Easing Into a New Model for Housing Finance: A Postmortem on Securitization and the Financial Crisis

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Many point to the bankruptcy of New Century Financial Corporation as the "official" beginning of the most recent subprime crisis. It would be difficult to trace this subprime crisis back to a particular date or to any single event. However, in hindsight, it is clear that the failure of subprime lenders was just a symptom of the underlying problems rather than the root cause of these problems. At this point, we have witnessed quite a number of other profoundly painful symptoms, including the failure of some of the country's largest thrifts, the failure of a global insurance giant, the failure of a significant number of banks, the failure of several investment banks, and plummeting stock prices. The government has taken a number of unprecedented steps to combat these problems. The Treasury has injected approximately $250 billion of capital into financial institutions, the Federal Deposit Insurance Corporation (FDIC) has expanded guarantees for bank liabilities, and the Fed has cut rates and has introduced a number of credit and other facilities intended to

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provide liquidity to different segments of the market. However, despite all of these emergency actions, the economy continues to weaken. Financial institutions continue to write down the value of their "troubled" assets. Lingering concerns about the value of these assets have proven to be stronger than the government's emergency measures. In the face of concerns regarding the stability of the largest financial institutions, loan modification programs and other mortgage mitigation have taken a back seat to other emergency measures. Discussions of alternative approaches to mortgage finance also have been deferred for better times.

In a recent speech, Federal Reserve Chairman Ben Bernanke noted that "The proximate cause of the crisis was the turn of the housing cycle in the United States and the associated rise in delinquencies on subprime mortgages, which imposed substantial losses on many financial institutions and shook investor confidence in the credit markets. However, although the subprime debacle triggered the crisis, the developments in the U.S. mortgage market were only one aspect of a much larger and more encompassing credit boom, the impact of which transcended the mortgage market and affected adversely many other forms of credit."[1] To the casual observer, it may seem inexplicable that mortgage delinquencies and foreclosures would be the triggering event that would precipitate a prolonged financial crisis. It certainly took many policymakers by surprise. Indeed, it may be difficult to connect the origination of one mortgage loan by a local bank in Middle America to a Wall Street investment bank selling complex financial instruments (that derive some or all of their value from mortgage loans) to other financial intermediaries. However, it is this connection and the gradual shift over the last two decades of the credit risk relating to mortgage loan originations from depositary institutions to Wall Street and beyond that lies at the center of the financial crisis.

In order to understand the domino effect that characterizes the downturn in the housing market and the rise in delinquencies and foreclosures, it is essential to understand the evolution of housing finance. Part I below explains the securitization finance model, and the breakdown of the model that resulted in the financial crisis. Part II provides a brief summary of the government's responses to the financial crisis. Part III discusses a number of factors that have contributed to the crisis. Part IV is intended to resume the dialogue commenced by regulators in early 2008 (before the bleakest days of the crisis) regarding alternatives to securitization.

PART I: THE SECURITIZATION MODEL

This section explains the process by which Joe the Homeowner's mortgage loan is financed (or more correctly, was financed) through se-

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curitization, the securitization finance model, and the breakdown in this securitization system.

A. Presecuritization

Presecuritization, Joe the Homeowner would visit his local bank (one of many banks that Joe the Homeowner might visit) to take out a mortgage loan. The local bank would finance the origination of mortgage loans through its deposit-taking activities and possibly through a warehouse line of credit. The local bank might be constrained in its new mortgage origination activities if it were not able to raise additional capital. The local bank would hold mortgage loans on its balance sheet, which would require that the bank maintain adequate capital levels to support these liabilities. Because the local bank held the mortgage loans it originated on its books, the local bank was motivated to make certain that it undertook a careful review of each mortgage prior to its origination. Of course, this meant that homeowners with more stable incomes and better credit histories invariably would have more reliable access to mortgage financing than homeowners with weaker credit histories.

As a result of the extremely high value placed on home ownership in this country, the government created several entities to facilitate and promote home ownership through mortgage lending. These include Ginnie Mae, Fannie Mae, and Freddie Mac. Government agencies, like Ginnie Mae, or government sponsored entities (GSEs), like Fannie Mae and Freddie Mac, purchase or insure mortgage loans that conform to certain established underwriting standards. In functioning as a buyer for already originated mortgage loans or pools of mortgage loans, these entities "free up" the balance sheets of banks so that the banks have the liquidity necessary to originate additional new mortgage loans.

The GSEs issue securities the income of which is derived from pools of home mortgages originated by banks and other financial intermediaries. Fannie and Freddie guaranteed many of the mortgages, thus making the first securitizations possible. In 2006, Ginnie Mae guaranteed the mortgages underlying approximately 4% of all mortgage-backed securities issued in 2006. Fannie Mae and Freddie Mac accounted for 40% of mortgage-backed securities issued in 2006.[2]

B. Securitization[3]

GSE-sponsored securitization was soon followed by the development of private securitizations, or securitizations packaged by private financial institutions. Securitization resulted in doubling the share of the U.S. mortgage debt held outside the GSEs in each of 2003, 2004, and 2005.[4] In a securitization, a financial intermediary, usually an investment

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bank referred to as a depositor, pools together mortgage loans and sells these mortgage loans to a special purpose vehicle. As discussed below, the special purpose vehicle is generally organized as a trust. The trust then issues and sells securities (publicly or privately) to investors. The financial intermediary underwrites the offering of the securitization trust securities to investors. The return on the securities depends upon the performance of the underlying mortgage loans. Essentially, these are "pass-through securities." Pass-through securities are structured to provide that a portion of the payments on the underlying mortgage loans is passed through to the holders of the securitization trust securities. Interest payments on the underlying mortgage loans are used to pay interest on the securitization trust securities. Principal payments are used to pay down the principal on the securities. The trust is structured as a bankruptcy-remote vehicle. Investors in the mortgage-backed securities depend on the payments on the underlying mortgage loans and do not have recourse to the original mortgage lender or to the depositor in the event of payment defaults. The investors are subject to all of the risks relating to the mortgage loans, including prepayments (which reduce the term of their mortgage-backed security) and defaults (which reduce the payments on their mortgage-backed security).

Through the securitization process, the original loan originator, a local bank or a mortgage lender not organized as a bank, gets paid once it sells a mortgage loan to be pooled for securitization. The loan originator is not exposed to the underlying credit risk associated with the mortgage loan. The mortgage loan is removed from the originator's books and becomes an asset of the securitization trust. This separation of credit risk has been referred to as "moral hazard." Mortgage loan originators gradually eased their loan underwriting standards and began to originate mortgages to borrowers according to lower underwriting standards.

The once personal process of originating a mortgage loan to a new borrower, like Joe the Homeowner, became less personal and less rigorous. From the perspective of the local bank, securitization provided an alternative means of financing new mortgage loan originations. The local bank could originate mortgage loans and had the option to sell bundles of mortgage loans for repackaging into a securitization. Banks could originate mortgages and securitize them immediately, eliminating the need to fund those assets on a long-term basis. Mortgage financing began to depend on the capital markets—as mortgage originators increasingly depended on securitization (instead of new bank deposits) to finance new originations. Investors could invest directly or indirectly in mortgage-backed securities. As a result of the securitization process, large pools of capital were committed to home mortgage finance, which

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lowered lending costs. In 2006, for example, the ratio of mortgage-backed securities to total mortgages was over 50%.[5]

For a securitization, the mortgage loans are required to have consistent terms and characteristics. Pools of mortgage loans are grouped based on their characteristics. The consistency of the terms facilitates the creation of securities to be issued by the securitization trust to investors. For GSE sponsored securitizations, the underlying mortgage loans had to be originated in conformity with their underwriting standards. For private securitization standards, the mortgage loans had to be originated in conformity with certain market standards. This need led both to an increasing commoditization of the mortgage origination process and also to many new entrants into the mortgage loan origination business, including entities that were not regulated depositary institutions. Securitization inevitably led to more concentration of mortgage finance in fewer financial institutions. The financial intermediaries, fewer than a dozen large investment banks (compared to thousands of local banks), played the key role in securitizations.

C. Innovation

As discussed above, the basic securitization structure is quite simple. Mortgage loans are pooled into a trust, and the trust issues trust securities to investors. For tax purposes, it is important that the trust be considered a "pass-through" entity so that the entity is not subject to a separate level of tax at the entity level. A separate tax at the trust level would make the structure uneconomic. Most securitizations are structured to comply with the REMIC (Real Estate Mortgage Investment Conduit) rules.[6] In order to qualify as a REMIC, all of the interests must consist of one or more classes of regular interest and one and only one class of residual interest. The trust is not intended to be an "active" entity that exercises any discretion. Consequently, securitization transactions are "hardwired" so that the trust essentially is a static pool of mortgages. An entity that initially qualifies as a REMIC may lose its qualification if a sufficiently large portion of its mortgages are "significantly modified." Modifications to the mortgages would be seen as indicative of active management rather than passive investment. As we discuss below, only certain limited modifications are permitted.

The security issued by the securitization trust may be structured in order to meet investor demands. Over time, investment banks became more and more creative and structured securities that had features that met investor demand—for example, interest-only payments. Also, a securitization trust may issue multiple classes of trust securities. These various classes (or tranches) of securities may differ in terms of their

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ranking in bankruptcy (more senior, or more junior), or may differ based on the rights to payment or to timing of payments. By varying the seniority, the collateralization and the payment features, investment banks could custom tailor securities to meet investor needs. These securitization trust securities could be repackaged (or resecuritized) and combined with other mortgage-backed securities. Over time, more complex securities were developed, such as collateralized debt obligations (or CDOs) and structured investment vehicles (or SIVs), all of which may contain mortgage-related securities as assets. The securities issued in private securitizations are rated by rating agencies, and the ratings are supposed to reflect the credit quality and probability of default or credit losses in connection with an investment in the securities.

D. Housing Boom and Subprime

Until recently, housing prices in the United States had increased steadily. Faced with increasing housing prices and the availability of credit, mortgage originators (perhaps moral hazard also played a part) began originating more loans to borrowers with weak credit histories. Some mortgage loans required little to no down payment. The loans include subprime mortgage loans or Alt-A mortgage loans. These borrowers were more susceptible to economic downturns. From 2001 to 2006, the volume of subprime and Alt-A mortgage loans soared from $0.2 trillion to $3 trillion.[7] However, given the backdrop of rising home prices, if these borrowers faced economic difficulties, they were able to refinance their mortgages or sell their homes and pay off their mortgages. Many of these borrowers entered into variable rate mortgages (adjustable rate mortgages, or ARMs) that required low down payments. Lulled by what seemed like continual increases in housing prices, borrowers believed that they would be able to refinance their mortgages. Once housing prices began falling in 2006 and 2007, defaults and foreclosures rose, and adjustable mortgages began to reset. Lenders cut back on new mortgage lending, and refinancing options were limited.

Mortgage defaults in turn led to foreclosures. Subprime loans have accounted for over half of the foreclosures begun since 2006.[8] Housing prices continued to fall. The value of mortgage-related securities also began to decline. As we discussed above, holders of mortgage-backed securities are exposed to the risk of defaults on the underlying mortgages. Naturally, the mortgage-backed securities decline in value as mortgage defaults increase. Similarly, the value of securities related to mortgages, including CDOs and SIVs, also declines as a result. Declines in the value of portfolios of mortgage-related securities concentrated with a small number of financial institutions led to write-downs by these institutions. To the extent that mortgage-related securities were included in, or re-

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packaged into, other financial products, the value of those financial products eroded. Depositary and other financial institutions could no longer rely on securitization to provide balance sheet liquidity. To the extent that credit had been advanced in the past based on pledges of mortgage-backed or mortgage-related securities, financial institutions now demanded new or additional collateral. This required financial institutions to deleverage and curtail their lending activities. Many institutions that were highly leveraged could not withstand the write-downs, the credit constraints, and the stock price declines. With write-downs came a loss of investor confidence in the underlying health of the institutions and falling stock prices.

E. Mortgage Modification

Prior to the crisis, a majority of all home loans in the United States were securitized. This fact has resulted in additional difficulties or impediments to mortgage modification efforts. Many financial institutions are considering mortgage modification plans, either as a means of addressing class action lawsuits or as a means of improving the return on their investments. From an economic perspective, it may be most cost-effective to permit borrowers to modify their existing mortgage loans instead of foreclosing on their homes. In connection with any foreclosure proceeding, a bank will incur legal and other administrative costs. In addition, once the bank has foreclosed on the property, the bank may have very limited options other than continuing to hold the property until the housing market improves.

If the mortgage loans are held in a securitization trust, there are a number of legal hurdles to loan modification. As discussed briefly above, there is a significant tax impediment. Most securitizations are structured to comply with the REMIC rules. To qualify initially as a REMIC, "substantially all" of the REMIC's assets must constitute "qualified mortgages" and "permitted investments." The terms of a qualified mortgage cannot be changed by the REMIC absent an exception. If a "qualified mortgage" is "significantly modified" and the modified obligation is not a "qualified replacement mortgage," the modified obligation will not be a qualified mortgage. If enough of its mortgage loans are modified, a trust may lose its status as a REMIC.[9] Under the REMIC rules, certain changes would not be considered significant modifications. The rules expressly permit the following modifications: (1) changes in the terms of an obligation occasioned by default or a reasonably foreseeable default; (2) assumption of the obligation; (3) waiver of a due-on-sale clause or a due on encumbrance clause; and (4) conversion of an interest rate by a mortgagor pursuant to the terms of a convertible mortgage. A REMIC will be subject to a penalty tax if it enters into a transaction that is a

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prohibited transaction. A prohibited transaction may arise as a result of a mortgage modification. Clearly, these exceptions would not permit a widespread mortgage modification program.

Given the importance of stemming foreclosures, Congress adopted a bill freezing adjustable rate mortgages subject to reset. In conjunction with the bill, the IRS issued Rev. Proc. 2007-72, which provided that, under certain conditions, the IRS will not challenge a REMIC's status for U.S. federal income tax purposes in connection with "fast-track modifications" of certain subprime mortgage loans under a framework recommended by the American Securitization Forum. A fast-track modification program is a program that permits servicers to modify eligible troubled mortgage loans subject to certain broad parameters. Specifically, the IRS stated that: (1) it will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the loan modifications are not permitted under the REMIC rules; (2) it will not contend that the loan modifications are prohibited transactions under the REMIC rules; and (3) it will not challenge a securitization vehicle's qualification as a REMIC on the grounds that the loan modifications resulted in a deemed reissuance of the REMIC regular interests. The Rev. Proc. was issued in an effort by the Treasury and the IRS to stem foreclosures by removing barriers imposed by tax laws, arguably too restrictive in light of prevailing economic and market circumstances, to broad-based mortgage modification plans.[10]

Rev. Proc. 2008-47 issued in July 2008 provides that the IRS will not challenge the tax status of a REMIC or assert that a REMIC is engaged in a "prohibited transaction" when certain mortgage loans—primarily adjustable rate mortgages with teaser rates—held by a REMIC are modified by freezing rates prior to their reset in accordance with the American Securitization Forum's "Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans" (issued in July 2008). The Rev. Proc. amplifies and supersedes Rev. Proc. 2007-72. Despite this limited tax relief, a number of other serious tax questions remain that may create disincentives for mortgage modification programs.

Aside from the tax considerations, there are other impediments to implementing mortgage modification programs. From a securitization perspective, a mortgage modification may require the mortgage loan servicer to take certain actions—for example, the servicer may be required to determine whether a default is "reasonably foreseeable" in order to proceed with a modification program. A servicer may be reluctant to take action. In most securitizations, the documentation (usually the pooling and servicing agreement) will require that security holders approve certain actions. A widespread mortgage modification plan generally

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would require the consent of security holders, which may be difficult and costly to obtain. In addition, the actual mortgage modifications will require compliance with applicable state laws, including mortgage-related disclosure statutes.

PART II: THE GOVERNMENT'S RESPONSE TO THE FINANCIAL CRISIS

There are frequent, and often daily, changes in the regulatory environment and governmental reaction to the current banking and financial markets crisis. The following discussion is summary in nature and addresses only the principal government initiatives. This discussion does not address the terms of the AIG, Citigroup, or auto industry-related bailout measures.

