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## Investment Opportunity in Legacy Securities Program of Public-Private Investment Program

This summary of the investment opportunity in the Legacy Securities Program of the Public-Private Investment Program ("PPIP") is designed to inform *investors*. The first closings are expected to occur in early October 2009, and additional closings are legally permitted to occur up to six months thereafter (*i.e.*, April 2010).

### PART I: BACKGROUND

The PPIP's Legacy Securities Program was originally proposed on March 23, 2009 to "unfreeze" the market in Commercial Mortgage Backed Securities ("CMBS") and in non-agency Residential Mortgage Backed Securities (RMBS). The proposal was to form leveraged funds with "public" (meaning U.S. Treasury) and "private" (meaning everyone else, including public pension funds) participation; these public-private partnerships would purchase qualifying CMBS and RMBS securities. Non-U.S. investors could invest on equal footing with U.S.-based private investors; however, a 9.9% equity ownership limit applies to all investors.

On July 8, 2009 nine primary asset managers were selected to operate PPIP Funds ("PPIFs"); these asset managers had partnered with 10 small-, veteran-, minority-, and women-owned businesses that would assist with asset management, capital raising, broker-dealer, investment sourcing, research, advisory, cash management and fund administration services.

The PPIFs will be structured in a manner that is very similar to private equity funds that have a large "sponsor" investor – with the Treasury as the "sponsor." The legal documents for the PPIF program were prepared by a New York law firm that represents many large private equity funds. Accordingly, a private equity-style legal review of this investment is appropriate.

*Minimum* capitalization for a PPIF would be:

| | |
|---|---|
| Private Capital: | $500 million |
| Matching Treasury Capital: | $500 million |
| Treasury Loan (with warrants): | either $500 million or $1 billion (at PPIF's election) |
| Additional Leverage Permitted: | (private debt and/or TALF, but only if Treasury Loan is the smaller of the two options) |
| Fund Sponsor Capital: | $20 million+ |
| TOTAL: | $1.52 billion to $2.02 billion++ |

Private capital and matching Treasury capital are *pari passu* on repayment and allocation of profits, but they would **not** invest on the same terms in other respects (*e.g.*, voting, fees).

A nonbinding, unsigned, detailed term sheet (UST Term Sheet) of the Matching Treasury Capital and Treasury Loan is publicly available; the final terms for these Treasury investments are still being negotiated between the Treasury and the PPIFs, using the UST Term Sheet as the framework.

## PART II: OPPORTUNITIES, RISKS AND OTHER CONSIDERATIONS FOR PRIVATE CAPITAL PARTICIPANTS

### A. Opportunities

1. Business Case: Leveraged Investment in Potentially Underpriced Assets. Investing in times of great distress historically has often produced exceptional returns. For example, many investors realized outsized gains on assets purchased from the Resolution Trust Corporation in the early 1990s. It is possible that CMBS and RMBS securities represent a similar opportunity – magnified through the use of leverage.

2. "Early Bird Gets the Worm?" According to the Treasury's July 8 Joint Statement on the PPIP program, each PPIF manager has 12 weeks (from July 8) to raise capital (minimum $500 million), and can begin purchasing eligible assets upon raising this private capital. It is possible that the best assets and superior pricing can be obtained by the first PPIF to get started, without other PPIFs to bid against them on the purchase of CMBS and RMBS assets. Thus, there may be some value to investing in a PPIF that is able to begin operations promptly – and there may be an opportunity cost to investing in those PPIFs that are slow to get started.

3. Subsequent Close / Additional Investment Opportunity. PPIFs may raise additional capital through subsequent closes, which are permitted up to six months following the initial close. Thus, there is an opportunity to invest (or increase the investment amount) in the PPIF program (using a private equity-style LIBOR + 2% catchup rate) through April 2010.

4. Freedom From Self-Dealing & Conflicts. The Treasury is focusing significant efforts to ensure that the PPIFs avoid self-dealing or conflicts of interest in purchasing assets. Accordingly, it is our expectation (to be verified by review of final terms) that no purchases of CMBS or RMBS securities would be permitted from affiliates (including banks in which the investment manager has an ownership interest). Some commentators have pointed out inevitable conflicts that would arise if new capital increases the value of all CMBS and RMBS securities – including those held by affiliates of the investment managers.

### B. Risks

1. Terms of Treasury Loan May Disadvantage Private Capital. While the private investor equity and matching Treasury capital are on the same economic terms (except with respect to fees – see C.2 below), the Treasury may be able to obtain favorable economic terms for itself (and thus adverse to private capital) via the Treasury Loan. *It will be important to understand the terms of the Treasury Loan* … including, by way of example: (i) interest rate charged by Treasury, (ii) the additional rights the Treasury (in its capacity as lender) would obtain if there is a deterioration of value of portfolio on mark-to-market basis, (iii) amount of Treasury Loan (is it 1x or 2x the Treasury's equity), (iv) loan fees, (v) covenants, and (vi) leverage limits, including from third party debt. In addition, the PPIF may contractually agree to follow more conservative investment guidelines (*e.g.*, with respect to leverage) than contemplated by the UST Term Sheet.

