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CLIENT MEMORANDUM

Emergency Economic Stabilization Act of 2008

October 3, 2008

BACKGROUND

Following the dramatic financial events of the week of September 14, U.S. Treasury Secretary Henry Paulson, Federal Reserve Board Chairman Ben Bernanke and SEC Chairman Christopher Cox determined that a comprehensive approach to relieving the stresses on financial institutions and markets was required.

On September 20, 2008, the Treasury Department proposed draft legislation to allow the Treasury Department to purchase up to $700 billion in troubled mortgage-related assets. Sen. Christopher Dodd and Rep. Barney Frank drafted alternative bills that would impose more stringent oversight on the Treasury Department's implementation of the rescue plan and require financial institutions participating in the plan to agree to certain concessions.

On September 24, 2008, Rep. Frank announced that the Democratic leadership of both the Senate and the House of Representatives had agreed to a general set of principles to implement the rescue. On September 25, 2008, those principles were presented in a meeting at the White House including President Bush, Sec. Paulson and congressional leaders from both parties. It was generally expected that all participants in the meeting would agree to the principles presented by Rep. Frank and move quickly toward drafting final legislation.

On Friday, September 26, 2008, Republican members of the House of Representatives produced an alternative statement of principles for a rescue plan, several provisions of which were subsequently incorporated into the final legislation.

On Sunday, September 28, 2008, a new version of the rescue plan legislation, now referred to as the Emergency Economic Stabilization Act of 2008, was released with the support of the Secretary of the Treasury and Congressional leaders of both parties. Following the three-page draft produced by the Secretary of the Treasury and the 44- and 42-page drafts produced by Sen. Dodd and Rep. Frank, respectively, the Emergency Economic

Stabilization Act of 2008 as presented to the House of Representatives had expanded to 110 pages.

On Monday, September 29, 2008, the House of Representatives rejected the Emergency Economic Stabilization Act of 2008 by a vote of 205 to 228.

On Wednesday, October 1, 2008, the Emergency Economic Stabilization Act of 2008 was introduced in the Senate. Because a bill involving raising revenue is constitutionally required to originate in the House of Representatives, the Senate introduced the act as an amendment to the Paul Wellstone and Pete Domenici Mental Health Parity and Addiction Equity Act of 2008 and also included the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, the Energy Improvement and Extension Act of 2008, and the Heartland Disaster Tax Relief Act of 2008. The Emergency Economic Stabilization Act of 2008 portion of the Senate bill is largely identical to the bill previously presented to the House of Representatives, but includes a temporary increase in the limit on FDIC deposit insurance to $250,000 and includes minor revisions to the provisions concerning executive compensation and the purchase of warrants from participating financial institutions.

On October 1, 2008, the Senate voted to include the Emergency Economic Stabilization Act of 2008 in the bill and then passed the bill, each by a vote of 74 to 25.

On Friday, October 3, 2008, the House of Representatives passed the bill by a vote of 263 to 171, and the President signed the bill into law.

The elements of the Emergency Economic Stabilization Act of 2008 are:

AUTHORITY OF THE SECRETARY OF THE TREASURY

- The Secretary of the Treasury is authorized to purchase from financial institutions both residential and commercial mortgages and any other related instruments originated or issued on or before March 18, 2008. The Secretary may also purchase any other financial instrument after consultation with the Chairman of the Federal Reserve and notification to Congress.
- Initially $250 billion will be available to Secretary of the Treasury for purchases of assets under the program. The President may request that an additional $100 billion be made available at any time. The President may then request that the final $350 billion be made available effective in 15 days. In that 15-day period, Congress may enact a joint resolution to deny the additional funds.
- The scope of financial institutions allowed to participate in the program is broad. Eligible financial institutions include any bank, savings association, credit union, security broker or dealer or insurance company. Financial institutions established or regulated in the United States and non-U.S. financial institutions with significant operations in the United States, other than central banks or entities owned by a foreign government, may participate. Statements by Congressional leaders suggest that pension funds and licensed U.S. branches and agencies of non-U.S. financial institutions are included in this definition.
- If the Secretary of the Treasury establishes an asset purchase program, the Secretary must also establish an insurance program available for the same assets eligible for purchase. The Secretary will set premiums at a level such that the premiums will be sufficient to satisfy all anticipated claims, which will be paid by financial institutions participating in the insurance program. The amount of funds available under the asset purchase program will be reduced to the extent that the insurance obligations of the Treasury exceed the collected premiums.
- The Secretary of the Treasury is directed to manage any purchased residential mortgages or related securities to minimize foreclosures and evictions. Other federal agencies that hold mortgages or related securities are similarly directed to minimize foreclosures and evictions.
- The Secretary of the Treasury may use loan guarantees and credit enhancements to facilitate loan

modifications to prevent avoidable foreclosures.

