulation D to prescribe the treatment of balances maintained by pass-through correspondents under the new rule and to eliminate transitional adjustments for reserve requirements in the event of a merger or consolidation. In addition, the Board approved associated minor changes to the method for calculating earnings credits under its clearing balance policy and the method for recovering float costs. The revisions to Regulation D and the other changes became effective October 9, 2008.
Federal Reserve	Commercial Paper Funding Facility (CPFF)	Oct 7, 2008	The CPFF will provide a liquidity backstop to U.S. issuers of commercial paper through a special purpose vehicle (SPV) that will purchase three-month unsecured and asset-backed commercial paper directly from eligible issuers. The Federal Reserve will provide financing to the SPV under the CPFF and will be secured by all of the assets of the SPV.
Federal Reserve	Money Market Investor Funding Facility (MMIFF)	Oct 21, 2008	The Federal Reserve created the MMIFF, which will support a private-sector initiative designed to provide liquidity to U.S. money market investors. Under the MMIFF, the New York Fed will provide senior secured funding to a series of special purpose vehicles to facilitate an industry-supported private-sector initiative to finance the purchase of eligible assets from eligible investors. Eligible assets will include U.S. dollar-denominated certificates of deposit and commercial paper issued by highly rated financial institutions and having remaining maturities of 90 days or less. Eligible investors will include U.S. money market mutual funds and over time may include other U.S. money market investors. The MMIFF should improve the liquidity position of money market investors, thus increasing their ability to meet any further redemption requests and their willingness to invest in money market instruments. Improved money market conditions will enhance the ability of banks and other financial intermediaries to accommodate the credit needs of businesses and households.
Federal Reserve	AIG II	Nov 10, 2008	The Federal Reserve and Treasury restructured the government's financial support of AIG. Treasury purchased $40 billion of newly issued AIG preferred shares. The purchase allowed the Federal Reserve to reduce from $85 billion to $60 billion the total amount available under the credit facility established by the New York Fed on September 16, 2008. Other terms of the existing New York Fed credit facility, established on September 16, will be modified. In particular, the interest rate on the facility will be reduced to three-month Libor plus 300 basis points from the current rate of three-month Libor plus 850 basis points, and the fee on undrawn funds will be reduced to 75 basis points from the current rate of 850 basis points. The length of the facility will be extended from two years to five years. The other material terms of the facility remain unchanged. The facility will continue to be secured by a

Sponsor	Program	Date Announced	Description and Information
			lien on many of the assets of AIG and of its subsidiaries. The Federal Reserve authorized the New York Fed to establish two new lending facilities relating to AIG under section 13(3) of the Federal Reserve Act: 1. Residential Mortgage-Backed Securities Facility. The New York Fed will lend up to $22.5 billion to a newly formed limited liability company (LLC) to fund the LLC's purchase of residential mortgage-backed securities from AIG's U.S. securities lending collateral portfolio. AIG will make a $1 billion subordinated loan to the LLC and bear the risk for the first $1 billion of any losses on the portfolio. The loans will be secured by all of the assets of the LLC and will be repaid from the cash flows produced by these assets, as well as the proceeds from any sales of these assets. The New York Fed and AIG will share any residual cash flows after the loans are repaid. Proceeds from this facility will be used to return all cash collateral posted for securities loans outstanding under AIG's U.S. securities lending program. As a result, the $37.8 billion securities lending facility established by the New York Fed on October 8, 2008, will be repaid and terminated. 2. Collateralized Debt Obligations Facility. The New York Fed will lend up to $30 billion to a newly formed LLC to fund the LLC's purchase of multi-sector collateralized debt obligations (CDOs) on which AIG Financial Products wrote credit default swaps (CDSs). AIG will make a $5 billion subordinated loan to the LLC and bear the risk for the first $5 billion of any losses on the portfolio. In connection with the purchase of the CDOs, the CDS counterparties will concurrently unwind the related CDS transactions. The loans will be secured by all of the LLC's assets and will be repaid from cash flows produced by these assets, as well as the proceeds from any sales of these assets. The New York Fed and AIG will share any residual cash flows after the loans are repaid.
Federal Reserve	Term Asset-Backed Securities Loan Facility (TALF)	Nov 25, 2008	The TALF will help market participants meet the credit needs of households and small businesses by supporting the issuance of asset-backed securities (ABS) collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration (SBA). The New York Fed will lend up to $200 billion on a non-recourse basis to holders of certain AAA-rated ABS backed by newly and recently originated consumer and small business loans. The FRBNY will lend an amount equal to the market value of the ABS less a haircut and will be secured at all times by the ABS. Treasury—under the Troubled Assets Relief Program (TARP) of the Emergency Economic Stabilization Act of 2008—will provide $20 billion of credit protection to the FRBNY in connection with the TALF. Assets underlying the ABS must be recently issued; the term of each loan is three years; and investors in the program cannot be affiliated with a party to the ABS they pledge.
Federal Reserve	Fannie Mae, Freddie Mac and Federal Home Loan Banks	Nov 25, 2008	The Federal Reserve purchased the direct obligations of housing-related government-sponsored enterprises (GSEs)—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks—and mortgage-backed securities (MBS)

