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Economic Stabilization Advisory Group, Property | October 10, 2008

Treasury Considers Role for Private Investors in Economic Stabilization Plan and Provides Guidance on Selection of Asset Managers and Financial Agents

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On October 3, 2008, President Bush signed into law the "Emergency Economic Stabilization Act of 2008" (the "Act"). The Act is intended to provide relief for troubled financial institutions in order to improve the functioning of the credit markets and to help homeowners and financial consumers. The Act gives the United States Federal Government the ability to purchase troubled mortgage-related (and potentially other) assets from eligible financial institutions through the "Troubled Assets Relief Program" (the "Program"), thereby taking these instruments off the balance sheets of their present owners. The Federal Government may hold these troubled assets until such time as they can be properly valued and ultimately sold to appropriate investors.*

The Act left open a number of significant questions, including:

- What opportunities, if any, will members of the private sector have to invest in troubled assets through the Program?
- How will asset managers be selected to administer the Program and what eligibility requirements will apply to them?
- How will conflicts of interest faced by asset managers and other contractors engaged by the Treasury in connection with the Program be resolved?

As described below, the answers to these questions are now starting to become clear.

The Role of Private Investors

As expected, private sector investors are looking to capitalize on any investment opportunities the Program may make available. Once the United States Treasury (the "Treasury") has acquired troubled assets pursuant to the Program, the Treasury may either hold such assets until maturity or sell them at a time the Secretary of the Treasury determines the market is ready. Media reports suggest that the Treasury will attempt to quickly resell troubled assets to private sector institutions such as banks, real estate funds and other investors. These private institutions will be seeking a leveraged return on any investment they make and therefore will likely need financing in order to purchase the troubled assets from the Treasury. In the current market, however, such financing is very difficult to find. Lenders that until recently had acted as financing sources for debt investors have pulled back from the market, and less traditional forms of financing, such as "repo" credit lines, are not available.

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To facilitate purchases of troubled assets by private investors from the Treasury, as well as to ensure a better return for U.S. taxpayers, the Treasury is considering providing "seller financing". In one such structure, the Treasury would sell troubled assets to joint venture vehicles partly owned by private investors and partly owned by the government. This would allow private institutions to purchase assets with a lower equity investment than an outright purchase would have required. If properly structured, the public/private joint ventures established to participate in these transactions can offer the target returns private investors are seeking. Further, because the Treasury will continue to have an ownership interest in the troubled assets that are sold, U.S. taxpayers will benefit from any appreciation on such assets. In another possible structure the Treasury would act solely as a lender. In lieu of retaining an ownership interest in the underlying troubled assets, the Treasury would provide financing with a shared appreciation feature whereby the Treasury, as lender, would receive additional payments tied to the achievement of certain levels of appreciation on the assets.

The Process for Selecting Asset Managers

On October 6, 2008, the Treasury announced procedures for the selection of asset managers to manage assets purchased by the Treasury through the Program. Two categories of asset managers will be selected:

- "Securities Asset Managers" will manage Prime, Alt-A and Subprime residential mortgage backed securities (MBS), commercial MBS and MBS collateralized debt obligations and other securities, and
- "Whole Loan Asset Managers" will manage residential first mortgage loans, home equity loans, second liens, commercial mortgage loans and other types of mortgage loans.

The asset managers selected will be deemed "financial agents" of the United States and, as such, will have a fiduciary agent-principal relationship with the Treasury and will be required to execute a Financial Agency Agreement with the Treasury.

The selection process will commence via public solicitation notices issued by the Treasury – one for each of the Securities Asset Managers and the Whole Loan Asset Managers categories. Such notices will describe the services required by the Treasury, include factors to be considered in the selection of asset managers, include minimum qualifications and eligibility requirements, and provide the rules for the submission of responses. Upon the Treasury's review of the responses, certain applicants will be chosen to continue to the second phase of the selection process during which applicants will provide additional information with respect to their ability and eligibility to serve as an asset manager. During the second and later phases of the process, confidentiality agreements may be introduced but any such confidentiality requirements must remain consistent with the transparency and public disclosure provisions of the Act. The third and final phase of the process will entail face-to-face discussions and interviews conducted by the Treasury to further assess the applicant's capabilities.