- The Secretary of the Treasury must publish guidelines for the program, including procedures for selecting asset managers, identifying assets, valuing assets and purchasing assets, by the earlier of the second business day following the first asset purchase under the program or 45 days following the enactment of the program. It is generally expected that the Secretary will rely heavily on private firms.
- The Secretary of the Treasury must establish an Office of Financial Stability through which the program will be implemented.
- The Secretary of the Treasury is permitted to bypass procedures for private contracting generally applicable to the federal government, but must develop standards to promote the inclusion of women, minorities and women- and minority-owned businesses. The Secretary must consider selecting the FDIC as asset manager of residential mortgages and residential mortgage-backed securities.
- The Secretary of the Treasury must issue regulations to manage or prohibit any conflicts of interest in connection with the program.
- The Secretary of the Treasury is directed to coordinate with foreign financial authorities and central banks to promote the establishment of similar programs.
- The Secretary of the Treasury is directed to encourage private entities to invest in troubled assets and financial institutions.
- The Secretary of the Treasury is directed to purchase assets using market mechanisms such as auctions and reverse auctions where possible, but there are no restrictions on the sort of market mechanisms that the Secretary may employ, and the Secretary has the option to purchase assets without an auction process when appropriate.
- The program will terminate on December 31, 2009, but may be extended at the request of the Secretary of the Treasury up to two years following the enactment of the program.

CONSEQUENCES TO PARTICIPATING FINANCIAL INSTITUTIONS

- If the Secretary of the Treasury purchases any assets from a financial institution where no bidding process or market prices are available, the Treasury must receive a "meaningful equity or debt position" in the seller. It should be noted that Sec. Paulson opposed the inclusion of any requirement to purchase equity in participating financial institutions.
- Financial institutions that are public companies must offer warrants to purchase non-voting common stock, preferred stock or common stock with voting rights, which voting rights the Secretary of the Treasury would agree not to exercise. Warrants must be convertible into senior debt or provide other protections in the event that the financial institution is no longer a public company. Other financial institutions must provide senior debt or warrants for common or preferred stock. The warrants or debt must be structured to provide for participation by the Treasury in future gains by financial institutions and protect the Treasury against losses. The Secretary may exclude de minimis purchases from these requirements if total asset purchases from a financial institution are not more than $100 million. At the time such warrants are provided, financial institutions must guarantee that sufficient shares are available for issuance. If the financial institution does not have sufficient authorized shares, including preferred shares that may carry dividend rights equal to a multiple number of common shares, then the Secretary may, to the extent necessary, accept a senior debt note in an amount, and on such terms as will compensate the Treasury with equivalent value, in the event that a sufficient shareholder vote to authorize the necessary additional shares cannot be obtained. This provision applies regardless of whether a bidding process is used.
- Financial institutions participating in the program will become subject to certain executive compensation restrictions under the following circumstances. A

financial institution that sells any assets under the program where no bidding process or market prices are available will be subject to the following restrictions:

- ◊ Incentive compensation paid to senior executives must include a claw-back provision for compensation based on metrics that are later proven to be inaccurate. This provision does not expire when the Treasury ceases to hold an equity or debt position in the financial institution. Senior executive officers means officers whose compensation is required to be disclosed (or would be required to be disclosed if the financial institution were a public company) under the Securities Exchange Act of 1934 and regulations issued thereunder.
- ◊ Executive compensation for senior executive officers must not create incentives to "take unnecessary and excessive risks that threaten the value of the financial institution" for so long as the Treasury holds an equity or debt position in the financial institution.
- ◊ Senior executive officers may not receive any "golden parachute payment" for so long as the Treasury holds an equity or debt position in the financial institution.
- ◊ The Secretary of the Treasury may impose additional executive compensation or corporate governance restrictions.

- Financial institutions that receive proceeds of $300 million or more from sales of assets to the Treasury will be subject to the following restrictions:
  - ◊ Such financial institutions are prohibited from entering any new employment agreement with any senior executive officer that provides for a golden parachute in the event of involuntary termination, bankruptcy filing, insolvency or receivership. The Secretary of the Treasury must issue guidance to implement this provision within two months after the enactment of the program. The provision will not take effect until such guidance is issued. The restriction will end when the program is terminated.
  - ◊ Subsection (m) of section 162 of the Internal Revenue Code of 1986 is amended to reduce the limit for an employer's deduction of executive compensation expenses from $1 million to $500,000. In addition, the existing exceptions under subsection (m) for commissions, other performance-based compensation and compensation under agreements in effect on February 17, 1993 are unavailable. This provision applies only to financial institutions that sell at least $300 million using an auction process.
  - ◊ Section 280G of the Internal Revenue Code of 1986 is amended to further restrict the circumstances under which an employer may deduct golden parachute payments. Golden parachute payments made to senior executives in the event of involuntary termination or any bankruptcy, liquidation or receivership will not be deductible expenses of the employer and the employee will be subject to an additional 20% tax. This provision applies only to financial institutions that sell at least $300 million using an auction process.
- The Secretary of the Treasury is directed to avoid unjustly enriching financial institutions participating in the program. Among other things, the Secretary is directed not to purchase assets at a higher price than that paid by the financial institution unless the assets were acquired in a merger or acquisition or purchased from an entity in conservatorship, receivership or bankruptcy.