A. Housing and Economic Recovery Act of 2008

On July 30, 2008, President George Bush signed the Housing and Economic Recovery Act of 2008 (HERA),[11] an omnibus housing bill combining regulatory reform of GSEs, modernization of the Federal Housing Administration (FHA), and provisions to help troubled borrowers. The Federal Housing Finance Regulatory Reform Act of 2008 created the FHFA, a new combined regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The power granted to the FHFA includes the authority to establish capital, management, and risk standards, to enforce its directives through cease and desist orders, to put a regulated entity into receivership, and to review and approve new product offerings. The affordable housing component of the GSEs mission was expanded, as was the conforming loan limit.

The HOPE for Homeowners Act of 2008[12] created a new temporary program within FHA designed to refinance distressed mortgage loans. The program was scheduled to begin October 1, 2008, and expire on September 30, 2011. The government estimated that 400,000 households would benefit from the program.

The Foreclosure Prevention Act of 2008[13] modernizes many aspects of FHA lending, including increasing the FHA loan limit, authorizing $3.92 billion in supplemental Community Development Block Grant Funds provided to communities hardest hit by foreclosures, providing funds for housing counseling, and modifying loan disclosure requirements.

B. Conservator Appointed for Fannie Mae and Freddie Mac

On September 7, 2008, the FHFA, working with Treasury and the Federal Reserve, put Fannie Mae and Freddie Mac into conservator-

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ship.[14] The CEOs of each of the GSEs were replaced with CEOs appointed by the FHFA. At the same time, Treasury announced several steps to increase investor confidence in the GSEs and improve liquidity in mortgage-related products.

Treasury agreed to provide up to $100 billion of support to each GSE. In exchange for this commitment, Treasury received preferred stock with a more senior liquidation preference than the GSEs' outstanding preferred stock or common stock. Treasury also received a warrant to purchase 79.9% of each GSE.[15] Treasury established a secured lending credit facility, available to Fannie Mae, Freddie Mac and the Federal Home Loan Banks. The facility acts as a liquidity back-stop to provide funding and liquidity, expiring in December 2009.[16] Beginning in 2010, the GSEs will be required to pay a commitment fee for the facility, at a rate to be determined. Finally, Treasury announced a program to purchase mortgage-backed securities issued by the GSEs in order to provide additional market liquidity.[17] The purchase program also is set to expire in December 2009.

FHFA announced that the primary mission of the GSEs at this time is "to proactively work to increase the availability of mortgage finance, including by examining the guarantee fee structure, with an eye toward mortgage affordability."[18] The GSEs received authority to increase their holdings of mortgage-backed securities through the end of 2009 and, thereafter, are required to reduce their holdings by 10% per year.

All of these actions were taken under the authority of the HERA.

C. Emergency Economic Stabilization Act of 2008

On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008 (the "Act" or EESA),[19] which authorized the Treasury Secretary ("Treasury") to establish the Troubled Assets Relief Program (TARP). The Act gives broad authority to Treasury to purchase, manage, modify, sell, and insure the troubled mortgage-related assets that triggered the current economic crisis, as well as other "troubled assets." EESA includes additional provisions directed at bolstering the economy, including: (1) assistance to homeowner provisions requiring each of the FDIC, the conservator of Fannie Mae and Freddie Mac and the Federal Reserve Board ("Federal Reserve"), in their capacity as direct or indirect property owners, to maximize assistance to homeowners;[20] (2) authority for the Federal Reserve Banks to pay interest on depository institution balances;[21] (3) amendments to the HOPE for Homeowners Program;[22] (4) a temporary increase in FDIC insurance coverage from $100,000 to $250,000 through December 31, 2009;[23] (5) reports and studies on crisis-related topics from the Treasury, the Comp-

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troller General, the Congressional Oversight Panel, and the Securities and Exchange Commission (SEC);[24] (6) reports by the Federal Reserve to Congress relating to any actions taken under existing authority to make loans directly to individuals, partnerships, or corporations;[25] and (8) SEC authorization to suspend mark-to-market accounting requirements for any issuer or class or category of transactions.[26]

D. Troubled Assets Relief Program

The Act permits Treasury to establish programs to buy and to insure financial institutions' troubled assets.[27] The outstanding program obligations will be $700 billion, subject to the requirements and limitations set forth in the Act.[28] Initially, Treasury announced a purchase program that permits the government to purchase or insure troubled assets of financial institutions.[29] Under the Act, a financial institution was broadly defined as any institution established and regulated under U.S. laws and having significant operations in the U.S.,[30] including, but not limited to, any bank, savings association, credit union, security broker or dealer or insurance company.[31] Consistent with the Act's requirements for protection of the taxpayers' investment, Treasury must acquire securities of each financial institution that sells troubled assets.[32] The type of security and structure of the investment depends on whether the financial institution has publicly traded securities.

The troubled asset purchase and insurance programs terminate on December 31, 2009.[33] Upon written certification to Congress identifying the expected cost, Treasury may extend the programs until October 3, 2010, provided the extension is necessary to achieve the goals of the Act.[34]

Treasury is authorized to purchase two categories of assets from financial institutions. The first includes residential or commercial mortgages and any securities, obligations or other instruments that are based on, or related to, such mortgages.[35] To qualify, an asset must have been originated or issued on or before March 14, 2008.[36] Treasury must make a determination under the program that purchase of the asset promotes financial market stability.[37] At the time the TARP was announced, Treasury officials stated that, through these direct purchases of mortgage-related assets, the government would provide a source of liquidity for financial institutions. On November 12, 2008, Secretary Henry Paulson announced that other TARP programs were being evaluated but that it was unlikely that any funds would be used to purchase mortgages or mortgage-related assets.

Second, Treasury can include other financial instruments if, after consultation with the Chairman of the Federal Reserve, Treasury makes a written determination that the purchase is necessary to promote financial markets stability, and that determination is provided to the appropriate

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congressional committees.[38] Treasury announced the development of the TARP Capital Purchase Program as part of this authority.

E. TARP Capital Purchase Program

1. General Program Requirements

On October 14, 2008, in a joint statement with the FDIC and the Federal Reserve, Treasury announced the Capital Purchase Program.[39] As discussed above, as a result of write-downs, market volatility, and eroding investor confidence, the stocks of financial institutions had been consistently losing value. Financial institutions were not able to access the public markets in order to raise much needed capital. This program was intended to provide a direct capital infusion and enable financial institution participants to use these funds to increase their lending activities. Program participants are subject to executive compensation and corporate governance requirements.

Treasury earmarked the first $250 billion from the Act for the program and allocated the first $125 billion to nine major financial institutions. The first nine institutions included: Bank of America, The Bank of New York Mellon, Citigroup, Goldman Sachs, J.P. Morgan Chase, Merrill Lynch, Morgan Stanley, State Street Corp., and Wells Fargo. Through December 31, 2008, the Treasury made direct investments in 214 financial institutions.

The terms of the program are standardized. Any financial institution may elect to participate by notifying its federal banking agency. After notification of an election to participate, Treasury will consult with the appropriate regulator and determine eligibility and allocations. For this purpose, Treasury defined qualified financial institutions (QFIs) to include banks, savings associations, bank holding companies, and savings and loan holding companies, in each case that are U.S. entities not controlled by a foreign bank. U.S. entities are those organized under the laws of the United States, any state, the District of Columbia or any territory or possession of the U.S. Bank holding companies and savings and loan holding companies are eligible only if they engage only in permitted activities under section 4(k) of the Bank Holding Company Act (BHCA) or have a depository institution subsidiary that is the subject of an application under section 4(c)(8) of the BHCA.

2. Capital Purchase Program for Publicly Traded Financial Institutions

Under the Capital Purchase Program for publicly traded financial institutions, the minimum subscription amount is 1% of the institution's risk-

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weighted assets and the maximum amount is the lesser of $25 billion or 3% of risk-weighted assets.[40] Each participating financial institution issues securities to Treasury, including senior preferred stock and a warrant.

The senior preferred stock: (1) qualifies as Tier 1 capital for regulatory purposes; (2) is senior to common stock and pari passu to the institution's existing preferred stock (other than junior preferred stock), (3) pays a 5% dividend for the first five years and a 9% dividend thereafter, (4) has cumulative dividends (unless the financial institution is bank that is not a subsidiary of a holding company), (5) pays dividends quarterly beginning February 15, (6) permits Treasury to elect two directors if dividends are not paid for six consecutive quarters, (7) is nonvoting (but for limited class voting rights on matters that could adversely affect the class), (8) is callable at par after three years (and otherwise redeemable with the proceeds of an offering of replacement equity securities that provide Tier 1 capital); (9) restricts the ability of a financial institution to increase its common dividends until the third anniversary of Treasury's investment (unless Treasury has transferred the investment); (10) requires the issuer to obtain Treasury's consent for any share repurchases other than in connection with a benefit plan or in the ordinary course of business consistent with past practice until the third anniversary of the investment; (11) is transferable by Treasury; (12) must be covered by a shelf registration statement filed by the financial institution as soon as practicable and be subject to piggyback registration rights; and (13) was funded by Treasury by December 31, 2008.

In connection with each investment, Treasury also receives warrants to purchase common stock with an aggregate market price equal to 15% of the senior preferred instrument. The warrant exercise price will be equal to the 20-day average market price of the institution's common stock prior to issuance. The warrants are immediately exercisable and have a 10-year term. The financial institution must file a registration statement as soon as practicable after the investment, grant piggyback registration rights to Treasury, and apply to list the underlying common stock on the relevant exchange. There are limitations on Treasury's ability to transfer warrants and the warrant exercise price is subject to reduction upon the successful completion by the financial institution of an offering of equity securities generating Tier 1 capital.

3. Capital Purchase Program for Private Institutions

On November 17, 2008, Treasury released a standard form term sheet detailing the terms and conditions of the Capital Purchase Program for financial institutions that are privately held.[41] As with the terms for public institutions, the terms of the program for private institutions are stan-

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dardized.[42] Any privately held financial institution could have elected to participate by notifying its primary federal banking agency by December 8, 2008.[43] After receipt of the notifications of election to participate, Treasury is required to consult with the appropriate regulators and determine eligibility and allocations.[44] As of this time, Treasury has not announced the final funding date.

The terms of the Capital Purchase Plan for private QFIs are similar to those for public QFIs. The principal differences between the public and private investment programs reflect the limited liquidity associated with the securities of private QFIs. The terms of the private Capital Purchase Plan assume that Treasury will hold the securities for a longer period of time.[45]

As with the Capital Purchase Program for public QFIs, the minimum subscription amount is 1% of risk-weighted assets, and the maximum amount is the lesser of $25 billion or 3% of risk-weighted assets.[46] The Treasury investment is structured as an investment in senior preferred stock and warrants exercisable for preferred stock.

The preferred stock issued to Treasury ("Treasury Preferred") will:[47] (1) qualify as Tier 1 capital; (2) rank senior to common stock; (3) rank pari passu with existing preferred stock (other than junior preferred stock); (4) pay a dividend of 5% per year for the first five years, and 9% per year thereafter; the dividend will be cumulative unless the financial institution is a bank that is not a subsidiary of a holding company; (5) pay quarterly dividends beginning February 15; (6) have a liquidation preference of $1,000 per share or such other amount as may be agreed to based on the available authorized preferred shares of the QFI; (7) permit Treasury to elect two directors if dividends are not paid for six dividend periods (subject to the provisions described below); (8) have limited voting rights; (9) be redeemable during the first three years, using proceeds of an offering of replacement equity securities that provide Tier 1 capital, subject to the approval of the QFI's primary federal bank regulator and callable thereafter; and (10) require that the QFI facilitate the transfer by Treasury of the Treasury Preferred.

There is no express right for the QFI to repurchase other securities of the QFI held by Treasury at fair market value, upon redemption of the Treasury Preferred, as is the case with securities issued under the Capital Purchase Program by public QFIs. Treasury's right to elect two directors ends, for noncumulative Treasury Preferred, upon the payment in full of dividends for four consecutive periods. However, the term sheet provides that, in the case of cumulative Treasury Preferred, the right ends upon payment of the dividend "for all prior dividend periods." Treasury's prior consent is required for any repurchases of equity securities or trust preferred securities other than in connection with a benefit plan in the

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ordinary course of business consistent with past practice until the 10th anniversary of the program (instead of the third anniversary for the public Capital Purchase Program) unless, prior to the 10th anniversary date (instead of the third anniversary date for the public Capital Purchase Program), all of the Treasury Preferred and Warrant Preferred (described below) are redeemed or Treasury has transferred all of the Treasury Preferred and Warrant Preferred to third parties. Treasury's consent is required for any increase in dividends payable to the holders of common stock until the third anniversary of the investment. Following the third anniversary and prior to the 10th anniversary, Treasury's consent shall be required for any increase in aggregate dividends payable to the holders of common stock greater than 3% per annum; provided that no increase in common dividends may be made as a result of any dividend paid in common shares, any stock split or similar transaction. These restrictions lapse if all of the Treasury Preferred and Warrant Preferred (as defined below) are redeemed or Treasury transfers all of the Treasury Preferred and Warrant Preferred to third parties. With respect to the public Capital Purchase Program, Treasury's consent is not required to increase dividends payable on the common stock after the third anniversary of the date of investment. From and after the 10th anniversary of the investment date, the QFI shall be prohibited from paying common dividends or repurchasing any equity securities or trust preferred securities until all equity securities held by Treasury are redeemed in whole or Treasury has transferred all of such equity securities to third parties. The public Capital Purchase Program has no similar provision.

The Treasury Preferred is not subject to any contractual transfer restrictions, but the term sheet specifies that the Treasury Preferred will not be subject to any pre-existing stockholders' agreements or similar arrangements restricting transfer. Treasury will agree not to effect any transfer of the Treasury Preferred that would cause the QFI to be required to become subject to the periodic reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). If the QFI otherwise becomes subject to the Exchange Act reporting requirements, the registration requirements of the public Capital Purchase Program will be imposed, including that the QFI will file a shelf registration statement covering the Treasury Preferred as promptly as practicable and the Treasury Preferred will be subject to piggyback registration rights.

For so long as Treasury holds any equity securities of the QFI, the QFI and its subsidiaries will not enter into transactions with related persons unless (1) such transactions are on terms no less favorable to the QFI and its subsidiaries than could be obtained from an unaffiliated third party

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and (2) have been approved by the audit committee or comparable body of independent directors of the QFI.

In connection with each investment, the private QFI will issue to Treasury warrants to purchase, upon net settlement, shares of Treasury Preferred (Warrant Preferred).[48] There is a limited exception to the requirement to issue the warrant outlined in the Treasury's Q&A for certified Community Development Financial Institutions where the Treasury investment is $50 million or less.[49] Treasury announced that it intends to exercise the warrants immediately upon closing.[50] Treasury agreed to defer exercise of the warrants issued to it by public QFIs. The Warrant Preferred will be identical to the Treasury Preferred except that the Warrant Preferred will immediately pay dividends at a rate equal to 9% per annum and may not be redeemed until all of the shares of Treasury Preferred have been redeemed.[51] The warrants issuable by private QFIs differ in certain respects from the warrants issuable by public QFIs.[52] For example, the warrants issued by public QFIs are exercisable for shares of common stock and are subject to exercise restrictions.[53]

4. Capital Purchase Program for Subchapter S-Corporations

On January 14, 2009, Treasury released a standard form term sheet detailing the terms and conditions for its direct investment in financial institutions organized as subchapter S-corporations ("S-Corps") pursuant to the Capital Purchase Program.[54] The terms of the investments are standardized. Any qualified financial institution may elect to participate in the Capital Purchase Program by notifying its primary federal banking agency by February 13, 2009.[55] The eligibility criteria for S-Corps are substantially the same as those for the private bank program. For the S-Corps program, the institution must be a corporation that has made a valid election to be taxed under subchapter S of Chapter 1 of the U.S. Internal Revenue Code (the "Code").[56] As of January 16, 2009, Treasury has not announced the final funding date for the Capital Purchase Program for S-Corps.

