The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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Emergency Economic Stabilization Act of 2008

[22975]

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TO: BOARD OF GOVERNORS No. 10-08
FEDERAL LEGISLATION MEMBERS No. 14-08
INVESTMENT COMPANY DIRECTORS No. 20-08
PRIMARY CONTACTS - MEMBER COMPLEX No. 11-08
SEC RULES MEMBERS No. 119-08
TAX MEMBERS No. 45-08 RE: EMERGENCY ECONOMIC STABILIZATION ACT OF 2008

On October 3rd, President Bush signed into law sweeping new legislation that included the Emergency Economic Stabilization Act of 2008 (the "Act"). [1] The stated purpose of the Act is to immediately provide authority and facilities that the Treasury Secretary ("Treasury") can use to restore liquidity and stability to the U.S. financial system. This memorandum briefly summarizes selected provisions of the Act that may be of interest to funds and advisers.

Troubled Asset Relief Program

General Framework

The Act authorizes Treasury to establish a troubled asset relief program ("TARP") to purchase troubled assets from financial institutions. [2] Treasury is required to publish program guidelines that include (1) 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. Purchases can be either direct (where no bidding process or market prices are available) or through market

mechanisms such as auctions or reverse auctions, at Treasury's discretion.

Treasury is required to make purchases at the lowest price it determines to be consistent with the purposes of the Act. In the case of direct purchases, Treasury must "pursue additional measures to ensure that prices paid for assets are reasonable and reflect the underlying value of the asset." In addition, Treasury must take steps to prevent the sale to Treasury of a troubled asset at a price higher than the seller's purchase price, subject to certain exceptions.

Eligibility to Participate in the TARP

The Act defines "financial institution," in part, as "any institution, including, but not limited to a bank, savings association, credit union, security broker or dealer, or insurance company" established and regulated under the laws of the U.S. or any state, and having significant operations in the U.S. (emphasis added). It thus appears that a fund or adviser may come within the definition. [3] The term "troubled assets" likewise is defined broadly and in an open-ended manner, to mean (1) "residential or commercial mortgages and any securities, obligations, or other instruments based on or related to such mortgages," in each case originated or issued on or before March 14, 2008, the purchase of which the Treasury Secretary determines promotes financial stability; or (2) "any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System ("FRB"), determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination in writing" to specified Congressional committees (emphasis added).

Requirements for Participants in the TARP

In an effort to minimize long-term costs and maximize benefits for taxpayers, the Act requires that Treasury receive, when it purchases troubled assets from a financial institution, either a warrant giving Treasury the right to receive non-voting common or preferred stock in the financial institution or a senior debt instrument. The Act directs Treasury to establish two types of exceptions from this requirement. First, Treasury must establish de minimis exceptions to apply where cumulative purchases of troubled assets from a single financial institution for the duration of the program do not exceed $100 million. Second, Treasury must establish an exception and "appropriate alternative requirements" for a participating financial institution that is "legally prohibited from issuing securities and debt instruments."

The Act requires Treasury to determine, for each type of financial institution that participates, "whether the public disclosure required for such financial institutions with respect to off-balance sheet transactions, derivative instruments, contingent liabilities, and similar sources of potential exposure is adequate to provide to the public sufficient information as to the true financial positions of the institutions." If not, Treasury must recommend additional disclosure requirements to the relevant regulators.

Executive Compensation Provisions

The Act imposes executive compensation restrictions and tax penalties on financial institutions that sell troubled assets under the program, in some circumstances.

If the financial institution sells troubled assets to Treasury solely through direct purchase, and Treasury receives a “meaningful” equity or debt position in the financial institution, Treasury must require the institution meet executive compensation and corporate governance standards. These standards must include:

- limits on compensation that exclude incentives for senior executive officers of the financial institution to take “unnecessary and excessive risks that threaten the value” of the institution;
- recovery by the financial institution of any bonus or incentive compensation paid to a senior executive officer based on financial statements that are later proven to be materially inaccurate; and
- prohibitions on the financial institution making any golden parachute payment [4] to its senior executive officers.

A senior executive officer is an individual who is one of the top 5 highly paid executives of a public company, whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934, and “non-public company counterparts.”

These standards will be effective as long as Treasury holds an equity or debt position in the financial institution.

If Treasury acquires at least some of the troubled assets through an auction, and where the purchases (both auction and direct) exceed $300,000,000, Treasury must prohibit, pursuant to regulations to be issued within two months of enactment, any new employment contract that produces a golden parachute in the event of an involuntary termination, bankruptcy filing, insolvency, or receivership. This restriction applies only as long as Treasury has authority under the Act to purchase troubled assets.

Tax penalties

The Act also imposes executive compensation tax penalties that piggyback on existing penalties under sections 162(m) and 280G of the Internal Revenue Code.

Section 162(m) currently prohibits public companies from deducting compensation in excess of $1 million paid to a covered employee in any year. A company’s “covered employees” are its CEO and the three highest-paid other officers, excluding the CFO. Payments that qualify as “performance-based compensation” (such as stock options and incentive bonuses), as well as deferred compensation payments made after an individual leaves employment and is no longer a covered employee, are excluded.