2. Treasury and Investors Have Different (Misaligned) Downsides. Because of different downsides, the interests of the Treasury and private investors

diverge … with the result that the Treasury may be less sensitive to losses than private investors. For example, with a 25% loss, a $2 billion (cost) portfolio (with $1 billion of Treasury Loan) would decline to $1.5 billion. Private investors would suffer a $250 million loss on $500 million invested (-50%), whereas the Treasury would suffer a $250 million loss on $1.5 million (loan & capital) invested (-16.67%). Thus, the Treasury may not be counted to "look out" for the investor's interests in the same way as would be the case if their downside were identical to that of investors – *and investors will need to negotiate robust protections for themselves*.

3. Treasury is Able to Withdraw at Any Time. The Treasury's April 6, 2009 "Summary of Terms" indicates, under the heading "Governance and Management," that "Treasury will retain the right to cease funding of committed but undrawn Treasury Equity Capital at its sole discretion." If this provision makes it into the final agreements, private capital will at least want the right to be excused from its commitments if the Treasury ceases finding the matching capital.

4. Unknown Amount of Eligible Assets Available to Purchase. Commentators have expressed uncertainty about the amount of eligible CMBS and RMBS that financial institutions would be willing to sell to PPIFs. This will depend on (a) pricing being offered by the PPIFs, and (b) the financial institution's capital needs. If the pool of eligible assets ends up being smaller than anticipated, it would be desirable for investors to be able to obtain a release from commitments.

**C. Other Considerations**

1. Alternative (or Additional) Investment Structure: Debt Investment by Private Investors. According to the U.S. Treasury's description of the PPIP program accompanying the July 8, 2009 Joint Statement:

    > PPIFs will be able to obtain debt financing raised from private sources, and leverage through the … Term Asset-Backed Securities Loan Facility (TALF), for those assets eligible for that program, subject to total leverage limits and covenants.

    And, according to the UST Term Sheet, this private debt would be structurally *senior* to the Treasury debt. Thus, those private capital investors seeking a more conservative investment could evaluate providing private senior debt financing, rather than private capital (*i.e.*, equity) financing. Alternatively, investors could split their investment among senior debt and equity capital. The third party debt investment might even be made through a PPIF different from the one where the equity investment resides.

2. Private Investors Are Source of (Almost) All PPIF Fee Income. In the UST Term Sheet, the Treasury agrees to pay to the PPIF a very low management fee, 0.2% of commitments (or 0.2% of assets after the investment period) – and no incentive fee or organization expenses. Thus, in order to collect reasonable compensation, PPIFs will seek to charge higher fees to private investors (including, perhaps, organizational cost passthrough, incentive fees and higher management fees). Among items to consider with respect to the fees are the following:

    - What is the fee amount and calculation methodology?

    - Will there be a preferred return?

- o Since the UST Term Sheet allows the PPIF to recycle capital for three year investment period, can incentive fee distributions be delayed or escrowed until it is certain that there is no giveback obligation from the PPIF asset manager?

3. Voting by Equity Investors / Treasury. The UST Term Sheet gives the Treasury a significant level of control (through a veto and approval process) over the PPIF's destiny. Investors (as a class) could seek to obtain commensurate control rights (*e.g.*, by requiring that all material actions involving the PPIF also receive approval by 50% of the private capital suppliers). More aggressive investors may (either alone, or by joining forces with other investors) seek to limit the Treasury's control rights.

4. Investor Side Letters Need Treasury Approval. The UST Term Sheet gives the Treasury the right to approve all side letters with other investors. Thus, at a minimum, investors would need to ensure that their side letters are accepted prior to allowing their commitment to become final.

5. Capital Investment by Manager. While $20 million is the minimum, more is obviously desirable; this should be on the same terms as private captial. In addition, it would be helpful to know whether this is a cash contribution or funded by other means (*e.g.*, waiver of fee income).

6. Amount Provided by Treasurer to Each of 9 Funds. The Treasury's July 8 Joint Statement contains inconsistent statements regarding the amount that Treasury will provide to the PPIFs: (1) "each PPIP fund manager will receive an equal allocation of capital from Treasury," and (2) "the equity capital raised from private investors will be matched by Treasury." This should be clarified during the investment process – if each PPIF receives an equal allocation of Treasury capital, then the leverage ratios (and investment case) for the PPIFs would vary depending on the amount of private capital raised. In the UST Term Sheets, this is addressed by an Exhibit, which contains the "maximum" UST commitment to that PPIF (regardless of the amount of private capital raised).

7. Conflicts Limit PPIF Opportunities. Investors should understand whether the PPIF investment managers own or control equity securities of financial institutions in sufficient amounts to trigger conflict of interest prohibitions on transactions. If triggered, these conflict of interest prohibitions could limit the ability of the PPIF investment manager to purchase (and sell) CMBS and RMBS assests.

8. Fiduciary Obligations. The PPIF's fiduciary obligations – including those arising under ERISA – would need to be explored carefully. Due to the non-control nature of the PPIF's investments, VCOC exemptions to ERISA compliance would not apply.

To discuss this summary of the Investment Opportunity in the Legacy Securities Program of the PPIP, please contact Jussi Snellman, 608-229-2243 jsnellman@reinhartlaw.com, or Keith Johnson, 608-229-2231 kjohnson@reinhartlaw.com.

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