The principal terms of the Capital Purchase Program for S-Corps are consistent with those established for public QFIs and private QFIs. The principal differences of the Capital Purchase Program for S-Corps reflect the restrictions applicable to S-Corps. For example, the securities to be offered are subordinated debentures and warrants as opposed to preferred stock and warrants.[57] Under the Code, S-Corps may issue only one class of stock. The subordinated debentures issued by S-Corps are expressly subordinated to claims by depositors and general and secured creditors or to senior indebtedness, depending on the type of S-Corp in question.[58] In addition, the government is not an eligible stockholder

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of an S-Corp.[59] S-Corps will be subject to the executive compensation requirements to which any direct seller of assets under TARP would be subject, including public and private QFIs.[60]

The securities issued by S-Corps that are banks or savings associations qualify as Tier 2 securities. The securities issued by S-Corps that are top-tier bank holding companies or top-tier savings and loan holding companies (Holding Companies) qualify as Tier 1; however, prior to any closing of an offering by an S-Corp, it will be necessary for the appropriate federal banking agency to issue an interim final rule designating the senior securities to be issued to Treasury as Tier 1 capital. [61]

F. Insurance Program

The Act requires that Treasury develop a program to provide insurance on troubled assets, in order to minimize the potential ongoing negative impact of these assets on financial institution balance sheets. On October 14, 2008, Treasury solicited public comment on such a program. On December 31, 2008, Treasury issued its report establishing the Asset Guarantee 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." Treasury noted its expectation that the guarantee program would not be made widely available.

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 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 arising in connection with the assets. The premium charged by Treasury for this loss protection may be paid through the issuance by the financial institution to Treasury of securities. Additionally, the financial institution would be subject to portfolio management guidelines for the covered assets.

The report on the program notes the unique accounting for the guarantee, which is mandated by the Act. 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. Noncash 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 insurance program in order to minimize the impact of this program on otherwise available TARP funds.

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Treasury also noted its 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: the impact to available TARP funds is the same for insuring an asset as for purchasing an asset. In addition, in order to determine the appropriate premium for a complex security, such as an 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 with protection of the taxpayers' investment. These technical difficulties are likely to limit the utility of the insurance program.

G. Mortgage Loss Mitigation and Homeowner Protection

The Act's purpose statement requires that, in implementing its programs, Treasury consider: the protection of home values, the preservation of homeownership and the stabilization of communities. The Act includes specific provisions that encourage foreclosure mitigation efforts.[62]

Treasury must coordinate with the Federal Reserve, the FHFA, and the FDIC (together with Treasury, the "Federal property managers"), each in its capacity as an owner of mortgages and mortgage-related securities, to identify opportunities for the purchase of classes of troubled assets that will improve Treasury's ability to improve loan modification and the restructuring process. Modifications of existing mortgages are encouraged through use of the HOPE for Homeowners Program, as well as by effecting term extensions, rate reductions, principal write-downs, increases in the proportion of loans within a pooled structure allowed to be modified, or removal of other limitations on mortgage modifications.[63] With respect to multi-family dwellings, the federal property managers are required to ensure continuation of existing rental subsidies and to undertake modifications that provide for sufficient cash flow to maintain decent and safe conditions at the property.[64]

Additionally, Treasury must consent, where appropriate, to any reasonable loan modification requests.[65] This includes requests related to individual loans, including term extensions, rate reductions and principal write-downs, as well as requests related to pools of mortgages, including amending contracts to permit an increased proportion of loans in a pool to be modified or other removal of limitations on modifications.[66] Treasury must balance its many purposes, including these foreclosure mitigation efforts and helping homeowners, with protecting taxpayer resources and providing stability and preventing disruption to the financial markets.

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H. Bailout-Related Tax Changes and Impacts[67]

The Act contains a number of significant tax provisions, particularly in the area of employee benefits and executive compensation.[68] The discussion below summarizes briefly the tax provisions directly related to the TARP.

1. Gain on Fannie/Freddie Preferred Stock

Gain or loss realized by banks, savings and loan associations and certain other specified financial institutions on Fannie Mae or Freddie Mac preferred stock held on September 6, 2008, or sold or exchanged on or after January 1, 2008, and before September 7, 2008, is treated as ordinary rather than capital gain or loss.[69]

2. Employee Benefit and Executive Compensation Provisions[70]

The Act contains a number of significant employee benefit and executive compensation provisions, some that apply to employee benefit plans generally, and some that apply only to the executive compensation arrangements of financial institutions that participate in TARP.

(a) Treasury Secretary to Consider Protecting Some but Not All Employee Benefits

Pursuant to TARP, Treasury is required to take various criteria into consideration, including the purchase of troubled assets from certain tax-qualified plans holding such assets. For this purpose, the plans that are eligible for protection include 401(k) plans, defined benefit pension plans, 403(b) plans, and qualified 457 plans of governmental and tax-exempt entities.

Individual Retirement Arrangements (IRAs) and Section 409A arrangements are not eligible for protection under this provision. Section 409A arrangements generally include unfunded deferred compensation plans, but may also include severance, change in control, and other similar arrangements.

(b) Treasury Secretary Given Broad Power over Design and Operation of Certain Financial Institutions' Executive Compensation Arrangements

Financial institutions taking advantage of TARP are subject to new limitations on executive compensation. Where direct purchases of troubled assets are made from a financial institution under TARP where no

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bidding process or market prices are available and Treasury holds a meaningful equity or debt position in the institution, Treasury has authority to restrict the executive compensation the institution affords to its senior executive officers.[71] The Act permits Treasury to limit compensation paid to a senior executive officer of a financial institution: (1) to prohibit incentives for executive officers to take unnecessary and excessive risks that threaten the value of the financial institution; (2) prohibit any golden parachute payments to the institution's senior executive officers; and (3) provide for the recovery of any bonus or incentive compensation paid to a senior executive officer that was based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate.[72]

In cases where Treasury determines that the purpose of the Act is best met through auction purchases of troubled assets, and where such purchases in the aggregate exceed $300 million, Treasury is required to prohibit any new employment contract with a senior executive officer that provides a golden parachute upon involuntary termination, bankruptcy filing, insolvency, or receivership.[73]

(c) Tax Law Changes Affecting Executive Compensation

In addition to giving Treasury power over the design of executive compensation and benefit plan provisions of financial institutions participating in the TARP, the Act also makes tax law changes that affect such institutions:

(i) Limitation of Employer's Deduction for Compensation over $500,000. With respect to an employer from which more than $300 million in troubled assets is acquired under TARP (other than an employer whose only sales of troubled assets under the Act are direct purchases), no deduction is allowed to the employer for executive remuneration of a covered executive[74] that exceeds $500,000 in any taxable year.[75] In addition, any deferred compensation that an executive earns in any year cannot be deducted in a subsequent year (when it is ordinarily paid to the executive) to the extent it exceeds $500,000 in the year in which such deferred compensation was earned, reduced by the amount of taxable pay the executive received in the same year.[76]

(ii) Limitation of Employer's Deduction for Severance Pay Equal to or in Excess of Three Times Employee's Base Pay. The Act limits the deductibility to an institution participating in the TARP for severance payments it makes to covered executives who are involuntarily terminated from employment by the financial institution, or who terminate their employment in connection with any bankruptcy, liquidation, or receivership of the institution and who receive severance pay that equals or exceeds three times the employees' base amount.[77] An executive's base

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amount is calculated in the same way as under existing golden parachute rules and generally means the executive's average compensation from the institution over the five most recent years. Once an executive triggers this rule by receiving compensation equal to, or exceeding, three times the executive's base amount, the amount that is not deductible to the institution is the amount of severance pay that equals or exceeds the executive's base amount (not three times the executive's base amount).[78] In addition, if an executive receives severance pay equal to, or exceeding, three times the executive's base amount, Treasury is authorized to implement regulations that would also impose an excise tax on the covered executive equal to 20% of any severance pay s/he receives equal to or exceeding the executive's base amount.[79]

On October 14, 2008, Treasury and the Internal Revenue Service (the IRS) issued Notice 2008-94,[80] clarifying certain technical points about the application of these new sections 162(m)(5) and 280G(e).[81]

3. Extension of Discharge of Mortgage Debt

The current exclusion from taxable income of the first $2 million of discharge of mortgage debt relating to a taxpayer's primary residence is extended through the end of 2012.

I. Treasury's Temporary Guarantee Program for Money Market Funds

Following the Lehman Brothers' bankruptcy filing on September 15, 2008, a money market mutual fund reported that the fund's share value fell below $1 as a result of the loss in value of its holdings of Lehman Brothers' commercial paper.[82] Money market funds began reporting significant increases in withdrawals as investors moved money to FDIC-insured bank deposits. On September 19, 2008, Treasury announced the establishment of a Temporary Guaranty Program for Money Market Funds.[83] The program was intended to stabilize money market funds by insuring the holdings of retail and institutional nongovernment, nonagency publicly offered Rule 2a-7 money market mutual funds. Treasury made $50 billion available from the assets of the Exchange Stabilization Fund to guarantee the payment to investors of any participating money market fund with a net asset value that falls below $1. Relief under the guarantee program will be triggered once a participating fund's board of directors acts to liquidate the fund and it is determined that holders would, absent the guarantee program, receive less than $1 per share.

On September 29, 2008, Treasury opened the Temporary Guarantee Program, providing coverage to holders for amounts held in participating money market funds as of the close of business on September 19,

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2008.[84] Most large money market fund managers entered the Temporary Guarantee Program, in order to boost investor confidence. On November 24, 2008, Treasury extended the Guarantee Program until April 30, 2009. 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. As of November 24, 2008, the Guarantee Program covered over $3 trillion of assets.

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

J. Federal Reserve Board Initiatives

During 2008, the Federal Reserve injected trillions of dollars into the financial system through a number of liquidity facilities implemented principally in reliance on the Federal Reserve's authority under section 13(3) of the Federal Reserve Act, which is available only in "unusual and exigent circumstances." These measures included expansion of the Term Auction Facility, establishment of the Term Securities Lending Facility, establishment of the Asset Backed Commercial Paper Money Market Fund Liquidity Facility, establishment of the Commercial Paper Funding Facility, establishment of the Term Asset Backed Securities Loan Facility, and creation of the GSE MBS purchase program. This section summarizes the principal liquidity programs. The Federal Reserve Bank of New York played an instrumental role in the bailout of AIG; however, a discussion of the AIG bailout is beyond the scope of this discussion.

On March 11, 2008, the Federal Reserve announced an expansion of its securities lending program.[85] The new Term Securities Lending Facility (TSLF) provides up to $200 billion of Treasury securities to primary dealers secured for a term of 28 days (rather than overnight, as in the previously existing program) by a pledge of other securities, including federal agency debt, federal agency mortgage-backed securities and non-agency triple-A rated private-label residential MBS. On May 2, 2008, the Federal Reserve expanded the range of collateral that may be pledged in the Schedule 2 TSLF auctions to include triple-A rated asset-backed securities.[86] On July 30, 2008, the TSLF was extended through January 30, 2009.[87]

On March 16, 2008, the Federal Reserve announced the authorization of a lending facility designed to improve the ability of primary dealers to provide financing to participants in the securitization markets.[88] The facility as initially announced was authorized for six months, although it was later extended through January 30, 2009. The interest rate charged

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for use of the facility is the discount rate at the Federal Reserve Bank of New York.[89]

On July 13, 2008, the Federal Reserve announced that it had granted the Federal Reserve Bank of New York the authority to lend to Fannie Mae and Freddie Mac should such lending prove necessary.[90] Any lending would be at the primary credit rate and collateralized by U.S. government and federal agency securities. The authorization was intended to supplement Treasury's existing lending authority and to help ensure the ability of Fannie Mae and Freddie Mac to promote the availability of home mortgage credit during a period of stress in financial markets.

On September 14, 2008, the Federal Reserve announced several initiatives to provide additional support to financial markets, including enhancements to its existing liquidity facilities.[91] The collateral eligible to be pledged at the Primary Dealer Credit Facility (PDCF) was expanded to match closely the types of collateral that may be pledged in the triparty repo systems of the two major clearing banks. Previously, PDCF collateral had been limited to investment-grade debt securities. The Federal Reserve also expanded the collateral that may be pledged for the TSLF to include all investment-grade debt securities.[92] Previously, only Treasury securities, agency securities, and AAA-rated mortgage-backed and asset-backed securities could be pledged. These changes represented a significant broadening in the collateral accepted under both programs. Schedule 2 TSLF auctions were increased to weekly from bi-weekly, and the amounts offered were increased to a total of $150 billion, from a total of $125 billion.

The Federal Reserve also adopted an interim final rule that provides a temporary exception to the limitations in section 23A of the Federal Reserve Act.[93] It allows all insured depository institutions to provide liquidity to their affiliates for assets typically funded in the tri-party repo market. This exception is subject to various conditions necessary to promote safety and soundness and expires on January 30, 2009, unless extended by the Federal Reserve.[94]

On October 7, 2008, the Federal Reserve announced the creation of the Commercial Paper Funding Facility (CPFF),[95] and published updated program terms and conditions on October 14, 2008.[96] As the credit crisis continued, issuers of commercial paper were encountering increasing difficulty in accessing the market to issue new commercial paper or to refinance portions of the approximately $1.5 trillion of commercial paper currently outstanding as it becomes due. The CPFF is structured as a credit facility to a special purpose vehicle (SPV) authorized under section 13(3) of the Federal Reserve Act. Treasury made a special deposit at the Federal Reserve Bank of New York in support of the CPFF. The Federal Reserve is committed to lend to the SPV at the target federal funds

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rate. Draws on the CPFF will be on an overnight basis, with recourse to the SPV and secured by all assets of the SPV. The SPV will be limited in the amount of commercial paper that it may purchase from a single eligible issuer; it will be limited to the greatest amount of commercial paper outstanding on any day between January 1 and August 31, 2008, less any amount of the issuer's outstanding commercial paper held by investors other than the SPV. Purchases of commercial paper by the SPV will cease on April 30, 2009, unless the Federal Reserve Board agrees to extend the facility. The Federal Reserve will continue to fund the SPV after that date until the SPV's assets mature.[97]

Commercial paper purchased by the SPV must be rated at least A1/P1/F1 by a major NRSRO and, if rated by multiple NRSROs, is rated at least A1/P1/F1 by two or more major NRSROs. Non-ABCP issuers will be charged an unsecured credit surcharge of 100 basis points per annum unless they can either provide collateral for the commercial paper that is acceptable to the New York Fed or obtain an endorsement or guarantee of its obligations that is acceptable to the New York Fed. Previously, the Federal Reserve has indicated several ways in which non-ABCP commercial paper may be secured.[98]

K. FDIC Guarantee of Debt and Deposits: Temporary Liquidity Guarantee Program

On October 14, 2008, the FDIC announced the creation of the Temporary Liquidity Guarantee Program (TLGP) as part of the larger and continuing government effort to strengthen confidence and encourage liquidity in the nation's banking system.[99] The FDIC announced the program in a joint statement with Treasury and the Federal Reserve in a coordinated effort to unfreeze interbank lending, encourage lending and enhance confidence in the banking system.[100] The TLGP is a voluntary and time-limited program funded through special fees without reliance on taxpayer funding.[101] The TLGP consists of two components: a temporary guarantee of newly issued senior unsecured debt (Debt Guarantee Program) and a temporary unlimited guarantee of funds in noninterest-bearing transaction accounts at FDIC-insured institutions ("Transaction Account Guarantee Program").[102] Financial institutions participating in the TLGP may participate in the Capital Purchase Program.