Sponsor	Program	Date Announced	Description and Information
			backed by Fannie Mae, Freddie Mac, and Ginnie Mae. Purchases of up to $100 billion in GSE direct obligations under the program will be conducted with the Federal Reserve's primary dealers through a series of competitive auctions. Purchases of up to $500 billion in MBS will be conducted by asset managers selected via a competitive process. The Federal Reserve expects to begin operations in January 2009 under the previously announced program to purchase mortgage-backed securities (MBS), having selected private investment managers to act as its agents in implementing the program. Under the MBS purchase program, the Federal Reserve will purchase MBS backed by Fannie Mae, Freddie Mac, and Ginnie Mae; the program is being established to support the mortgage and housing markets and to foster improved conditions in financial markets more generally.
Federal Reserve	Primary Dealer Credit Facility Extension	Dec 2, 2008	The program was extended through April 30, 2009.
Federal Reserve	ABCP Money Market Fund Liquidity Facility Extension	Dec 2, 2008	The program was extended through April 30, 2009.
Federal Reserve	Term Securities Lending Facility Extension	Dec 2, 2008	The program was extended through April 30, 2009.
Federal Reserve	Bank of America	Jan 15, 2009	Treasury, the Federal Reserve, and the FDIC provided a package of guarantees, liquidity access, and capital to Bank of America as part of its commitment to support financial market stability. Treasury and the FDIC will provide protection against the possibility of unusually large losses on an asset pool of approximately $118 billion of loans, securities backed by residential and commercial real estate loans, and other such assets, all of which have been marked to current market value. These assets were assumed by Bank of America as a result of its acquisition of Merrill Lynch. Bank of America will issue preferred shares to Treasury and the FDIC. In addition and if necessary, the Federal Reserve stands ready to backstop residual risk in the asset pool through a non-recourse loan. In addition, Treasury will invest $20 billion in Bank of America from the Troubled Asset Relief Program's Targeted Investment Program in exchange for preferred stock with an 8% dividend to Treasury. Bank of America will comply with enhanced executive compensation restrictions and implement a mortgage loan modification program.
FDIC	Temporary Liquidity Guarantee Program (TLGP)	Oct 14, 2008	Program was designed to increase inter-bank liquidity and restore confidence in the banking system. Eligible entities were automatically included and were required to opt out by December 5, 2008 if they did not wish to participate. There is a fee for each program.

Sponsor	Program	Date Announced	Description and Information
			Debt Guarantee Program: Participants can issue senior unsecured debt that carries an FDIC guarantee through the earlier of the maturity of the debt and June 30, 2012. Transaction Account Guarantee Program: Non-interest bearing transaction account deposits in participating institutions benefit from unlimited FDIC insurance.
FDIC	Citigroup	Nov 23, 2008	Treasury, the Federal Reserve, and the FDIC entered into an agreement with Citigroup to provide a package of guarantees, liquidity access, and capital. As part of the agreement, Treasury and the FDIC will provide protection against the possibility of unusually large losses on an asset pool of approximately $306 billion of loans and securities backed by residential and commercial real estate and other such assets, which will remain on Citigroup's balance sheet. As a fee for this arrangement, Citigroup will issue preferred shares to Treasury and the FDIC. In addition and if necessary, the Federal Reserve stands ready to backstop residual risk in the asset pool through a non-recourse loan. In addition, Treasury will invest $20 billion in Citigroup from the Troubled Asset Relief Program in exchange for preferred stock with an 8% dividend to Treasury. Citigroup will comply with enhanced executive compensation restrictions and implement the FDIC's mortgage modification program.
FDIC	Bank of America	Jan 15, 2009	Treasury, the Federal Reserve, and the FDIC provided a package of guarantees, liquidity access, and capital to Bank of America as part of its commitment to support financial market stability. Treasury and the FDIC will provide protection against the possibility of unusually large losses on an asset pool of approximately $118 billion of loans, securities backed by residential and commercial real estate loans, and other such assets, all of which have been marked to current market value. These assets were assumed by Bank of America as a result of its acquisition of Merrill Lynch. Bank of America will issue preferred shares to Treasury and the FDIC. In addition and if necessary, the Federal Reserve stands ready to backstop residual risk in the asset pool through a non-recourse loan. In addition, Treasury will invest $20 billion in Bank of America from the Troubled Asset Relief Program's Targeted Investment Program in exchange for preferred stock with an 8% dividend to Treasury. Bank of America will comply with enhanced executive compensation restrictions and implement a mortgage loan modification program.