FDIC INSURANCE

- The limit on FDIC-insured deposit accounts is increased from $100,000 to $250,000, which will take effect immediately when the plan is enacted and expire on December 31, 2009. The FDIC is not permitted to consider this increase in setting assessments for insured institutions. The deposit insurance limit for credit union deposits insured by the Credit Union Administration Board is similarly increased. The FDIC and the Credit Union Administration Board may borrow from the Treasury as needed to satisfy any such insurance obligations.

MARK-TO-MARKET ACCOUNTING

- The Securities and Exchange Commission is given the authority to suspend mark-to-market accounting. The Securities and Exchange Commission is directed to conduct a study on mark-to-market accounting in consultation with the Federal Reserve and the Secretary of the Treasury. The report must be prepared within 90 days following the enactment of the program. On September 30, 2008, the Securities and Exchange Commission released an interpretation of FASB Statement No. 157, Fair Value Measurements, which clarifies the application of mark-to-market accounting.

OTHER REPORTS AND FUTURE REGULATORY CHANGES

- The Secretary of the Treasury is directed to prepare a report analyzing the effectiveness of current regulation of the financial markets by April 30, 2009. The report will include an analysis of over-the-counter swaps and government-sponsored enterprises.
- Five years following the enactment of the program, the Director of the Office of Management and Budget, in consultation with the Director of the Congressional Budget Office, will determine whether the Treasury has incurred a loss under the plan. If so, the President is directed to submit a legislative proposal to recoup any shortfall from the financial industry. Based on statements from Congressional leaders, it is expected that this proposal would involve an excise tax on transfers of stock or transfers of other securities.
- The Comptroller General is directed to undertake a study to determine the extent to which leverage and sudden deleveraging of financial institutions contributed to the current financial crisis. The study will include an analysis of the authority of the Federal Reserve to limit leverage and recommendations for regulatory change. The study is to be completed by June 1, 2009.

OVERSIGHT

- The Secretary of the Treasury is directed to consult with the Federal Reserve, the FDIC, the Comptroller of the Currency, the Director of the Office of Thrift Supervision and the Secretary of Housing and Urban Development.
- A Financial Stability Oversight Board is established to oversee the implementation of the program. The members will be the Chairman of the Federal Reserve, the Secretary of the Treasury, the Director of the Federal Home Finance Agency, the Chairman of the Securities and Exchange Commission and the Secretary of Housing and Urban Development.
- The program will also be audited by the Comptroller General and overseen by a new Office of the Special Inspector General for the Troubled Asset Relief Program and a new Congressional Oversight Panel.
- Actions by the Secretary of the Treasury under the program will be subject to judicial review, but no injunction or other form of equitable relief will be available with respect to the Secretary's purchase, sale or management of assets. Temporary restraining orders, preliminary injunctions and permanent injunctions will be available.

OTHER PROVISIONS

- The Federal Deposit Insurance Act is amended to prohibit misrepresentations suggesting that uninsured deposits are insured by the FDIC.
- Any standstill, confidentiality or other agreement that affects, restricts or limits the ability of any person to acquire all or part of any insured depositary institution in connection with any transaction in

which the FDIC exercises its authority under Sections 11 or 13 of the Federal Deposit Insurance Act and intervenes in a troubled depositary institution is unenforceable.

- The provision of the Financial Services Regulatory Relief Act of 2006 authorizing the Federal Reserve to pay interest on reserves, which had been scheduled to take effect on October 1, 2011, will now take effect on October 1, 2008.
- Any funds used for the temporary guarantee of money market mutual funds by the Exchange Stabilization Fund will be reimbursed using funds authorized under the plan.
- Certain financial institutions that held Fannie Mae and Freddie Mac preferred stock will recognize any gain or loss from the sale of such preferred stock as ordinary gain or loss.
- The temporary tax provision allowing homeowners to avoid recognition of income from the discharge of residential mortgage indebtedness is extended from January 1, 2010 to January 1, 2013.
- The U.S. debt limit will be increased from $10.615 trillion to $11.315 trillion.

PROVISIONS NOT IN THE FINAL LEGISLATION

- The final legislation does not include an amendment to bankruptcy law allowing bankruptcy judges to order modifications to home mortgages.
- The draft proposed by Rep. Frank had included a provision requiring participating financial institutions to adopt specific corporate governance reforms including allowing shareholders holding at least 3% of the voting shares to nominate directors and allowing shareholders a non-binding vote on executive compensation. That provision is not included in the final legislation.
- The proposal introduced by the Republican leadership of the House of Representatives on September 26, 2008 included an appeal to reduce regulatory barriers obstructing private investment in financial institutions. This may have been a proposal to relax bank holding company regulations to facilitate investments in bank holding companies by private equity firms. No such proposal is included in the final legislation.
- All proceeds from the sale of assets by the Treasury will be paid to the general fund of the Treasury for the purpose of reducing public debt. No proceeds will be directed toward affordable housing programs.

This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners can be obtained from our website, www.simpsonthacher.com.

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