On October 23, 2008, the Board of Directors of the Federal Deposit Insurance Corporation announced that it had approved an interim rule (the "Interim Rule") under the FDIC's systemic risk exception process to govern the TLGP.[103] The Interim Rule was effective immediately, but the FDIC indicated that comments would be taken for the 15-day period following publication of the Interim Rule in the Federal Register.[104] On November 21, 2008, the Board of Directors of the FDIC approved the final

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rule for the TLGP (“Final Rule”).[105] The FDIC guarantee covers timely payment of interest and principal upon an uncured payment default.[106] The Final Rule states that the guaranteed debt is backed by the full faith and credit of the United States[107] and has a 20% risk weighting.[108]

1. Overview

As noted above, the TLGP consists of two programs: the Debt Guarantee Program and the Transaction Account Guarantee Program.[109] The TLGP guarantees have been in place since the FDIC’s announcement on October 14, 2008. All eligible entities were included automatically.[110] Eligible entities not interested in participating were required to opt out.[111] During the first 30 days no fees were assessed on eligible entities, and no fees are to be assessed on eligible entities that have opted out.[112] The FDIC has posted on its Web site a list of those entities that opted out of either or both components of the TLGP so that potential lenders and transaction account depositors can determine which entities have opted out of the one or both components of the TLGP.[113]

2. Eligible entities

Eligible entities include (1) FDIC insured depository institutions, (2) U.S. bank holding companies and financial holding companies with at least one operating insured depository institution subsidiary, and (3) U.S. savings and loan holding companies, with at least one operating insured depository institution subsidiary, that either engage only in activities that are permissible for financial holding companies to conduct under section 4(k) of the BHCA or had at least one insured depository subsidiary that was the subject of an application under section 4(c)(8) of the BHCA pending on October 13, 2008.[114] FDIC-insured branches of foreign entities are not eligible to participate in the Debt Guarantee Program.[115]

3. Debt Guarantee Program

The Debt Guarantee Program provides an FDIC guarantee on newly issued senior unsecured debt instruments issued by participants. The guarantee covers debt issued from October 14, 2008, through June 30, 2009, and expires upon the earliest to occur of (1) the date the issuer opts out, (2) the maturity of the debt, or (3) June 30, 2012.[116] The aggregate newly issued senior unsecured guaranteed debt a participant may have outstanding may not exceed the issuance cap for that participant.[117] The issuance cap is 125% of that participant’s outstanding debt on September 30, 2008, that was scheduled to mature on or before June 30, 2009.[118] The estimated amount of eligible entity qualifying senior unsecured debt outstanding as of June 30, 2008, was $1.4 trillion.[119]

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(a) Definition of Senior Unsecured Debt

The Debt Guarantee Program covers senior unsecured debt issued on or after October 14, 2008, and prior to June 30, 2009.[120] The Final Rule excludes debt with a maturity of 30 days or less, if issued after the opt-out date.[121]

The FDIC has stated that the program "is not designed to encourage the development of or to promote innovative or complex sources of funding but to enhance the liquidity of the inter-bank lending market and senior unsecured bank debt funding."[122] The Final Rule provides a nonexclusive list of senior unsecured debt instruments covered by the guarantee, as well as a nonexclusive list of excluded debt.[123] Senior unsecured debt includes unsecured borrowing, denominated in either U.S. dollars or a foreign currency, that[124] is evidenced by written agreement (including a trade confirmation); has a specified and fixed principal amount to be paid in full on demand or on a date certain; is noncontingent and contains no embedded options, forwards, swaps, or other derivatives; is not by its terms subordinated to any other liability; and (after December 5, 2008) is issued with a stated maturity of more than 30 days. The debt may pay interest at a fixed or floating rate. The floating interest rate must be based on a single index of a Treasury bill rate, the prime rate, or LIBOR.[125] Senior unsecured debt includes, but is not limited, to:[126] federal funds purchased; promissory notes; commercial paper; unsubordinated unsecured notes, including zero-coupon bonds; U.S. dollar denominated certificates of deposit owed to an insured depository institution, an insured credit union as defined in the Federal Credit Union Act or a foreign bank;[127] U.S. dollar denominated deposits in an international banking facility of an insured depository institution owed to an insured depository institution or a foreign bank; and U.S. dollar denominated deposits on the books of foreign branches of U.S. insured depository institutions that are owed to an insured depository institution or a foreign bank.

Senior unsecured debt as defined in the Final Rule excludes:[128] any obligation with a stated maturity of one month;[129] obligations from guarantees or other contingent liabilities; derivatives; derivative-linked products; debts that are paired or bundled with other securities; convertible debt; capital notes; the unsecured portion of otherwise secured debt; negotiable certificates of deposit; deposits denominated in foreign currency and or other foreign deposits (except those otherwise permissible in the rule); revolving credit agreements; structured notes; instruments that are used for trade credit; retail debt securities;[130] any funds that are, regardless of form, swept from individual, partnership, or corporate accounts held at insured depository institutions; and loans from affiliates, including parents and subsidiaries, and institution affiliated parties.

The FDIC has excluded most of the securities that financial institutions issue as part of their Tier 1 issuances. This may result in an incon-

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sistency with the Capital Purchase Program because a financial institution should be motivated to issue Tier 1 replacement capital to redeem a portion of the Treasury's common stock warrant that is part of the Capital Purchase Program. Debt will not be guaranteed if the proceeds are used to prepay outstanding nonguaranteed debt.[131] Under the Final Rule, the proceeds from the issuance of FDIC-guaranteed debt may be issued to prepay other FDIC-guaranteed debt, but may not be used to prepay outstanding nonguaranteed debt.

(b) Long-Term Nonguaranteed Debt Program for Participating Entities

If a participating entity wants the option to issue long-term nonguaranteed senior unsecured debt at any time, and before issuing guaranteed debt up to its cap amount, it had the option to elect to do so through *FDICconnect* on its election form on or prior to the opt-out deadline.[132] Upon making an election, the participant was required to pay a nonrefundable fee.[133] Long-term nonguaranteed senior unsecured debt must mature after June 30, 2012.[134]

(c) Master Agreement

Participants in the Debt Guarantee Program were required to execute a master agreement ("Master Agreement") no later than the opt-out deadline and to provide a copy to the FDIC no later than 10 days thereafter.[135] The Master Agreement facilitates the payment guarantee by the FDIC and, among other things, requires that the participant provide notice, within one business day, of any failure to pay interest on or principal of any indebtedness when due.[136] A participant also must appoint a representative that will make claims for payment under the guarantee on behalf of the security holders.[137] No document governing guaranteed debt may provide for automatic acceleration of debt upon a default by the participant while the FDIC guarantee is in effect or while guarantee payments are being made by the FDIC (default is not limited in this provision to payment defaults).[138]

(d) Notice Requirements

Participants are required, following the opt-out date, to notify the FDIC through *FDICconnect* of each issuance of guaranteed debt.[139] Participants in the Debt Guarantee Program are required to use the Final Rule's prescribed disclosure language in all written materials provided to lenders or creditors when issuing either guaranteed or nonguaranteed debt.[140] A participant may be issuing nonguaranteed debt either as part of the long-term nonguaranteed debt program or for issuances after the participant has reached its issuance cap.[141] The disclosures are only required

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in respect of debt that is eligible for the guarantee; the participant does not have to provide disclosure when issuing ineligible debt.[142]

4. The Transaction Account Guarantee Program

Deposits in a participant's noninterest-bearing deposit transaction accounts will be guaranteed fully by the FDIC, regardless of the amount on deposit.[143] This guarantee is separate from, and in addition to, the coverage provided under the FDIC's general deposit insurance regulations.[144] The estimated amount of uninsured noninterest-bearing transaction account deposits, prior to the TLGP, was between $400 and $500 billion.[145]

5. Fees for the TLGP

The fees are expected to fully fund the TLGP, with no reliance on taxpayer funding.[146] All fees and assessments will be held by the FDIC in a separate account and will not be included in the Deposit Insurance Fund.[147] If the fees and assessments collected under the TLGP are insufficient to cover the cost of the program, the FDIC will impose an emergency special assessment on insured depository institutions.[148] Because the special assessment is required by statute to be based on the financial institutions' liabilities, rather than deposits, larger financial institutions will bear the greater burden of the assessment as they typically maintain a higher proportion of liabilities than smaller financial institutions.[149] All financial institutions whose deposits are insured by the FDIC will be subject to any special assessment, irrespective of their participation in the TLGP.[150] Many community banks and banks not owned by holding companies expressed concern during the rulemaking comment process that if there were a shortfall, insured depository institutions would bear a disproportionate burden because holding companies would not be subject to the special assessment.[151] As a result of these comments, the FDIC created a surcharge for certain holding companies participating in the Debt Guarantee Program, as described below.[152] If there are excess funds remaining at the termination of the program, they would be deposited in the Deposit Insurance Fund.[153]

6. Payment of Claims

Under the Guaranteed Debt Program, upon the ultimate failure of the issuer of guaranteed debt to pay interest or principal, the FDIC will make the required payment.[154] If the FDIC is paying interest and principal on debt that remains outstanding after June 30, 2012, it will have the right to elect to make a final payment of all outstanding principal and interest due through the date of final payment, without incurring a prepayment penalty.[155]

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L. Private Equity Investments in Banks[156]

On September 22, 2008, the Federal Reserve issued guidelines for noncontrolling, minority investments in banks and bank holding companies.[157] The guidelines clarify and liberalize the conditions under which an investor can make a minority investment in a banking organization without being regulated as a bank holding company under the BHCA.[158] The guidelines were intended to facilitate private equity fund investment in the financial services sector.

1. BHCA Framework

Under the BHCA, an investor is deemed to control a banking organization if it: (1) directly or indirectly owns 25% or more of any class of voting securities of the banking organization; (2) controls the election of a majority of the board of directors of the banking organization; or (3) otherwise exercises a controlling influence over the management or policies of the banking organization.[159] The Federal Reserve guidelines deal with the third prong of this test—by addressing, in general terms, which investments do not constitute the exercise of a controlling influence. Ultimately, a determination of whether a particular minority investment involves the exercise of "controlling influence" by an investor depends on all the facts and circumstances of each investment, but the guidelines are helpful in that they provide a degree of predictability that should encourage minority investment.

2. Prior Policy Statement

The prior policy statement in this area was issued in 1982, in the context of stakeholder investments by out-of-state banks seeking to prepare for the advent of interstate banking.[160] The 1982 policy statement provided important reference points for controlling influence determinations involving a broad range of proposed investments. Over time, the Federal Reserve has grappled with many "controlling influence" issues not contemplated by the 1982 policy statement, which has resulted in staff-developed policy in the area. The discussion below summarizes the general guidance provided by the policy statement with respect to arrangements that have been particularly sensitive in controlling influence determinations.

3. Director Representation

The Federal Reserve generally has regarded board participation by an investor with between 10% and 24.9% of the voting shares of a banking organization as indicative of control.[161] Under the new policy, a minority investor generally will be permitted to have a single representative on an organization's board of directors without being deemed to exercise

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controlling influence over that organization. The policy statement also permits a minority investor in an organization to elect two directors of that organization's board, subject to the following conditions: (1) board representation must be proportionate to the minority investment; (2) no more than 25% of the board seats can be controlled by the minority investor; and (3) another shareholder, approved by the Federal Reserve, must control the banking organization. Without regard to the number of board seats held, no minority investor's board representative can serve as Chairman of the Board or chairman of any committee without raising control concerns.[162]

4. Determinations of Control

An investor is deemed to exercise control over a banking organization if it controls 25% or more of any class of voting securities of that banking organization.[163] The BHCA does not address explicitly the holding of nonvoting equity (or a combination of voting and nonvoting equity). In the 1982 policy statement, the Board suggested that holding 25% or more of the total equity of a banking organization would be indicative of control.[164] The policy statement relaxed the standards for holding nonvoting equity, while continuing to express a belief that a large equity investment (regardless of voting power) may provide an investor with controlling influence over the organization. Under the new policy statement, a minority investor will not be seen to exercise controlling influence if its investment meets the two following criteria: (1) its total equity investment does not exceed one-third of the total equity of the organization; and (2) it does not own 15% or more of any class of voting securities of the organization.[165]

In the context of investment in nonvoting shares, the Federal Reserve also discusses situations under which rights to convert nonvoting shares into voting shares will be deemed to trigger control issues.

5. Controlling Influence

Minority investors often seek to protect their investments by communicating to management and/or to the board their views about how best to enhance the value of the organization. Thus a minority investor's board representative might seek to advocate changes in management; new strategies for the organization; capital or liquidity policies; mergers or acquisitions; or other major corporate policies or decisions. Under the policy statement, advocacy in and of itself will not be equated with controlling influence as long as decision-making is left to an organization's board, shareholders or management, as the case may be.[166] Nonetheless, control could be inferred if advocacy were linked to explicit or implicit

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threats to divest, sponsor proxy solicitations or take other actions that might coerce a banking organization or its management to take a particular course of action.

6. Other Indicia of Control

In the past, a noncontrolling minority investor generally has been prohibited from conducting any material business transactions or having material business relationships with the banking organization in which it has invested.[167] However, in the past, business relationships that are limited both quantitatively and qualitatively, have been allowed if the minority investment were closer to 10% than to 25%. Such relationships will continue to be reviewed on a case-by-case basis to determine whether they might involve a controlling influence.[168]

Precedent and the 1982 policy statement also recognize that controlling influence might be exercised through the imposition by the investor of particular covenants accompanying the investment.[169] In this regard, there has been particular concern about covenants that might affect hiring, firing, executive compensation, engaging in new business lines, making substantial changes in operations, raising additional capital or otherwise retaining, disposing of or acquiring material corporate assets. On the other hand, covenants that are protective of the essential characteristics of the security held by the minority investor generally have been viewed as permissible. As the policy statement makes clear, these would include, for example, covenants that might prohibit the issuance of senior securities or the incurrence of senior borrowings that might adversely affect the existing rights or preferences of the security in which the minority investor has invested. Covenants that provide information rights to an investor also do not necessarily trigger control considerations.[170]

These guidelines should ease the path for action on pending applications that involve controlling influence determinations and encourage minority investment in banking organizations at a time when capital in the industry is sorely needed. In particular, the guidelines provide a constructive framework for private equity funds to invest in the financial services sector.

M. Recent IRS and Treasury Guidance[171]

During the last year, the Internal Revenue Service has issued a wave of guidance in response to the credit crisis. This guidance is unprecedented in that it, in effect, relaxes the rules of the Code to adjust to the financial crisis. These changes began in late 2007 with narrow technical guidance aimed at municipal bonds and real estate mortgage investment conduits (REMICs). By late September, the IRS relaxed the Code's loss

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trafficking rules, apparently in order to encourage the acquisition of failing banks. The following discussion briefly summarizes the most significant rulings and guidance issued by the IRS.

1. Section 382-Related Guidance—Preservation of Tax Losses

In general, section 382 of the Code limits the ability of a corporation that undergoes an "ownership change" to use its prechange net operating losses (NOLs) and "net unrealized built-in losses" (NUBILs).[172] In general, an ownership change occurs if the percentage (by value) of stock of the loss corporation owned by any one or more 5% shareholders (by value) has increased by more than 50% compared to their lowest percentage ownership in the prior three years. Such an ownership change can result from an acquisition of outstanding stock of the loss corporation (whether taxable or in a tax-free acquisition) or an issuance by the loss corporation of new stock for additional capital. If a loss corporation undergoes an ownership change, postchange use of its prechange NOLs and NUBILs is generally subject to an annual limitation (the Section 382 Limitation) equal to the product of the fair market value of its outstanding stock immediately before the ownership change, multiplied by a statutorily prescribed interest rate (the applicable long-term tax-exempt rate). This interest rate is currently 4.65% but is adjusted monthly based on market rates.

Two recent Internal Revenue Service (IRS) Notices designed to help failing banks may (1) permit a corporate acquiror to acquire a bank's built-in loan losses and use those built-in losses against its taxable income, and (2) ease the application of potential tax loss carryover limitations for corporations that raise additional capital by issuing new stock. These Notices should make more attractive the acquisition of U.S. banks with underwater mortgages and investment in distressed banks.

(a) Notice 2008-78—Capital Contributions to Loss Corporations

As described above, the Section 382 Limitation is determined by valuing a corporation's stock immediately before the ownership change. Capital contributions that increase the total value of the outstanding stock could have the effect of increasing the annual limitation and, if made ratably by existing shareholders, could reduce the likelihood that other stock transactions would constitute an ownership change. Accordingly, to prevent these potential abuses, section 382(l) of the Code presumes (except as provided in regulations) that capital contributions made within a two-year period ending on the change date are part of a

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tax avoidance plan and, therefore, excludes such capital contributions in determining the Section 382 Limitation.