The selection process will be conducted by personnel from the Offices of the Fiscal Assistant Secretary and the Assistant Secretary for Financial Markets, and possibly personnel from the Offices of Domestic Finance and Economic Policy – all units of the Treasury Department. Recommendations will then be made to the head of the Office of Financial Stability (Neel Kashkari was named as the interim head of the Office of Financial Stability on October 6, 2008) who will make the final decisions.

The Treasury plans to select multiple asset managers and sub-managers and will not select all asset managers at the same time. Separate notices will be issued by the Treasury specifically directed at smaller and minority- and women-owned institutions. Those institutions may also qualify to act as "sub-managers" under the Program. The procedures issued by the Treasury do not discuss compensation for the asset managers and sub-managers that are selected other than to state that applicants will not be reimbursed for any costs or expenses incurred during the selection process.

Treasury Issues Solicitations for Financial Agents

Following its announcement of the procedures for the selection of asset managers to administer the Program, the Treasury posted three solicitations for financial agents. The solicitations are for asset managers to perform the following services:

- Custodian, Accounting, Auction Management, and Other Infrastructure Services,
- Securities Asset Management Services, and
- Whole Loan Asset Management Services.

Applicants for these positions must submit their responses by 5:00 p.m. EST on October 8, 2008. The Treasury expects to confirm its selections during the week of October 13, 2008. Each solicitation notice sets forth the requirements of the position, eligibility requirements and qualifications, the specific information the response must include as well as the specific format of the response and further information about the selection process and related deadlines.

Each of the solicitations sets forth the organizational requirements for a financial institution to be eligible to serve in the applicable capacity. In each case, the applicant must be a "financial institution" as defined in the Act, must not be on the Federal Debarment or Suspension list, must not be delinquent on any debts owed to the government, must not be subject to any pending or current enforcement actions or regulatory investigations, and must not be on probationary status with the Treasury or any other Federal Agency.

Custodian, Accounting, Auction Management, and Other Infrastructure Services

This solicitation notice seeks a single financial institution to provide custodian, accounting, auction management, and other infrastructure services. The named financial institution will provide infrastructure services for the entire portfolio of troubled assets purchased by the Treasury – both mortgage-related securities and whole mortgage loans. Such services will include providing custody accounts and cash accounts, receiving, holding and tracking cash and assets, managing credits and debits to the accounts, providing asset tagging, serving as auction manager for reverse auctions, designing, implementing and testing auction formats, conducting auctions, providing accounting disclosure for the portfolio, producing management and operational reports, assisting with reporting to oversight entities, providing cash management services, providing asset pricing and valuations for assets to be purchased, confirming all trades and settlements, maintaining records of all trades and settlements, enforcing internal controls, warehousing title and legal documents and monitoring servicer compliance with the Act's servicing and loss mitigation guidelines.

To be eligible, applicants must have at least $500 billion in domestic assets under custody, covenant to disclose all potential conflicts of interest and mitigate to the extent possible and to the Treasury's satisfaction any existing conflicts of interest, and be willing to work with financial institutions, federal reserve banks, federal agencies, government entities and other organizations designated by the Treasury.

Securities Asset Management Services

This solicitation notice seeks multiple asset managers and sub-managers to manage various classes of securities, obligations and other instruments related to residential and commercial mortgage loans. Specifically, the portfolio of securities at issue will include Prime, Alt-A and Subprime residential mortgage backed securities (MBS), commercial MBS and MBS collateralized debt obligations and other types of securities determined by the Secretary of the Treasury to promote market stability. The notice notes that assets are expected to be purchased through reverse auctions and other market mechanisms. The

portfolio will hold the purchased assets until market conditions have stabilized, which time periods could vary from months to years. The financial institutions selected will provide services including management of the portfolio, execution of trades, measuring and reporting on standards for the best trade execution, confirming all trades, maintaining records of trades and settlements, coordinating with the custodian selected by the Treasury, reporting on the performance of the portfolio, forecasting estimated payments, providing risk management services, and responding to all inquiries from the Treasury regarding trading and market conditions.

