

## Impact of the Emergency Economic Stabilization Act of 2008 on Investment Management Firms

October 4, 2008

The Emergency Economic Stabilization Act of 2008 (Act) will directly impact investment management firms of all kinds, with the greatest impact on those firms managing accounts holding “troubled assets” eligible for purchase by the U.S. Treasury and the few firms chosen to manage the Treasury’s portfolios of troubled assets. Although the Act runs 451 pages, details on key aspects of the government’s troubled asset recovery program that affect the investment management industry remain to be spelled out by the Treasury. Despite this, investment management firms should start considering how various aspects of the Act may affect their business activities. We discuss these subjects below.

### Troubled Asset Purchase Program

The most dramatic provisions of the Act authorize the Treasury to purchase troubled assets from financial institutions. Specifically, the Act permits the Treasury to purchase troubled assets from any financial institution on terms determined by the Treasury.<sup>1</sup>

- The Act defines “troubled assets” as “(A) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary [of the Treasury] determines promotes financial market stability; and (B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.”
- “Financial institutions” are defined broadly—but not exclusively—as “*any institution*, including, but not limited to, any bank, savings association, credit union, security broker or dealer, or insurance company, established and regulated under the laws of the United States or any State, territory, or possession of the United States, the District of Columbia, Commonwealth of Puerto Rico, Commonwealth of Northern Mariana Islands, Guam, American Samoa, or the United States Virgin Islands, and having significant operations in

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<sup>1</sup> Although the Treasury’s authority to purchase troubled assets under the Act expires December 31, 2009, its ability to hold or to purchase or fund the purchase of troubled assets under a commitment entered into before that date is not subject to the sunset provision.

the United States, but excluding any central bank of, or institution owned by, a foreign government.” (Emphasis added.)

Accordingly, hedge funds, mutual funds, and other institutional accounts may be eligible sellers of troubled assets to the Treasury. In this regard, although not specifically identified in the definition of “financial institution,” other sections of the Act suggest that corporate pension plans and governmental pension plans may also be considered financial institutions covered by the Act even though they are not specifically identified as “financial institutions.” Ineligible sellers may sell assets to eligible financial institutions (but, as noted below, sales to the Treasury may not be for a higher price than the price paid for the troubled asset).

The Act gives the Treasury flexibility in purchasing troubled assets through a variety of means, including directly and through market mechanisms such as auctions and “reverse auctions,” subject to the mandate that the Treasury make purchases at the “lowest price that the Secretary determines to be consistent with the purposes” of the Act.

Although the Act gives the Treasury latitude to make direct purchases where appropriate, the Act imposes two notable requirements on the Treasury:

- First, the Treasury is required to implement measures to ensure the prices paid for troubled assets are reasonable and reflect the underlying value of the assets.
- Second, when considering whether to purchase directly from particular financial institutions, the Treasury is required to consider, among other considerations, the long-term viability of a financial institution, the need to ensure stability for state, county, and municipal instrumentalities that have suffered losses in the current market turmoil, and the need to protect the retirement security of Americans by purchasing troubled assets from pension plans.

The program will be administered through the Treasury’s newly-created Office of Financial Stability. To implement the program, the Treasury is required to publish program guidelines describing (1) the mechanisms for purchasing troubled assets; (2) methods for pricing and valuing troubled assets; (3) procedures for selecting asset managers; and (4) criteria for identifying troubled assets for purchase. The Act also requires that the Treasury issue regulations or guidelines to address conflicts of interest, including those arising from the selection of asset managers and the purchase or management of troubled assets.

On the issue of valuing troubled assets, the Act requires that the Treasury take steps to prevent unjust enrichment, including, as noted above, by preventing the sale of a troubled asset at a price exceeding what the seller paid to purchase the asset, subject to exceptions for troubled assets acquired in a merger, acquisition or by purchase from a financial institution in conservatorship, receivership or bankruptcy.

We expect that the Treasury will provide for transparency of the pricing of offers and transactions for troubled assets. The Act mandates that the Treasury make available publicly electronic reports of the amounts and prices of troubled assets the Treasury acquires under the program within two business days of each transaction. (The program announced by the Treasury on September 7, 2008 to purchase GSE mortgage-backed securities contemplated only monthly reports.)<sup>2</sup>

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<sup>2</sup> See Treasury, Fact Sheet: GSE Mortgage Backed Securities Purchase Program (September 7, 2008).

Investment managers will need to assess how this information may affect any fair valuations they make for the same or equivalent assets held in their managed portfolios, especially since current transaction information may not otherwise be available now for many of the assets. In this regard, although the SEC and FASB provided interpretive guidance on September 30 that was intended to provide greater flexibility to valuations under FASB Statement No.157,<sup>3</sup> offers or transactions in distressed assets will affect the considerations bearing on whether firms rely on unobservable inputs (Level 3) in their valuations for the particular troubled assets. These considerations will be complicated for troubled assets sold with warrants (discussed below) because the resulting transaction price may reflect an implied cost of the warrants and, as such, may not be a pure price for the troubled asset.

Accordingly, investment managers considering whether they are in a position to sell troubled assets of eligible clients to the Treasury will want to consider a variety of issues, including:

- Whether the sale of troubled assets is at a price that comports with the investment manager's duty of care;
- Whether a sale of assets on a direct basis to the Treasury or in an auction or reverse auction is permitted under the client's restrictions or governing documents, and whether the investment manager has the authority to act on behalf of the client in such a sale;
- Whether the practice of selling client troubled assets would require additional prospectus, SAI, or other disclosure;
- As noted, how information on sales of troubled assets to the Treasury may affect any fair valuations of portfolio assets; and
- The need for specific compliance procedures governing their participation in the program.