On September 26, 2008, the IRS issued Notice 2008-78, I.R.B. 2008-41 (Notice 2008-78), in which it announced that it will waive the presumption that a capital contribution within the two-year prechange period is part of a tax avoidance plan.[173] Notice 2008-78 instead provides a facts and circumstances test for determining whether the contribution is for tax avoidance. The Notice also provides four safe harbors under which a contribution will not be deemed to have a tax avoidance motive. A contribution will not be considered as part of a plan for tax avoidance if: (i) the contribution is made by a person who is neither a controlling shareholder[174] (determined immediately before the contribution) nor a related party,[175] (ii) no more than 20% of the total value of the loss corporation's outstanding stock is issued in connection with the contribution, (iii) there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change, and (iv) the ownership change occurs more than six months after the contribution. A contribution also will not be considered as part of a plan for tax avoidance if: (i) the contribution is made either by a related party (provided that no more than 10% of the total value of the loss corporation's stock is issued in connection with the contribution), or by a person other than a related party, and (ii) in either case, there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change, and (iii) the ownership change occurs more than one year after the contribution.

(b) Notice 2008-83—Built-in Loss Limitations of Banks

On September 30, 2008, the IRS issued Notice 2008-83, 2008-42 I.R.B. 1 (Notice 2008-83), in which it announced that losses and deductions attributable to loans or bad debts[176] of a bank[177] (including any deduction for a reasonable addition to a reserve for bad debts by a bank) after the date of an ownership change under section 382 of the Code and that are otherwise allowable will not be treated as built-in losses or deductions attributable to a prechange period.[178] Accordingly, Notice 2008-83 effectively removes a potential barrier to acquisitions of struggling banks that have unrecognized loan losses and to equity infusions by prospective investors by assuring that the IRS does not intend to challenge the use of unrecognized losses to offset future taxable income after an ownership change occurs.

(c) Impact of Notice 2008-78 and Notice 2008-83[179]

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Notice 2008-78 means that a bank (as well as other corporations) may now raise capital without creating a concern for existing stockholders and potential investors that the value of the corporation's tax "assets" (i.e., the built-in losses) automatically will be impaired by excluding the new capital from the Section 382 Limitation calculation if circumstances should force a change in ownership within the following two years. Notice 2008-83 means that banks can issue stock to raise new capital without a concern that losses subsequently recognized on troubled mortgages, including those arising from sales under the TARP, will be treated as NUBILs for purposes of section 382 of the Code.[180]

In practice, Notice 2008-83 means that an acquiring corporation, e.g., a bank holding company (acquiror), can acquire a bank owning underwater mortgages in a basis preservation transaction (e.g., a stock sale or tax-free reorganization), sell the mortgages (including to Treasury under the TARP), and then use those losses recognized on the sale to offset future income of the Acquiror or other members of its affiliated group.[181]

(d) Additional Provisions Modifying Section 382 Treatment (Notice 2008-76, Notice 2008-84, and Notice 2008-100)

On September 29, 2008, the IRS and Treasury announced in Notice 2008-76 that they will issue regulations under section 382(m) providing that the "testing date" (as defined in Regulations section 1.382-2(a)(4)) does not include any date on or after the date on which the United States (or an agency or instrumentality thereof) acquires, in a "Housing Act Acquisition," stock or an option to acquire stock in a corporation. The regulations were applicable after September 6, 2008.

On the same day, the IRS and Treasury issued Notice 2008-84, in which they announced that they will issue regulations under section 382(m) providing that the "testing date" does not include any date as of the close of which the United States owns a more-than-50 % interest in a section 382 loss corporation. The regulations are applicable to any taxable year ending after September 25, 2008.

Finally, on October 14, 2008, the IRS and Treasury issued Notice 2008-100, providing very favorable guidance regarding the application of section 382 to loss corporations whose instruments are acquired by Treasury pursuant to the Capital Purchase Program under the Act. The Notice generally provides (1) that shares of stock of a loss corporation acquired by Treasury pursuant to the Capital Purchase Program shall not be considered to have caused Treasury's ownership in the loss corporation to have increased over its lowest percentage owned on any earlier date, but, subject to certain exceptions, are considered outstanding for

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purposes of calculating the ownership percentage of other 5% shareholders on a testing date; (2) that once shares of stock acquired by Treasury pursuant to the Capital Purchase Program are redeemed by the corporation, such shares are not treated as having ever been outstanding for purposes of measuring ownership shifts of any 5% shareholder on any testing date on or after the redemption; (3) that any preferred stock acquired by Treasury pursuant to the Capital Purchase Program is treated as stock described in section 1504(a)(4) for all federal income tax purposes (and is, therefore, carved out of the definition of "stock" for purposes of section 382(k)(6)(A); (4) that warrants acquired by Treasury pursuant to the Capital Purchase Program shall be treated as options (and not as stock) for all federal income tax purposes and that options acquired by Treasury will not be deemed exercised for purposes of section 382; and (5) that capital contributions made by Treasury to a loss corporation pursuant to the Capital Purchase Program shall not be considered to have been made as part of a plan for purposes of section 382(l)(1) of the Code.

The Notice states that Treasury and the IRS intend to issue regulations setting forth the rules provided in the Notice, but that taxpayers may rely on the Notice unless and until there is additional guidance. Additionally, the Notice states that any future guidance issued contrary to that provided in the Notice will not apply to instruments acquired by Treasury (1) prior to the publication of the contrary guidance or (2) pursuant to binding written contracts entered into prior to the publication of the contrary guidance.

2. Money Market Share-Price Guarantee

In Notice 2008-81, Treasury announced the Temporary Guarantee Program to enable money market funds to maintain stable $1 per share net asset values and said that participation in the program will not be treated as a federal guarantee that jeopardizes the tax-exempt treatment of payments by "tax-exempt money market funds" (i.e., money market funds holding enough of their total assets in tax-exempt bonds to be eligible to pay section 852(b)(5) exempt interest dividends).[182]

In Notice 2008-92, the IRS and Treasury announced that they will not assert that participation in the Temporary Guarantee Program by an "insurance-dedicated money market fund" (a fund with beneficial interests held by investors permitted under Regulations section 1.817-5(h)(1)) causes a violation of the section 817(h) diversification requirements in the case of a segregated asset account investing in the fund, or that the fund's participation causes the holder of a variable contract supported by a segregated asset account investing in the fund to be treated as an owner of the fund.[183]

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3. Borrower's Default on Securities Loan Does Not Trigger Taxable Event to Lender (Notice 2008-63)

Under a securities loan agreement, a borrower typically borrows securities from a lender and posts collateral to secure its obligation to return identical securities. The initial transfer of securities to the borrower and the return of identical securities to the lender upon termination of the securities lending agreement generally do not result in any gain or loss to the lender for U.S. federal income tax purposes, provided the loan agreement meets certain specified requirements under section 1058. If, upon a borrower default, the lender applies the collateral to purchase securities that are identical to the securities borrowed, the lender would be required to realize gain, if any. In most situations, losses would be expected to be disallowed as a result of the application of the wash sale rules. On September 29, 2008, the IRS published Revenue Procedure 2008-63 to preserve nonrecognition treatment and restore symmetrical results in the case of gains and losses.[184] The Revenue Procedure, effective for taxable years ending on or after January 1, 2008, provides that if a borrower defaults under a securities loan agreement as a direct or indirect result of its bankruptcy (or the bankruptcy of an affiliate) and the lender applies the collateral to purchase identical securities as soon as is commercially practicable after the default (but not more than 30 days following the default), then the transaction will not be a recognition event for U.S. federal income tax purposes to the lender.[185]

4. Relief for Auction-Rate Securities

Since the 1980s, closed-end funds, corporations, municipal authorities and student loan organizations have issued auction-rate securities (ARSs), typically in the form of bonds with long-term maturities or as preferred stock. The interest or dividend rate on ARSs is determined by a Dutch auction mechanism through which investors already holding ARSs and investors seeking to acquire ARSs indicate their interest in holding, purchasing or selling the ARSs at specified rates. Auctions are typically held every seven, 28, 35, or 49 days, but with respect to some ARSs the auctions can occur daily or at longer intervals such as every six months. For issuers, ARSs are beneficial as they can provide financing at rates that are lower than variable rate debt instruments. To investors, ARSs are attractive as their yield is typically higher than the yield on deposits or money market funds. The ARS market currently has an estimated size of a few hundred billion dollars. Lately, as a result of the current credit crunch, there has been little or no interest in purchasing ARSs resulting in wholesale auction failures. Upon an auction failure, the interest or dividend rate on the ARS defaults to a maximum rate that, generally, is intended to be an above-market rate at original issuance that

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is intended to compensate holders of the ARS for the illiquidity of the securities. However, due to the credit crisis, some of these rates are now viewed as below market, causing ARSs to become even more illiquid.

In response to the illiquidity problem, the IRS issued Notices 2008-27[186] and 2008-41,[187] providing guidance to issuers of tax-exempt bonds that wish to either convert their outstanding bonds from ARSs to bonds with a fixed or floating interest rate to maturity or to purchase their own ARSs from the market. Pursuant to these notices, under certain limited circumstances, the conversion of a tax-exempt ARS to a bond with a fixed or floating interest rate will not result in a reissuance for U.S. federal income tax purposes, and, in applying the tax-exempt bond rules, an issuer may purchase its own tax-exempt ARS without such purchase resulting in a retirement of the bonds for U.S. federal income tax purposes, which could potentially result in adverse tax consequences to the issuer.

With respect to ARSs issued as preferred stock, in order to preserve their status as "equity" for tax purposes, it is particularly important that investors not be viewed as having the right to put the ARSs to the issuer on demand. Notwithstanding, some had proposed that holders of such ARS be permitted to sell, pursuant to a liquidity facility agreement, their shares to a liquidity provider upon a failed auction. This would broaden the market for potential ARS investors as tax-exempt money market funds (frequently referred to as 2a-7 funds) would subsequently be allowed to purchase ARSs under the 1940 Act from issuers that are themselves RICs. Under the proposal, the liquidity provider would try to sell the ARSs (including by participating in subsequent auctions). Further, the issuer would be required to redeem the stock after a specified period of time if the liquidity provider is unable to sell the ARSs. The proposal was designed to permit new investors to invest in ARSs.

In response, the IRS issued Notice 2008-55,[188] confirming that it will not challenge the equity characterization of the ARSs if a liquidity facility agreement, such as the one described above, were entered into. As a result, payments on the ARSs should still be characterized as exempt-interest dividends (to the extent of the issuer's exempt interest) and not as taxable interest, which would have been the consequence if the ARSs were instead treated as debt for U.S. federal income tax purposes. In general, the notice only applies if, among other requirements, the ARSs are issued by closed-end funds that are RICs and that invest exclusively in taxable or tax-exempt bonds, the ARSs were outstanding on February 12, 2008 (or issued after that date to refinance ARSs that were outstanding on that date) and the liquidity provider is unrelated to the issuer.

The IRS's latest installment of relief provisions for the ARS market provides guidance to holders of ARSs in light of recent announcements by Wall Street firms that they will buy back billions of dollars worth of

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ARSs from aggrieved investors. On September 29, 2008, the IRS issued Revenue Procedure 2008-58,[189] providing assurance to investors in the auction rate securities market that the IRS will not challenge certain tax positions taken with regard to settlement of potential legal claims related to such securities.

Rev. Proc. 2008-58 focuses on ARS holders that have the right during a specified "window period" to cause an issuer to buy back the ARSs for par amount in order to settle potential legal claims against the issuer (e.g., that the issuer did not properly disclose the potential that the ARSs would become illiquid).[190] Alternatively, the ARS holder may borrow the par amount of the ARSs from the issuer prior to the window period, while securing the "loan" with the ARSs. Rev. Proc. 2008-58 also contemplates a scenario in which the ARS holder does not exercise the settlement right, in which case the ARS holder would continue to receive payment under the maximum penalty rate upon a continued auction failure or receive a return that would fluctuate based on the auction rate-setting process, ultimately affecting the holder's economic return.[191] If the ARS holder were to hold the security after the window period, the ARS holder would continue to be entitled to exercise all voting rights associated with the security and to sell the security to a third party.

The IRS stated that it will not challenge the following positions: (1) that the taxpayer continues to own the auction rate security upon accepting (or "opting into") the settlement offer until the tender of the security; (2) that the taxpayer does not realize any income as a result of accepting the settlement offer and does not reduce the basis of ARSs from its original purchase price; and (3) that the taxpayer's amount realized from the sale of ARSs during the window period to the party offering the settlement is the full amount of the cash proceeds received from that party.[192] Rev. Proc. 2008-58 applies to taxpayers that accept settlement offers prior to June 30, 2009, and have such settlement offers in which the window period does not extend beyond December 31, 2012, where such relevant ARSs were purchased prior to February 14, 2008. Significantly, a revision to Rev. Proc. 2008-58 on September 29, 2008, clarifies that the relief provisions would still apply even if an ARS holder is not required to release claims in connection with the settlement. The new Rev. Proc. serves to eliminate some uncertainty for the throngs of ARS investors that will face various tax issues as a result of these settlements.

5. Facilitating Intercompany Liquidity

In general, the provisions in the Code applicable to a controlled foreign corporation (CFC) may result in phantom income inclusion to a U.S. shareholder that owns 10% or more of the voting stock of the CFC under certain circumstances. Code section 956 provides for such an income

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inclusion when a CFC makes an investment of earnings in U.S. property, which includes certain loans by the CFC to related U.S. persons.[193] The IRS and Treasury had previously announced in Notice 88-108 that final regulations issued under section 956 will exclude an obligation from the purview of section 956 where the obligation is collected within 30 days from the time it is incurred.[194] To facilitate liquidity in the near term, on October 10, 2008, the IRS and Treasury announced in Notice 2008-91 that they will issue regulations providing that, for section 956 purposes, a CFC may choose to exclude an obligation held by the CFC that would otherwise be an investment in "United States property" if the obligation is collected within 60 days from the time it is incurred.[195] The exclusion does not apply if the CFC holds for 180 or more calendar days during its taxable year obligations that would be an investment in "United States property," without regard to the new 60-day rule. Additionally, a CFC may apply Notice 2008-91 or Notice 88-108, but not both. Notice 2008-91 applies for the foreign corporation's first two taxable years ending after October 3, 2008.[196]

6. Assessing the Government's Responses to the Crisis

The TARP was intended to address the financial credit crisis by providing balance sheet liquidity for financial institutions. As discussed in Part I, as a result of the subprime crisis and falling housing prices, the value of mortgage-backed securities held by financial institutions fell. These securities became illiquid. Financial institutions were forced to write down the value of their mortgage-backed securities portfolios. It became more and more difficult to use these mortgage-backed securities as collateral to secure financing from anyone other than the lender of last resort, the Federal Reserve. The stocks of financial institutions became increasingly volatile as investors lost confidence that many of these institutions would have sufficient capital to weather the storm. Names such as Bear Stearns, Lehman Brothers, IndyMac, Washington Mutual, and Wachovia became well-recognized metaphors for inadequate capital and liquidity. Every part of the market that depended on credit advances, even if the market segment was not related to mortgages or mortgage-related securities, seized up. For example, in the auction rate securities market, there were few if any real concerns about credit quality. Nonetheless, starting in February 2008, auctions began to fail as the broker-dealers that provided liquidity stopped participating in the regular auctions. Market participants were concerned about counterparty risk. The interbank lending market froze.

Originally, TARP was intended to provide financial institutions with liquidity by providing a buyer (the Treasury) for the most illiquid mortgage-backed and asset-backed securities. These purchases were aban-

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doned in favor of direct capital injections in banks that were deemed "healthy." The capital infusions were intended to stabilize the banking system and provide necessary capital so banks could resume their mortgage lending activities. However, Treasury did not impose any express requirements (other than in connection with the Citigroup bailout) that capital provided through the Capital Purchase Program be used in connection with mortgage lending activities or loan modification programs. Understandably, many banks, facing a progressively deteriorating situation and the prospect of additional write-downs, did not use these funds to make business and consumer loans. Also, in retrospect, it appears that many of the "healthy" banks that were recipients of the capital injections were not in particularly good health.