To be eligible, applicants must be registered investment advisors under the Investment Advisors Act of 1940, must have been continuously engaged in managing these types of assets as a principal business for the last five years, must have received an unqualified auditor's opinion for the last five years, must currently manage at least $100 billion in dollar-denominated fixed income assets, must covenant to disclose all potential conflicts of interest and mitigate to the extent possible and to the Treasury's satisfaction any existing conflicts of interest, must be willing to work with financial institutions, federal reserve banks, federal agencies, government entities and other organizations designated by the Treasury and willing to partner with other financial institutions selected as sub-managers and with subcontractors. In addition, the primary portfolio manager selected must have at least ten years of experience managing fixed income assets.

Whole Loan Asset Management Services

This solicitation notice seeks one or more asset managers to manage a portfolio of dollar-denominated mortgage whole loans. The portfolio will include residential first mortgages, home equity loans, second liens, commercial mortgage loans and other types of mortgage loans. The financial institutions selected will provide services including pre- and post-transactional diligence, transactional infrastructure services (such as the processing of data files and the execution of acquisition transactions), valuation of loans and loan portfolios, management and control of the loans and loan portfolios, cooperation with the central loan trustee and custodian on execution and settlement, cash management, reporting, warehousing of title and legal documents and monitoring servicer compliance, loss and foreclosure mitigation, managing liquidation of assets and property, maintaining records and books, and reporting on loan performance.

To be eligible, applicants must have been continuously engaged for the last five years in managing whole loan assets as a principal business, must currently manage at least $25 billion in mortgage loans, or provide clear evidence that the applicant can manage a portfolio of this size, must covenant to disclose all potential conflicts of interest and mitigate to the extent possible and to the Treasury's satisfaction any existing conflicts of interest, must be willing and able to partner with the appointed central custodian and trustee for the Treasury, must be willing and able to coordinate with any sub-managers appointed for the portfolio and to work with small and minority- and women-owned businesses hired as contractors for the portfolio, and must be able and willing to work with financial institutions, federal reserve banks, federal agencies, government entities and other organizations designated by the Treasury.

Interim Conflict of Interest Guidelines

On October 6, 2008, the Treasury released Interim Guidelines for Conflicts of Interest (the "COI Guidelines"). The guidelines summarize the process by which conflicts of interest (COIs) among contractors hired by the Treasury to perform various services under the Act will be reviewed and addressed. The interim guidelines are intended to remain in effect until permanent guidelines are finalized. So-called "impaired

objectivity" COIs are possible under the Act whereby a "contractor's judgment or objectivity may be impaired due to the fact that the substance of the contractor's performance has the potential to affect other interests of the contractor". Additionally, access to sensitive and non-public information during the contractor's performance may also cause COIs. Further, employees of a contractor may face personal COIs due to the fact that such individuals are not subject to the same ethical restrictions as government employees.

When faced with the above-mentioned COIs, the Treasury will follow these guidelines:

- The Treasury may obtain non-disclosure agreements and COI agreements;
- Solicitations should alert applicants that they must disclose any actual or possible COIs. If actual COIs are identified, a mitigation plan must be provided with the applicant's submission. The applicant may also be asked to identify potential personal COIs of its employees;
- Solicitations should include criteria for Treasury assessment of the effectiveness of any proposed COI mitigation plan and should identify minimum requirements for COI mitigation plans;
- Contractors who will owe a fiduciary duty to the Treasury shall be told so in the solicitation;
- Solicitations should include non-disclosure provisions and possibly additional provisions for the non-disclosure and/or COI agreements from subcontractors or employees;
- Solicitations should state that the Treasury will oversee and enforce proposed COI mitigation plans;
- The Treasury Senior Procurement Executive will review and approve all COI provisions in solicitations;
- Solicitations should require that applicants submit COI mitigation plans with their initial submissions;
- COI mitigation plans will be reviewed by Treasury evaluators, legal counsel and other personnel and mitigation plans may be negotiated;
- If a COI mitigation plan is determined to be ineffective or unacceptable, the applicant will not be eligible unless the COI is specifically waived and such waiver is coordinated with the Treasury Senior Procurement Executive;
- Upon award of a contract, any COI mitigation plans will be included in the contract so as to be a contractually binding obligation.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or the following:

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