The Act would provide additional restrictions on financial institutions from whom troubled assets are acquired by the Treasury, if the aggregate amount of the assets acquired for all taxable years exceeds $300,000,000. [5] These financial institutions are called “applicable employers” in the Act. For purposes of the provision, two or more affiliated entities who are treated as a single employer for certain tax purposes would be aggregated in determining whether the $300,000,000 threshold is met and which five individuals are subject to the restrictions.

The additional restrictions that would be applied are as follows:

- The limit would be lowered from $1 million to $500,000.
- “Performance based compensation” would not be excluded.
- Deferred compensation attributable to services during a covered year would not be excluded even if paid in a subsequent year.
- The CFO would be covered.
- An “applicable employer” need not be a public company to be covered.

The penalties would apply beginning in the first taxable year in which the aggregate troubled assets acquired (including those in prior years) exceed $300,000,000, and would apply in any subsequent year in which Treasury has authority under the Act to purchase troubled assets.

Section 280G and companion provision section 4999 of the Code provide that an “excess parachute payment” paid to a disqualified individual is not deductible by the paying employer, and impose a 20% excise tax on the recipient of the excess parachute payment. These rules are triggered whenever a “parachute payment” is made. A “parachute payment” is any payment in the nature of compensation to officers and certain highly compensated individuals which is contingent on a change in control of a corporation, but only if the value of the payment equals or exceeds three times the individual’s average annual compensation over the preceding five years. If a parachute payment is made, the “excess parachute payment” is the difference between the aggregate payments and the individual’s average annual compensation over the preceding five years. (The preceding simplifies the current rules to some extent.)

The Act would expand these rules for financial institutions from whom troubled assets are acquired by the Treasury, if the aggregate amount of the assets acquired for all taxable years exceeds $300,000,000. For those institutions, the rules would apply to any payment made for severance from employment by reason of an involuntary termination or in connection with a bankruptcy, liquidation, or receivership of the financial institution (in other words, instead of solely to payments contingent on a change in control). This would apply only to individuals (CEO, CFO, and 3 other highest paid officers) subject to the new 162(m) restrictions. The restrictions, once they apply, would continue to apply to any severances while Treasury has authority under the Act to purchase troubled assets.

Other Provisions of Interest to Funds and Advisers

Insurance of Troubled Assets

Under the Act, if Treasury establishes the TARP, it also "shall establish" a program to guarantee troubled assets originated or issued before March 14, 2008. The Act provides that in establishing this program, Treasury "may," upon the request of a financial institution, guarantee the timely payment of principal of and interest on troubled assets, in amounts not to exceed 100 percent of such payments, and on terms and conditions determined by Treasury. Treasury is authorized to establish premiums that take into account the credit risk associated with the assets being guaranteed.

Money Market Funds

The Act requires Treasury to reimburse the Exchange Stabilization Fund for any amounts used for the Treasury Money Market Fund Guaranty Program, from funds under the Act. It prohibits use of the Exchange Stabilization Fund to establish any future guaranty programs for money market mutual funds.

Mark-to-Market Accounting

The Act authorizes the SEC to suspend the application of FAS 157 for any issuer or with respect to any class or category of transaction if the SEC determines that is necessary or appropriate in the public interest and consistent with the protection of investors.

Also, the SEC, in consultation with the FRB and Treasury, must conduct a study on mark-to-market accounting standards as provided in FAS 157, as applicable to financial institutions including depository institutions. The SEC is required to submit a report to Congress on this study within 90 days of the Act's enactment.

Regulatory Modernization

Treasury must submit a report to specified Congressional committees by April 30, 2009 that (1) analyzes the current state of the regulatory system and its effectiveness at overseeing participants in the financial markets, including the over-the-counter swaps market and government-sponsored enterprises, and (2) recommends improvements.

Recoupment

Five years from enactment of the Act, the Office of Management and Budget and the Congressional Budget Office must report to Congress on the net amount within the TARP. In the case of any "shortfall," the President must propose legislation to recoup that amount from "the financial industry."

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endnotes

[1] Copies of the legislation are available at http://financialservices.house.gov/essa/essabill.pdf and http://banking.senate.gov/public/_files/latestversionAYO08C32_xml.pdf. The legislation also: (1) requires brokers (including mutual funds) to report cost basis information to shareholders and the Internal Revenue Service; (2) extends several tax provisions that expired at the end of 2007, including the flow-through of interest and short-term capital gains to foreign investors and the income exclusion for charitable distributions from individual retirement accounts ("IRAs"); and (3) modifies the standard for certain tax return preparer penalties. These provisions were described in detail in a separate memorandum to members. See Institute Memorandum 22916, dated October 3, 2008.

[2] An initial tranche of $250 billion is authorized immediately. Upon certification by the President, another $100 billion will be authorized. Thereafter, an additional $350 billion can be authorized if the President submits a written report to Congress, unless within 15 days of the report Congress enacts a joint resolution of disapproval.

[3] The broad reach intended by the legislation is further illustrated by a provision requiring Treasury to consider, in exercising its authorities under the Act, "ensuring that all financial institutions are eligible to participate in the program, without discrimination based on size, geography, form of organization, or the size, type, and number of assets eligible for purchase" under the Act.

[4] The Act does not define "golden parachute payment" for this purpose.

[5] If the only sales of troubled assets by a financial institution are through direct purchases, then the financial institution is not subject to the tax penalty (but could be subject to the restrictions imposed by Treasury described earlier).