The Federal Reserve relaxed many of the requirements that had limited private equity investment in regulated financial institutions. Tax changes were implemented that created incentives for investments in distressed financial institutions or acquisitions of distressed financial institutions. However, there has been limited investment and acquisition activity (other than government supported mergers). Market participants in the private equity arena continue to face their own liquidity constraints. Moreover, the number of recent bank failures may be too chilling for even an opportunistic buyer. In 2008, 25 banks with over $300 billion in total assets failed. The FDIC's list of "problem" banks continues to grow. Private equity funds must answer to their investors and, in unsettled times, tend to experience high redemptions. Also, investors may be made anxious by an investment in a bank. With continuing announcements of additional write-downs by financial institutions, significant numbers of private investments in financial institutions seem unlikely in the near term. Potential private equity investors are likely to sit it out on the sidelines, waiting for these assets to reach a bottom, waiting for government assistance in connection with an acquisition and waiting for redemptions to approach more normal levels.

The FDIC's Temporary Liquidity Guarantee Program, which guarantees the liabilities of qualified financial institution participants, was intended to restart interbank lending. Financial institutions have availed themselves of the guarantee program and have issued guaranteed debt securities in the public markets. In fact, the investment grade debt market currently seems to be comprised principally of government guaranteed securities. Nonetheless, the financial institution participants continue to face regulatory capital and balance sheet demands. The Temporary Liquidity Guarantee Program does not address these concerns, although it has been providing "capital" to offset a new series of write-downs. In the face of these pressures, financial institutions have not significantly increased their business and consumer lending activities.

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The emergency government measures, which began with proposed purchases of troubled assets and then morphed into direct capital injections, have not yet stabilized our financial institutions. All of these actions were intended to provide liquidity and liquidity in turn was supposed to lead to new mortgage lending. However, there has been no direct nexus between the assistance and mortgage lending or mortgage mitigation. The “toxic” mortgage-related assets remain on balance sheets—awaiting additional write-downs, which will further erode investor confidence. These efforts also have not directly addressed mortgage losses or foreclosures. Depositary institutions have no new alternative method to finance their mortgage loan originations. There are those who despair over the fact that no single initiative or series of initiatives has thus far provided us with a financial crisis magic bullet or “eureka” cure. While this is true, it is equally true that there is no authoritative basis to gauge how much more unsettled the capital markets would be in the absence of these initiatives. What has become apparent is that the current financial crisis is not the result any single event or factor. Part III discusses a number of the factors that have contributed to the crisis.

PART III: OTHER FACTORS CONTRIBUTING TO THE FINANCIAL CRISIS

Over the last 18 months, there has been a steady stream of explanations of the origins of the financial crisis. Short selling, or the practice of selling a security that the seller does not own at the time of sale but intends to purchase at a lower price, is a time-honored securities trading technique that has been identified as a factor contributing to the financial crisis. The frequency and extent of the failures of rating agencies to identify accurately the risks associated with certain issuers and certain securities, especially with complex mortgage-backed securities, are also understood to have contributed to the financial crisis. As has been widely reported, rating agencies often did not appreciate fully the risks inherent in certain mortgage-backed securities and failed to disclose the extent to which these securities had been subjected to “stress testing” that would reveal potential risk of default. The fact is that while ratings could have served as an early warning regarding the effect of a decline in the housing market on existing mortgage-backed securities, this did not happen. Fair value accounting, or mark to market accounting, is a methodology that attempts to value assets based on what the assets might be sold for in current markets. In the context of our current market, the problem with fair value accounting is quite basic. If there ceases to be a functioning market, fair value accounting principles generally require that the institution write down the value of the assets. However, these new written down values frequently bear no relationship to the intrinsic value of

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the assets. The impact of fair value accounting on financial institutions, especially those institutions holding large portfolios of mortgage-backed and asset-backed securities, has been devastating and likely has exacerbated the current financial crisis. Following announcements by AIG and various monoline insurers regarding their exposures to credit derivatives, shell-shocked investors were quick to blame credit derivatives, especially credit default swaps (CDSs), for contributing to the financial crisis. Market participants and regulators alike were troubled by the fact that there was limited awareness regarding the actual size of the credit derivatives market. Regulators also became increasingly concerned as they detected a correlation between CDS prices and subsequent public announcements related to the failures of various financial institutions. Finally, regulatory shortcomings were blamed for the financial crisis.

A. Short Selling

In 2008, the SEC took a series of dramatic actions aimed at restoring investor confidence in the financial markets and curbing 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 the 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 regulation and enforcement.

Permanent Prohibitions on Naked Shorting

On September 17, 2008, the SEC adopted, under its emergency authority, three rules that permanently prohibit naked short selling.[197]

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 both located and pre-borrowed. The prohibition on the broker-dealer's activity applies not only to short sales for the particular naked short seller, but

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to all short sales in that security for any customer. Rule 204T became effective on September 18, 2008, and the interim final temporary rule is effective through July 31, 2009.[198] Comments were due by December 16, 2008, and the SEC expects to follow with further rulemaking. The SEC has released non-binding interpretive guidance in the form of Frequently Asked Questions, or FAQs, regarding the application of Rule 204T.[199]

Exceptions to the Closeout Requirement. Second, the SEC adopted proposed amendments to Reg SHO eliminating the "options market maker exception." On October 17, 2008, these rules became final.[200] 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 to the effect 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 under the Securities Exchange Act of 1934.[201] 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 then 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.

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.[202] The order was amended on September 21, 2008, to require

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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.[203] On September 24, 2008, the SEC issued FAQs[204] to provide guidance on the preparation and filing of Form SH. The FAQs indicated 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.[205]

B. Credit Rating Agencies

Actions of nationally recognized statistical ratings (NRSROs), or credit rating agencies, have been identified as a contributing factor in the financial crisis. The July 2008 SEC *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*[206] found that ratings assigned to mortgage-backed and mortgage-related securities backed by subprime loans were based on limited diligence of the underlying assets and over-reliance on statistical models, without disclosure to investors. 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 SEC's 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, and new reporting and new recordkeeping requirements. In addition to the proposed rules on which no action has been taken and the re-proposed rules, additional rulemaking from the SEC can be expected as the SEC continues to develop its NRSRO examination and oversight responsibilities.

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. Also proposed is a rule that it would be a prohibited conflict of interest for an NRSRO to rate a structured finance product the rating of which is being 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 also 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.

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C. Fair Value Accounting

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 2008. 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 debate over fair value and mark-to-market accounting resulted in Congress mandating a study and report by the SEC that was released on December 30, 2008.[207] The target 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

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to determine fair value, many auditors and financial statement preparers were unwilling to deviate from the market price as the measure of fair value. The lack of guidance under FAS 157 left financial institutions holding mortgage-backed securities or auction rate securities writing 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, 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 also has been 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*.[208] 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.

D. Credit Derivatives

A popular belief echoed by politicians, regulators, and financial pundits throughout 2008 is that credit derivatives—and, in particular, credit default swaps (CDSs)—were major contributors to the current global financial crises. Credit derivatives isolate specific aspects of risk relating to referenced bonds and/or entities and transfer that risk. In a CDS,

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a protection buyer transfers the credit risk associated with one or more reference assets or entities to the protection seller by assuming the risk of the occurrence of one or more credit events, like the occurrence of a bankruptcy event. A CDS functions like a put option on a bond. A protection buyer may actually own the reference asset (a covered CDS) or have exposure to it through derivatives contracts or it may not. Many compare a CDS to an insurance contract. However, under an insurance contract, payment is conditioned on the beneficiary suffering an actual loss, which is not the case with CDS. Prior to the growth of credit derivatives, credit was an area of risk for which there was no tailored risk management product, with loan assignments and participations being the dominant vehicles. As a result, credit risk management was limited and the credit markets were dominated by depositary institutions.

The CDS market has been referred to as a "black hole." Last year, when insurer AIG first disclosed that it held more than $440 billion of credit swap trades linked to CDS, market participants realized that a lack of transparency had obscured the actual size of CDS exposures. CDSs trade over the counter and between institutions. There is currently no exchange or clearing house. CDSs tend to be highly customized. As a result, it may be difficult to assess market value and to quantify actual CDS exposure. As with other segments of the financial markets, the CDS market has been affected by the credit crisis. The few financial institutions that are still selling protection are demanding to be paid more to take on risk because it is becoming more difficult for them to offset the risk associated with their own positions. The amount of margin that dealers require that their counterparties post on CDSs has more than doubled. At the same time, financial institutions have been disappearing and those that remain have been consolidating, reducing the number of actual CDS dealers.

Many market observers have noted that the availability of CDSs may have encouraged banks and insurers to take on more risk than they could actually handle. The CDS market has been tested in recent months by the occurrence of credit events relating (but not limited) to Bear Stearns, the GSEs, and Lehman. During this period, CDS auctions have functioned. Nonetheless, federal and state regulators have called for CDS market oversight. It is not clear which regulator has or would have authority for this. It also is not clear whether CDSs would be deemed "insurance contracts." In recent weeks, the SEC has granted approvals and exemptions enabling the creation of an exchange (and effectively a single counterparty) to trade and clear CDS. Several other exchange operators have yet to be approved.

A consequence of the negative attention that credit derivatives have received, whether or not justified, is that the U.S. credit derivatives markets

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will undergo substantial regulatory and operational changes in 2009. 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 credit default swap 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 credit default swaps 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.

E. Regulatory Reform

Although regulators have been intensely focused on emergency initiatives that will stem the financial crisis, there has been an acknowledgment that, at least in part, regulatory shortcomings may have contributed to the financial crisis. In particular, there is a consensus that, in many respects, regulation has not kept pace with market developments since the establishment of our current regulatory framework. Globalization of the capital market, 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 have all become factors since the regulatory framework was set in place.

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In March 2008, Treasury Secretary Paulson released the Blueprint for a Modernized Financial Regulatory Structure[209] (the "Blueprint"). The Blueprint takes a three-step approach to regulatory reform, proposing short-term and intermediate-term recommendations that could be implemented under the current regulatory system, as well as offering a framework for an "optimal" regulatory system. The financial crisis has deepened since publication of the Blueprint and the Blueprint identified priorities based on the events that had transpired only through early 2008. Since, there have been a number of other reports and recommendations regarding 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[210] (the "Framework"). The Framework reviews the historical underpinnings of our current structure and outlines the rationale for significant reform intended to prevent future crises. The Act required a number of studies regarding various oversight functions. As required by the Act, on 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 for our financial system.

PART IV: ALTERNATIVES TO SECURITIZATION

The financial crisis has made clear the need to consider alternative means of financing mortgage loan originations. As discussed in Part I, in the United States, mortgage finance relied heavily on the GSEs (Fannie Mae and Freddie Mac), on local bank access to the Federal Home Loan Bank system, and on a thriving securitization market. There are fundamental issues with the GSEs. While the crisis response measures legislation establishes a new central regulator with oversight responsibility for the GSEs, market participants generally regard this as only an interim measure. They consider the future of Fannie Mae and Freddie Mac to be uncertain. The costs associated with the use of the Federal Home Loan Banks makes them more expensive than other current financing alternatives. Finally, the crisis has revealed that the securitization model may well be too broken to fix—at least too broken to fix without significant regulatory change. Much of the dialogue on regulatory reform has been a reaction to crisis. Although there is an appropriate emphasis on creating a regulatory system that will mitigate systemic risk and enhance market integrity, there has been considerably less discussion of the future of the capital markets. For example, there has been little discussion of the "resale" or eventual transfer of Treasury's stake in financial institutions. There has been little discussion regarding the effect on how the capital markets might continue to remain central to mortgage finance. This sec-

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tion discusses a few alternatives to mortgage finance that would rely on the capital markets.

A. Covered Bonds

Covered bonds are debt instruments that have recourse both to the issuing entity or to an affiliated group to which the entity belongs. Upon an issuer default, bondholders also have access to a pool of collateral called the cover pool. The cover pool remains on the issuer's balance sheet but is segregated from the issuer's other assets. The cover pool usually consists of high quality assets, including residential mortgage loans, public debt or ship loans, though other assets may be used. The assets are subject to various criteria and must be replaced should they fail to meet those criteria. Typically, the cover pool provides for overcollateralization to preserve the value of the covered bond holders' claim in the event of the issuer's insolvency. Covered bond holders usually have a security interest in, and therefore a privileged or preferential claim against, the cover pool in the event of the issuer's insolvency.

In Europe, most jurisdictions have covered bond legislation that provides a statutory preference in bankruptcy for covered bond holders. Covered bonds that are not issued pursuant to statutes imposing special bankruptcy protection for covered bond holders are not entitled to preferential risk weighting by the European Central Bank.[211] To compensate for the lack of legislation, to date, issuers in the U.S. have relied on contractual arrangements to create synthetically covered bond structures. The basic requirement for covered bonds is a statutory or a contractual framework to ring fence the cover pool from unsecured creditor claims and to ensure payment to covered bond holders. Until recently, there was little guidance in the U.S. as to how the FDIC would treat covered bonds in a receivership scenario.

On July 15, 2008, the FDIC issued its Final Policy Statement on covered bonds.[212] The FDIC intended for the Policy Statement to clarify for investors how the FDIC would respond if it were appointed conservator or receiver for a depositary institution that had issued covered bonds. The Final Policy Statement "define[s] the circumstances and the specific covered bonds transactions for which the FDIC will grant consent to expedited access to pledged covered bond collateral." On July 28, 2008, Treasury announced the publication of its Best Practices for U.S.-covered bonds, intended to further promote covered bond issuances.[213]

The Final Policy Statement confirms that the FDIC will, when acting as conservator or receiver, consent to a covered bond holder's exercise of its rights to collateral if (1) the bank is, and remains, in monetary default for at least 10 business days after the obligee delivers a written request

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to the FDIC to exercise its contractual rights or (2) the FDIC as conservator or receiver provides written notice of repudiation of a contract to the covered bond obligee and does not pay damages as a result of such repudiation within 10 days after the effective date of such notice. In both cases the conservator or receiver need not be involved in order for the covered bond holder to exercise its rights. This statement eased investor concerns about how long it would take to access the collateral in the event of a bank's insolvency—removing covered bonds from the 90-day automatic stay under the Federal Deposit Insurance Act.

The Final Policy Statement narrowly defines covered bonds as recourse debt obligations of an insured depositary institution with a term of greater than one year and not exceeding 30 years, secured directly or indirectly by perfected security interests in a pool of mortgage loans or, not exceeding 10% of the collateral, by AAA-rated mortgage bonds.

The Final Policy Statement places strict limits on the collateral eligible for inclusion in the cover pool. Only "eligible mortgages" (defined as performing mortgages on one-to-four family residential properties, underwritten at the fully indexed rate based on documented income) may be used as collateral. The FDIC permits cover pool substitution with cash, Treasury, and agency securities. The FDIC declined to expand the assets acceptable for inclusion in the cover pool, believing that many assets (including second-lien home equity loans and home equity lines of credit, credit card receivables, mortgages on commercial properties, public sector debt, and student loans) would be subject to substantial volatility while others would be unsuitable for supporting additional "liquidity for well-underwritten residential mortgages." The Best Practices establish a standard framework for U.S.-covered bond issuances, though they are not binding. The additional standards from Treasury are intended to work in conjunction with the Final Policy Statement.

In addition to the requirements set forth in the Final Policy Statement, the Best Practices recommend that collateral have a maximum LTV of 80% at the time of inclusion in order to be eligible for the cover pool. In addition, no single Metro Statistical Area should make up more than 20% of the cover pool and negative amortization mortgages should not be included. All mortgages in the cover pool should be first lien only, and issuers should maintain overcollateralization of at least 5% of the outstanding principal amount of the covered bonds at all times, counting only the 80% portion of the LTV.

The Best Practices specifically contemplate covered bond issuance either through a newly created, bankruptcy-remote SPV or directly by the depository institution and/or a wholly owned subsidiary. The Best Practices also clarify that covered bonds may be issued either as registered

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securities or pursuant to an exemption from the registration requirements of the Securities Act. This means that covered bonds could be issued to institutional investors or possibly to institutional and accredited investors in the United States.