### **Executive Compensation & Warrants**

It is currently unclear whether the Act's widely publicized provisions that limit executive compensation at a financial institution selling troubled assets to the Treasury would apply to mutual funds and other managed accounts (i.e., nonoperating companies). Even if technically applicable, it seems likely that the provisions would be far less burdensome to participants such as mutual funds, as they typically have only officers who are uncompensated. These limits apply only where the Treasury receives a "meaningful equity or debt position" in a financial institution as a result of a direct purchase of troubled assets and auctioned purchases of troubled assets exceeding \$300 million (in the aggregate, including direct purchases).

In addition to limits on executive compensation, it is also unclear whether the Act's requirements that a financial institution selling troubled assets to the Treasury issue warrants to the Treasury would apply to mutual funds and other managed accounts. The Act gives the Secretary the authority to establish limited exceptions, including a *de minimis* exception for any financial institution selling not more than \$100 million in troubled assets to the Treasury.

### **Opportunities to Manage Troubled Asset Portfolios**

For some money managers, the Act will provide compelling opportunities to manage troubled assets acquired by the Treasury. In this regard, the Act dramatically expands the program announced by the Treasury on September 7, 2008 to hire financial institutions to act as

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<sup>3</sup> SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (September 30, 2008).

“financial agents” of the government in managing portfolios of troubled assets. The initial program announced by the Treasury on September 7 was then limited to Treasury portfolios containing GSE mortgage-backed securities.

Specifically, the Act authorizes the Treasury to designate financial institutions as financial agents of the government. The proposed legislation does not identify any particular eligibility criteria for participating asset managers; however, we note that the concept of a “financial agent” under current regulations appears limited to financial institutions with insured assets.<sup>4</sup> The Act refers to “asset managers” almost interchangeably with financial agents, and so it is unclear whether asset managers chosen as financial agents need to be depository institutions as is required under current Treasury regulations.

As noted above, to implement this aspect of the program, the Treasury is required to publish program guidelines describing procedures for selecting asset managers. The Act also requires that the Treasury issue regulations or guidelines to address conflicts of interest, including those arising from the selection of asset managers and the purchase or management of troubled assets. Although the Act permits the Treasury to waive specific provisions of the Federal Acquisition Regulation (applicable to bidding for government contracts) in certain circumstances and subject to Congressional reporting, the Treasury is required to establish standards and procedures to promote the use of women- and minority-owned businesses in the selection process.

Investment management firms acting as asset managers or financial agents may face a variety of issues when managing portfolios of troubled assets for the Treasury—the magnitude of which will turn on the size of the portfolios they are called on to manage and the precise directives they are called on to follow. These issues include conflicts among clients, possible insider trading and manipulation concerns and the more mundane (but burdensome) rules by which government contractors are bound. There is a lack of developed law or statutory and rule provisions dealing with the use of financial agents to manage investment portfolios, and this creates a certain measure of uncertainty concerning the exact role and status of a financial agent,<sup>5</sup> and the privileges and defenses it may enjoy when acting as agent of the government.

### **Insurance for Troubled Assets**

If the Treasury proceeds with a program to purchase troubled assets, the Treasury is also required to establish a program to guarantee troubled assets originated or issued before March 14, 2008, subject to such guarantees and premiums as the Treasury determines (including by category or class of the troubled assets). Under the guaranty program, a financial institution could acquire insurance covering the troubled asset covering the timely payment of principal

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<sup>4</sup> See, e.g., 31 CFR 202.2 (defining “depositories and financial agents” of the government as (i) financial institutions insured by the FDIC; (ii) credit unions insured by the National Credit Union Administration; and (iii) banks, savings banks, savings and loan, building and loan, and homestead associations, credit unions created under the laws of any State, the deposits or accounts of which are insured by a State or agency thereof or by a corporation chartered by a State for the sole purpose of insuring deposits or accounts of such financial institutions, United States branches of foreign banking corporations authorized by the State in which they are located to transact commercial banking business, and Federal branches of foreign banking corporations, the establishment of which has been approved by the Comptroller of the Currency).

<sup>5</sup> See *United States v. Citizens & Southern National Bank*, 889 F.2d 1067 (Fed. Cir. 1989) (describing the appointment of a financial agent as a relationship in which the “government as principal and in its sovereign capacity delegates to its financial agents some of the sovereign functions that the government itself would otherwise perform”).

and interest on the troubled asset in an amount not exceeding 100% of such payments. The operation and terms for the guarantee program remain to be established by the Treasury but may provide a means for investment managers or their financial institution clients to establish partial principal protection for qualifying troubled assets. For example, if implemented, such an insurance program likely would be far more desirable for a money market mutual fund than selling troubled assets to the Treasury at a price less than amortized cost. This program also may raise a host of questions similar to those raised under the Treasury's Temporary Guarantee Program for Money Market Funds, including:

- Who (the investment manager or the client) should make the decision on coverage and who should bear the cost of the premiums (and for mutual funds with fee caps, whether the premiums are an extraordinary expense not covered by the fee cap);
- Disclosures about the guarantees; and
- If a guarantee is triggered, how that would affect performance reporting involving the mutual fund or account.

### **Co-Investment Opportunities**

Although most attention has been focused on the Treasury's authorization to purchase troubled assets, the Act also requires that the Treasury "encourage the private sector to participate in purchases of troubled assets, and to invest in financial institutions." Accordingly, the Act contemplates mechanisms for auction participation by outside purchasers as well as sellers.

If you have any questions concerning these important legal developments or would like copies of any of the documents mentioned, please contact any of the following Morgan Lewis attorneys:

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