- Market resiliency in Europe—While covered bonds still represent an interest in residential mortgage securities (assuming the structure established by U.S. regulators), the covered bond market in Europe has demonstrated a resiliency during the credit crisis which suggests that investors may view these securities as more akin to corporate debt or, at least, as hybrids.
- Dual recourse obligation—In a securitization, an investor only has recourse to the SPV that issues the securities and to that SPV's assets, which include the asset pool and its cash flows. By contrast, covered bonds are dual recourse obligations—with recourse to the issuing entity and, upon a default, recourse to the cover pool.
- On balance sheet—From the investor's perspective, covered bonds remain on balance sheet, aligning the interests of the mortgage originator (covered bond issuer) more closely with those of securities holders, which may lead to improved mortgage origination practices. This is not the case in a securitization, in which the fate of the issuing SPV is often remote from that of the issuer.
- High quality assets—Along these lines, the cover pool in a covered bond offering consists of high quality assets, as opposed to a securitization, in which assets of varying quality will comprise the SPV's assets.
- Regulatory protection—Covered bonds generally are issued by depositary institutions that are regulated entities subject to supervision by domestic banking authorities, which also ensures that regulators would step in if a safety and soundness issue were to arise.
- Funding alternative—For issuers, covered bonds provide a means of funding mortgage originations and provide a security that can be pledged or presented in order to obtain advances from the Fed window. Even if the securitization market were to reopen, covered bonds will provide an important funding alternative to public or private label or agency securitizations.

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B. Collateralized Debt

Currently, the FDIC's Debt Guarantee Program covers senior unsecured debt issued on or after October 14, 2008, and prior to June 30, 2009, for a three-year period through 2012. Recently, the FDIC announced that it was considering extending the maturity on the guarantee program to include debt that has a 10-year term. In its announcement, the FDIC explained that the guarantee would apply to debt that is supported by collateral provided that the proceeds from the debt issuance are used to support consumer lending. The FDIC said its board would propose rule changes in order to implement these measures. Without the benefit of any additional details or other information, it would seem that the FDIC guarantee would provide for a government guarantee of a covered bond. The underlying assets securing the debt may not be required to be mortgage loans, but the concept is basically the same. Eligible financial institutions will be able to issue and sell to investors securities that are backed by collateral and in addition are guaranteed. Although it is not clear whether the collateral must be mortgage-related; however, the proceeds must benefit consumer lending. This may serve to kick start the covered bond market in the United States and, while admittedly only a temporary measure, may prove an interesting alternative to government guarantees of certain mortgage loans.

C. TARP Purchases and/or Sales of Treasury Stakes

Although direct purchases of troubled assets were initially proposed and subsequently ruled out by Secretary Paulson in favor of other priorities, it has become clear that the "troubled assets" that remain on financial institution balance sheets are a continuing source of concern. With each new earnings announcement, comes an announcement of additional write-downs related to these securities. A new write-down announcement causes a chain reaction—counterparties become increasingly nervous about the financial health and viability of the reporting institution; other institutions that hold the same or similar securities in their own portfolios are forced to analyze whether this new valuation assessment has created a "market price" for the assets; speculation causes the institution's stock price to drop and become more volatile; rating agencies now scarred by their experiences make conservative judgments regarding the ratings of the institution's outstanding debt securities; the institution is forced to deleverage further since capital raising options (that do not involve government assistance) are limited; and on and on. Recent government bailout announcements have tacitly acknowledged the toxicity of these troubled assets. In each of the most recent bailout plans, Treasury has provided for guarantee or insurance on a segregated or specific pool of as-

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sets. As discussed in Part II above, under the Act, Treasury is required to account for insurance on assets as it would for a direct purchase of the assets. Given this dynamic and the need to stabilize financial institutions, it would seem sensible to reconsider actual direct purchases of troubled assets. Ultimately, the proceeds from sales of these troubled assets, whether through repackaging or auctions or otherwise, could be set aside in fund to support consumer lending or these assets could be used to capitalize a government created bad bank. In the future, the Treasury stakes in various financial institutions (those acquired through direct capital injections, either through the Capital Purchase Program or on an ad hoc basis) could be transferred to the bad bank or sold with the proceeds used to fund new business and consumer loans.

D. GSE Reform

The future of Fannie Mae and Freddie Mac is quite uncertain. As discussed in Part I above, the GSEs have historically played an important role in facilitating home ownership by buying conforming mortgage loans from banks. Prior to the financial crisis, there were a number of proposals to overhaul the regulation of these entities. Both entities were investigated for their accounting practices and found to have engaged in improper financial reporting and ineffective reporting and disclosure controls. At various times, regulators have noted that, due to the private/public nature of these entities, conflicts of interest have arisen. Many commentators also have noted that Fannie and Freddie represented a disproportionately large percentage of the mortgage market in the United States. It was reported that Fannie and Freddie had purchased $4.9 trillion of the mortgages outstanding as of the end of 2007. Even as housing prices fell in recent years, the GSEs continued to increase their purchases of mortgages. As the subprime crisis became more severe, the GSEs played an essential part in the mortgage market. The only securitizations that have been conducted in recent months are those involving the GSEs. However, their continued operations required capital and the GSEs found themselves thinly capitalized. Their stocks were subjected to the same market volatility that affected the stocks of other financial institutions.

As discussed in Part II above, in July 2008, HERA created a new single regulator for the GSEs, the FHFA. HERA also made a number of other significant changes to the housing finance system, including giving Treasury authority to purchase obligations and securities of the GSEs. In September 2008, the FHFA was appointed as the conservator, and senior management is replaced at each of Fannie Mae and Freddie Mac. When the conservatorship was announced, a plan was announced to scale back the size of the two GSEs beginning in 2010. The delayed start of this rollback was intended to permit the GSEs to support the mortgage market

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through this period of dislocation. Also in September 2008, Treasury announced a program to purchase mortgage-backed securities of the GSEs in the open market in order to stabilize trading. This was followed by a direct injection of capital into the GSEs in November 2008. Most recently, in December 2008, the Federal Reserve announced a program to purchase GSE securities in the open market in order to promote liquidity. Additional government intervention and support for the GSEs may be required before we see the end of this financial crisis. Looking to the future, it is not clear whether the GSEs will remain private/public entities (with all of the conflicts that entails) nor that the GSEs will have an essential role to play in the postcrisis mortgage market.

PART V: CONCLUSION

By the time this article appears in print, the President-elect will be the President, there will be a new Secretary of the Treasury, and many other financial policy positions will have been filled. The policy makers come to their new positions at a time of urgent priorities. The United States is neither at the beginning nor the end of the financial crisis. The housing markets, the capital markets, and corporate America are in decline. There has been a widespread loss of confidence in the financial sector, the employment outlook is bleak, and consumer spending continues to decline. The problems in the financial and housing markets actually developed over a long period of time and, unfortunately, can be expected to take a long period of time to resolve. Already discussion has turned from stabilization measures to stimulus proposals. This may be precipitous, particularly when as discussed above, the emergency measures taken to date have not address the financing of mortgage loan originations and housing finance more broadly. Effective regulatory reform relating to housing finance will be necessary to restarting lending. Moreover, it will be essential to providing a viable alternative to the broken securitization model.

NOTES

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20. Pub. L. No. 110-343, § 113.

21. Pub. L. No. 110-343, § 102.

22. Pub. L. No. 110-343, § 124.

23. Pub. L. No. 110-343, § 136.

24. See, e.g., Pub. L. No. 110-343, § 202(a).

25. Pub. L. No. 110-343, § 121(f).

26. Pub. L. No. 110-343, § 132.

27. Pub. L. No. 110-343, § 101(a).

28. Pub. L. No. 110-343, § 115.

29. Pub. L. No. 110-343, § 101(a).

30. Pub. L. No. 110-343, § 3(5).

31. Pub. L. No. 110-343, § 3(5).

32. Treasury may adopt certain de minimis and other exceptions.

33. Pub. L. No. 110-343, § 121(a).

34. Pub. L. No. 110-343, § 121(b).

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45. See U.S. Department of the Treasury, TARP Capital Purchase Program Term Sheet, available at http://www.ustreas.gov/press/releases/reports/document5hp1207.pdf; U.S. Department of the Treasury, TARP Capital Purchase Program (Non-Public QFIs, excluding S Corps and Mutual Organizations) Term Sheet, available at http://www.ustreas.gov/press/releases/reports/term%20sheet%20%20private%20c%20corporations.pdf.

46. See U.S. Department of the Treasury, TARP Capital Purchase Program Term Sheet, available at http://www.ustreas.gov/press/releases/reports/document5hp1207.pdf; U.S. Department of the Treasury, TARP Capital Purchase Program (Non-Public QFIs, excluding S Corps and Mutual Organizations) Term Sheet, available at http://www.ustreas.gov/press/releases/reports/term%20sheet%20%20private%20c%20corporations.pdf.

47. See U.S. Department of the Treasury, TARP Capital Purchase Program Term Sheet, available at http://www.ustreas.gov/press/releases/reports/document5hp1207.pdf; U.S. Department of the Treasury, TARP Capital Purchase Program (Non-Public QFIs, excluding S Corps and Mutual Organizations) Term Sheet, available at http://www.ustreas.gov/press/releases/reports/term%20sheet%20%20private%20c%20corporations.pdf.

48. See U.S. Department of the Treasury, TARP Capital Purchase Program (Non-Public QFIs, excluding S Corps and Mutual Organizations) Term Sheet, available at http://www.ustreas.gov/press/releases/reports/term%20sheet%20%20private%20c%20corporations.pdf.

49. See U.S. Department of the Treasury, Private Bank Program Q&A, available at http://www.treas.gov/press/releases/reports/faq%20111708%20%20private.pdf.

50. See U.S. Department of the Treasury, TARP Capital Purchase Program (Non-Public QFIs, excluding S Corps and Mutual Organizations) Term Sheet ("Non-Public Term Sheet"), available at http://www.ustreas.gov/press/releases/reports/term%20sheet%20%20private%20c%20corporations.pdf.

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51. See U.S. Department of the Treasury, TARP Capital Purchase Program (Non-Public QFIs, excluding S Corps and Mutual Organizations) Term Sheet ("Non-Public Term Sheet"), available at http://www.ustreas.gov/press/releases/reports/term%20sheet%20%20private%20c%20corporations.pdf.

52. See Non-Public Term Sheet.

53. See U.S. Department of the Treasury, TARP Capital Purchase Program Term Sheet, available at http://www.ustreas.gov/press/releases/reports/document5hp1207.pdf; U.S. Department of the Treasury, TARP Capital Purchase Program (Non-Public QFIs, excluding S Corps and Mutual Organizations) Term Sheet ("Non-Public Term Sheet"), available at http://www.ustreas.gov/press/releases/reports/term%20sheet%20%20private%20c%20corporations.pdf.

54. Press Release, U.S. Department of the Treasury, Treasury Releases Capital Purchase Program Term (Jan. 14, 2009), available at http://www.treas.gov/press/releases/hp1354.htm.

55. See Press Release, U.S. Department of the Treasury, Treasury Releases Capital Purchase Program Term (Jan. 14, 2009), available at http://www.treas.gov/press/releases/hp1354.htm.

56. See U.S. Department of the Treasury, TARP Capital Purchase Program (Subchapter S Corporation) Term Sheet ("S-Corp Term Sheet"), available at http://www.treas.gov/initiatives/eesa/docs/scorp-term-sheet.pdf.

57. See U.S. Department of the Treasury, TARP Capital Purchase Program (Subchapter S Corporation) Term Sheet ("S-Corp Term Sheet"), available at http://www.treas.gov/initiatives/eesa/docs/scorp-term-sheet.pdf.

58. See U.S. Department of the Treasury, TARP Capital Purchase Program (Subchapter S Corporation) Term Sheet ("S-Corp Term Sheet"), available at http://www.treas.gov/initiatives/eesa/docs/scorp-term-sheet.pdf.

59. Eligible shareholders of S-Corps include individuals, decedents' estates, estates of individuals in bankruptcy, certain trusts and tax-exempt organizations. In general, a government will not qualify as an eligible S-Corp shareholder.

60. See U.S. Department of the Treasury, TARP Capital Purchase Program Term Sheet, available at http://www.ustreas.gov/press/releases/reports/document5hp1207.pdf; U.S. Department of the Treasury, TARP Capital Purchase Program (Non-Public QFIs, excluding S Corps and Mutual Organizations) Term Sheet, available at http://www.ustreas.gov/press/releases/reports/term%20sheet%20%20private%20c%20corporations.pdf.

61. See U.S. Department of the Treasury, TARP Capital Purchase Program Term Sheet, available at http://www.ustreas.gov/press/releases/reports/document5hp1207.pdf; U.S. Department of the Treasury, TARP Capital Purchase Program (Non-Public QFIs, excluding S Corps and Mutual Organizations) Term Sheet, available at http://www.ustreas.gov/press/releases/reports/term%20sheet%20%20private%20c%20corporations.pdf.

62. Pub. L. No. 110-343, § 109.

63. Pub. L. No. 110-343, § 109.

64. Pub. L. No. 110-343, § 109.

65. Pub. L. No. 110-343, § 109(c).

66. Pub. L. No. 110-343, § 109(c).

67. See Morrison & Foerster LLP's News Bulletin "Bailout Bill Tax Provisions: An Executive Summary" at http://www.mofo.com/news/updates/files/14546.html.

68. See e.g. Pub. L. No. 110-343, § 302.

69. Pub. L. No. 110-343, § 301(f).

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70. See Morrison & Foerster LLP's News Bulletin "Economic Stabilization Act: Employee Benefits and Executive Compensation" at http://www.mofo.com/news/updates/files/14549.html.

71. For purposes of these rules a "senior executive officer" is defined as an individual who is one of the top five highest-paid executives of a public company whose compensation is required to be disclosed under the Exchange Act, as well as nonpublic company executive counterparts. Pub. L. No. 110-343, § 111(b)(3).

72. Pub. L. No. 110-343, § 111(b)(1)(B).

73. Pub. L. No. 110-343, § 111(c). It is not clear how "golden parachute" will be defined for purposes of this provision, but that question may be answered under regulations that Treasury is directed to issue within two months following enactment of the Act. The provision described in this paragraph expires on December 31, 2009, unless extended by certification by Treasury to Congress.

74. For purposes of this rule, a "covered executive" includes the chief executive officer, the chief financial officer, and the other three most highly compensated executive officers for the taxable year. Any individual who is considered a covered executive for any year retains that status for all succeeding years. Pub. L. No. 110-343, § 302(a).

75. Pub. L. No. 110-343, § 302(a).

76. Pub. L. No. 110-343, § 302(a).

77. Pub. L. No. 110-343, § 302(b).

78. Pub. L. No. 110-343, § 302(b).

79. Pub. L. No. 110-343, § 302(b).

80. See Internal Revenue Service, Guidance for Sections 162(m)(5) and 280G(e) of the Internal Revenue Code, Nov. 3, 2008, http://www.irs.gov/irb/2008-44_IRB/ar08.html.

81. See Internal Revenue Service, Guidance for Sections 162(m)(5) and 280G(e) of the Internal Revenue Code, Nov. 3, 2008, http://www.irs.gov/irb/2008-44_IRB/ar08.html.

82. Blanton, Money market funds battered, Boston Globe, Sept. 18, 2008, at A1.

83. U.S. Department of the Treasury, Press Release: Treasury Announces Guaranty Program for Money Market Funds, Sept. 19, 2008, http://www.treasury.gov/press/releases/hp1147.htm.

84. U.S. Department of the Treasury, Press Release: Treasury Announces Guaranty Program for Money Market Funds, Sept. 29, 2008, http://www.ustreas.gov/press/releases/hp1161.htm.

85. Board of Governors of the Federal Reserve System, Press Release—Federal Reserve and other central banks announce specific measures to address liquidity pressures in funding markets, Mar. 11, 2008, http://www.federalreserve.gov/newsevents/press/monetary/20080311a.htm.

86. Board of Governors of the Federal Reserve System, Press Release—Federal Reserve, European Central Bank, and Swiss National Bank announce an expansion of liquidity measures, May 2, 2008, http://www.federalreserve.gov/newsevents/press/monetary/20080502a.htm.

87. Board of Governors of the Federal Reserve System, Press Release—Federal Reserve announces steps to enhance the effectiveness of its existing liquidity facilities, July 30, 2008, http://www.federalreserve.gov/newsevents/press/monetary/20080730a.htm.

88. Board of Governors of the Federal Reserve System, Press Release—Federal Reserve announces two initiatives designed to bolster market liquidity and promote

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orderly market functioning, Mar. 16, 2008, http://www.federalreserve.gov/newsevents/press/monetary/20080316a.htm.

89. Board of Governors of the Federal Reserve System, Press Release—Federal Reserve announces two initiatives designed to bolster market liquidity and promote orderly market functioning, Mar. 16, 2008, http://www.federalreserve.gov/newsevents/press/monetary/20080316a.htm.

90. Board of Governors of the Federal Reserve System, Press Release—Board grants Federal Reserve Bank of New York the authority to lend to Fannie Mae and Freddie Mac should such lending prove necessary, July 13, 2008, http://www.federalreserve.gov/newsevents/press/other/20080713a.htm.

91. Board of Governors of the Federal Reserve System, Press Release—Federal Reserve Board announces several initiatives to provide additional support to financial markets, including enhancements to its existing liquidity facilities, Sept. 14, 2008, http://www.federalreserve.gov/newsevents/press/monetary/20080914a.htm.

92. Board of Governors of the Federal Reserve System, Press Release—Federal Reserve Board announces several initiatives to provide additional support to financial markets, including enhancements to its existing liquidity facilities, Sept. 14, 2008, http://www.federalreserve.gov/newsevents/press/monetary/20080914a.htm.

93. Board of Governors of the Federal Reserve System, Transactions Between Member Banks and Their Affiliates, Sept. 14, 2008, available at http://www.federalreserve.gov/newsevents/press/monetary/monetary20080914a1.pdf.

94. Board of Governors of the Federal Reserve System, Transactions Between Member Banks and Their Affiliates, Sept. 14, 2008, available at http://www.federalreserve.gov/newsevents/press/monetary/monetary20080914a1.pdf, at 4.

95. Board of Governors of the Federal Reserve System, Press Release—Board announces creation of the Commercial Paper Funding Facility (CPFF) to help provide liquidity to term funding markets, Oct. 7, 2008, http://www.federalreserve.gov/newsevents/press/monetary/20081007c.htm.

96. Board of Governors of the Federal Reserve System, Board announces additional details regarding the Commercial Paper Funding Facility (CPFF), Oct. 14, 2008, http://www.federalreserve.gov/newsevents/press/monetary/20081014b.htm.

97. Federal Reserve Bank of New York, Commercial Paper Funding Facility: Program Terms and Conditions, Oct. 14, 2008, http://www.newyorkfed.org/markets/CPFF_Terms_Conditions.html.

98. Federal Reserve Bank of New York, Commercial Paper Funding Facility: Program Terms and Conditions, Oct. 14, 2008, http://www.newyorkfed.org/markets/CPFF_Terms_Conditions.html.

99. See Press Release, Federal Deposit Insurance Corporation, FDIC Announces Plan to Free Up Bank Liquidity (Oct. 14, 2008), available at http://www.fdic.gov/news/news/press/2008/pr08100.html.

100. See Press Release, Federal Deposit Insurance Corporation, Statement by Federal Deposit Insurance Corporation Chairman Sheila Bair; U.S. Treasury, Federal Reserve, FDIC Joint Press Conference, Oct. 14, 2008, available at http://www.fdic.gov/news/news/press/2008/pr08100a.html.

101. See Press Release, Federal Deposit Insurance Corporation, FDIC Announces Plan to Free Up Bank Liquidity (Oct. 14, 2008), available at http://www.fdic.gov/news/news/press/2008/pr08100.html.

102. See Temporary Liquidity Guarantee Program,12 C.F.R. § 370 (2008), available at http://www.fdic.gov/news/board/08BODtlgp.pdf.

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103. See Press Release, Federal Deposit Insurance Corporation, FDIC Issues Interim Rule to Implement the Temporary Liquidity Guarantee Program, Oct. 23, 2008, available at http://www.fdic.gov/news/news/press/2008/pr08105.html.

104. See Press Release, Federal Deposit Insurance Corporation, FDIC Issues Interim Rule to Implement the Temporary Liquidity Guarantee Program, Oct. 23, 2008, available at http://www.fdic.gov/news/news/press/2008/pr08105.html.

105. See Press Release, Federal Deposit Insurance Corporation, FDIC Issues Interim Rule to Implement the Temporary Liquidity Guarantee Program, Oct. 23, 2008, available at http://www.fdic.gov/news/news/press/2008/pr08105.html.

106. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.3(a) (2008).

107. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.5(h)(2).

108. See Appendix A: 12 C.F.R. 325, "Statement of Policy on Risk-Based Capital."

109. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370 (2008).

110. See Temporary Liquidity Guarantee Program, 73 Fed Reg. 64179, Oct. 29, 2008.

111. See Temporary Liquidity Guarantee Program, 73 Fed Reg. 64179, Oct. 29, 2008; Temporary Liquidity Guarantee Program, 12 C.F.R. § 370 (2008).

112. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.6 (2008).

113. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.5(h)(1)(i) to (ii).

114. See Temporary Liquidity Guarantee Program Frequently Asked Questions (last updated Jan. 12, 2009), p. 2, available at http://www.fdic.gov/regulations/resources/TLGP/faq.html.

115. However, U.S. branches of foreign banks that are insured by the FDIC are eligible for the Transaction Account Guarantee Program. See Temporary Liquidity Guarantee Program Frequently Asked Questions (last updated January 12, 2009), p.3, available at http://www.fdic.gov/regulations/resources/TLGP/faq.html.

116. See 12 C.F.R. § 370.3(d); Temporary Liquidity Guarantee Program, 73 Fed. Reg. 64179, 64181 (Oct 29, 2008).

117. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.3(b)(1) (2008).

118. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.3(b)(1).

119. See Statement of Richard Brown, Chief Economist, Federal Deposit Insurance Corporation, Technical Briefing on the Temporary Liquidity Guarantee Program,(October 14, 2008), available at http://www.fdic.gov/regulations/resources/TLGP/101408_am.html.

120. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.2(f)(1)(i) to (ii) (2008).

121. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.2(e)(1)(ii) (2008).

122. See Temporary Liquidity Guarantee Program, 73 Fed. Reg. 72244, 72260 (Nov. 26, 2008).

123. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.2(e)(3).

124. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.2(e)(1)(i)(A) to (D) (2008).

125. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.2(e)(2).

126. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.2(e)(3).

127. The term "foreign bank" does not include a foreign central bank or other similar foreign government entity that performs central bank functions or a quasi-governmental international financial institution such as the IMF or the World Bank. References to debt owed to an insured depository institution, an insured credit union, or foreign bank mean owed to the institution solely in its own capacity and not as agent. See Temporary Liquidity Guarantee Program, 73 Fed. Reg. 72254, 72260 (Nov. 26, 2008).

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128. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.2(e)(5) (2008).

129. This recognizes that certain instruments have stated maturities of "one month" but have a term of up to 35 days because of weekends, holidays, and calendar issues.

130. The FDIC's updated Frequently Asked Questions clarifies that retail debt securities are those debt instruments the marketing of which is targeted to retail investors, typically with small denominations. It does not include debt securities purchased in the secondary market by retail investors if the initial marketing was targeted to nonretail investors.

131. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.3(e)(1) (2008).

132. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.3(e)(1) (2008).

133. See Temporary Liquidity Guarantee Program, 12 C.F.R. §§ 370.3(e)(1), 370.6(f) (2008).

134. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.3(g).

135. See Temporary Liquidity Guarantee Program Frequently Asked Questions (last updated Jan. 12, 2009), p.22, available at http://www.fdic.gov/regulations/resources/TLGP/faq.html.

136. See Master Agreement for Temporary Liquidity Guarantee Program, Section 4.03, available at http://www.fdic.gov/regulations/resources/TLGP/master.pdf.

137. See Master Agreement for Temporary Liquidity Guarantee Program, Section 4.03, available at http://www.fdic.gov/regulations/resources/TLGP/master.pdf, at Terms Annex A.

138. See Master Agreement for Temporary Liquidity Guarantee Program, Section 4.03, available at http://www.fdic.gov/regulations/resources/TLGP/master.pdf, at Terms Annex A.

139. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.6(b)(1) to (2) (2008).

140. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.5(h)(2) to (3).

141. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.5(h)(2) to (3).

142. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.5(h)(2) to (3).

143. A "noninterest-bearing transaction account" is defined as a transaction account, such as a corporate checking account, that allows for an unlimited number of deposits and withdrawals at any time. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.4(a).

144. See Press Release, Federal Deposit Insurance Corporation, FDIC Board of Directors Approves TLGP Final Rule (Nov. 21, 2008), available at http://www.fdic.gov/news/news/press/2008/pr08122.html.

145. See Technical Briefing on the Temporary Liquidity Guarantee Program, PM Session (October 14, 2008), available at http://www.fdic.gov/regulations/resources/TLGP/101408_pm.html.

146. See Press Release, Federal Deposit Insurance Corporation, FDIC Board of Directors Approves TLGP Final Rule, Nov. 21, 2008, available at http://www.fdic.gov/news/news/press/2008/pr08122.html.

147. See Temporary Liquidity Guarantee Program, 73 Fed. Reg. 72244, 72257 (Nov. 26, 2008).

148. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.8 (2008).

149. See 12 U.S.C.A. § 1823(c)(4)(G)(ii) (2008).

150. See 12 U.S.C.A. § 1823(c)(4)(G)(ii) (2008).

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151. See Temporary Liquidity Guarantee Program, 73 Fed. Reg. 72244, 72251 (Nov. 26, 2008).

152. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.6(c)(3) (2008).

153. See Press Release, Federal Deposit Insurance Corporation, FDIC Board of Directors Approves TLGP Final Rule (Nov. 21, 2008), available at http://www.fdic.gov/news/news/press/2008/pr08122.html.

154. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.12(b)(1).

155. See Temporary Liquidity Guarantee Program, 12 C.F.R. § 370.12 (b)(2) (2008)

156. See Morrison & Foerster LLP's News Bulletin "Federal Reserve Board Liberalizes Rules for Investments In Banks" at http://www.mofo.com/news/updates/files/14497.html.

157. 12 C.F.R. § 225.144, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf.

158. 12 U.S.C.A. §§ 1841 to 1849.

159. 12 U.S.C.A. § 1841(a)(2)(A) to (C).

160. 12 C.F.R. § 225.143.

161. 12 C.F.R. § 225.144, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf.

162. 12 C.F.R. § 225.144, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf.

163. 12 C.F.R. § 225.144, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf, at 9.

164. 12 C.F.R. § 225.144, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf, at 8.

165. 12 C.F.R. § 225.144, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf, at 10.

166. 12 C.F.R. § 225.144, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf, at 11-12.

167. 12 C.F.R. § 225.144, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf, at 13.

168. 12 C.F.R. § 225.144, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf, at 13.

169. 12 C.F.R. § 225.144, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf, at 13.

170. 12 C.F.R. § 225.144, available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf, at 13.

171. See "Tax Talk" published by Morrison & Foerster LLP, Volume 1, Issue 3.

172. NUBILs are generally losses that are recognized in the five-year period after the ownership change but that are attributable to unrealized prechange declines in asset values. Certain deductions during postchange periods that are attributable to periods before the change date are treated as recognized NUBILs under section 382(h)(6)(B), and therefore limited.

173. Notice 2008-78 states that the IRS and the Treasury intend to issue regulations to implement the rules described in the Notice. Taxpayers may rely on the Notice until further guidance is issued.

174. With respect to a public company, a controlling shareholder is a shareholder that owns at least 5% (directly or indirectly) of any class of stock outstanding and who

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actively participates in the management or operation of the corporation (e.g., a corporate director).

175. A related party generally would include (but would not be limited to), as determined immediately after the capital contribution: (1) an individual or trust owning more than 50% of the stock (by value) of the loss corporation, (2) a corporation that is a member of the same "controlled group" (meaning generally 50% affiliation by vote or value) as the loss corporation, and (3) a partnership or an S corporation if the same persons own a greater than 50% interest in both such partnership or S corporation and the loss corporation. A related party may include certain coordinated groups.

176. The Notice does not define the term "loans"; however, it should be broad enough to include debt interests in securitization vehicles as well as direct interests in residential or commercial mortgages. It does not appear that the Notice would apply to most derivative positions.

177. In order to qualify for the treatment described in Notice 2008-83, the taxpayer must be a bank as defined in section 581 of the Code immediately before and immediately after the ownership change.

178. No effective date is specified in the Notice, so it appears that it may also benefit banks that have already had an ownership change.

179. See Morrison & Foerster LLP's News Bulletin "Notice 2008-83: The IRS Offers Reassurance to Troubled Banks" at http://www.mofo.com/news/updates/files/14544.html.

180. Preexisting NOLs would be subject to the Section 382 Limitation, if sufficient shares to constitute an ownership change were issued.

181. Preexisting NOLs of the target would still be subject to the Section 382 Limitation (assuming that the acquisition results in a greater than 50% shift in the ultimate equity ownership of the target). Section 382 of the Code should displace the consolidated return regulations' limitation on built-in-losses (via the separate return limitation year rules), so that the treatment provided by Notice 2008-83 should apply whether the target bank is merged into the acquiror (or a disregarded entity of the acquiror) or remains in existence as a consolidated subsidiary of the acquiror.

182. Notice 2008-81, 2008-41 I.R.B. 852.

183. Notice 2008-43, 2008-15 I.R.B. 748.

184. Rev. Proc. 2008-63, 2008-42 I.R.B. 946.

185. Rev. Proc. 2008-63, 2008-42 I.R.B. 946.

186. Notice 2008-27, 2008-10 I.R.B. 543.

187. Notice 2008-41, 2008-15 I.R.B. 742.

188. Notice 2008-55, 2008-27 I.R.B. 11.

189. Rev. Proc. 2008-58, 2008-41 I.R.B. 856.

190. Rev. Proc. 2008-58, 2008-41 I.R.B. 856.

191. Rev. Proc. 2008-58, 2008-41 I.R.B. 856.

192. Rev. Proc. 2008-58, 2008-41 I.R.B. 856.

193. I.R.C. § 956.

194. Notice 88-108, 1988-40 I.R.B. 18, 1988-2 C.B. 446.

195. Notice 2008-91, 2008-43 I.R.B. 1001.

196. Notice 2008-91, 2008-43 I.R.B. 1001.

197. SEC Release No. 34-58572, Sept. 17, 2008, is available at http://www.sec.gov/rules/other/2008/34-58572.pdf.

198. SEC Release No. 34-58773, Oct. 17, 2008.

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199. Guidance Regarding Temporary Rule 204T, Sept. 23, 2008, is available at http://www.sec.gov/divisions/marketreg/204tfaq.htm.

200. SE Release No. 34-58775, Oct. 17, 2008.

201. SEC Release No. 34-58774, Oct. 17, 2008.

202. SEC Release No. 34-58591, Sept. 18, 2008.

203. SEC Release No. 34-58785, Oct. 18, 2008.

204. Guidance Regarding the Commission's Emergency Order Concerning Disclosure of Short Selling (Sept. 24, 2008) is available at http://www.sec.gov/divisions/marketreg/shortsaledisclosurefaq.htm.

205. SEC Release No. 34-58591A (Sept. 21, 2008).

206. A copy of the report is available at http://www.sec.gov/news/studies/2008/craexamination070808.pdf.

207. 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.

208. FASB Staff Position FAS 107-a (posted for comment on Dec. 24, 2008).

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

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

211. For a discussion of risk weighting issues, please see Pinedo and Tanenbaum, Lucrative Knockoffs, Global Banking and Policy Review, 2007/2008, at 16.

212. See the Final FDIC Policy Statement at: http://edocket.access.gpo.gov/2008/pdf/E8-17168.pdf.

213. See the Treasury Best Practices at http://www.treas.gov/press/releases/reports/USCoveredBondBestPractices.pdf.

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