CRAVATH, SWAINE & MOORE LLP

WORLDWIDE PLAZA
825 EIGHTH AVENUE
NEW YORK, NY 10019-7475

TELEPHONE: (212) 474-1000
FACSIMILE: (212) 474-3700

CITYPOINT
ONE ROPEMAKER STREET
LONDON EC2Y 9HR
TELEPHONE: 44-20-7453-1000
FACSIMILE: 44-20-7860-1150

WRITER'S DIRECT DIAL NUMBER

April 10, 2009

<u>Public-Private Investment Program</u>
<u>Legacy Loans Program</u>

Ladies and Gentlemen:

This letter responds to the FDIC's request for comment on the proposed Legacy Loans Program (LLP). We have discussed the program with several clients who may be interested in participating in the LLP, particularly as bidders for loans. The primary focus of our comments is therefore to identify structural, legal/regulatory and procedural impediments to the realization and execution of the LLP and to wide participation in the program by potential bidders. We have responded to certain specific questions formulated by the FDIC in the Legacy Loans Program – Program Description and Request for Comment that address these issues. We are not responding to many of the questions that concern policy issues relating to the types of included assets and the size and characteristics of the asset pools, the extent of government equity and upside participation, and other matters as to which there may be reasonable differences among potential participants.

I. Specific Questions Raised in the Program Description and Request for Comment

Set forth below are comments with respect to certain of the questions formulated by the FDIC in the Legacy Loans Program – Program Description and Request for Comment. For convenience, we have repeated the text of each question and provided our comments immediately after the question.

2. Should the initial investors be permitted to pledge, sell or transfer their interests in the PPIF? If so, how should the FDIC ensure that subsequent investors meet the program's criteria for investors?

We believe that the issue of whether investors can pledge, sell or transfer their interests should be viewed as a matter of internal governance to be determined by the participants in a particular PPIF to the greatest extent possible. The task of making sure that transferees meet the program's eligibility criteria could be the responsibility of a fund manager or general partner (depending on what the criteria are).

4. Is there any reason that investors' identities should not be made publicly available?

We believe that private investors will, in general, prefer not to be identified. However, if some disclosure is necessary as a public policy matter, we suggest that disclosure be made of the identities of investors directly or indirectly owning 10% or more of the private capital in the PPIF ", provided such amount is above a specified dollar threshold. Both the LLP and the Legacy Securities Program use the 10% threshold for purposes of defining affiliates of a PPIF who may not sell assets into the PPIF.

5. How can the FDIC best encourage a broad and diverse range of investment participation? How can the FDIC best structure the valuation and bidding process to motivate sellers to bring assets to the PPIF?

We believe that achieving these objectives requires development of appropriate rules and procedures in several areas outlined below:

- **Bidding/Auction Process**: We believe the greatest volume of transactions can be achieved by (1) adding a step to the process for initial indications of interest and (2) with respect to certain assets and investors which we believe otherwise will not participate, creating, as a complement to the auction process, a process for negotiated bilateral sales without an auction but utilizing many of the other procedures currently contemplated. We have discussed this in detail in response to question 6 below.

- **Management of PPIF:** The summary of terms state that the PPIFs will be managed "within parameters pre-established by the FDIC and UST, with reporting to the FDIC and oversight by the FDIC". We believe it would be very helpful not just to clarify what these parameters are at the outset, but also to design them narrowly to achieve the public policy objectives of the FDIC and Treasury. In particular, the guidelines should not restrict unnecessarily the ability of private investors to manage the PPIF and determine its strategy with respect to whether to hold, transfer or liquidate assets.

- **TARP/Executive Compensation:** Although the Frequently Asked Questions regarding the LLP make it clear that executive compensation restrictions will not apply to "passive Private Investors," the terms of the LLP should be clarified to specify that no private participants (investors, asset managers and PPIF general partners or managers) will be subject to executive compensation restrictions. More importantly, it should be made clear that the PPIF will not be treated as a TARP participant or "recipient" under the American Recovery and Reinvestment Act of 2009 for purposes of executive compensation and other restrictions.

- **Risk of Retroactive Changes:** Many private investors are concerned that the rules will be changed "in the middle of the game"—e.g., that there could be an imposition of "unrelated" requirements, taxes and the like. We believe that any steps the FDIC and Treasury can take to minimize this risk would be well received by the potential investor community.

- **Legal/Regulatory Impediments to Participation:** There are two principal regulatory areas in which we see legal or regulatory impediments to participation by certain types of investors in the LLP – ERISA and Investment Company Act of 1940.

  - **ERISA:** In order to promote Treasury's stated objective of encouraging participation in the LLP by pension plans, as well as to increase the sources of capital available to participate in the LLP, we recommend that the Department of Labor provide targeted relief from the "plan assets" regulation for purposes of the LLP, for example by increasing the 25% limitation or by clarifying that a PPIF could be regarded, under certain circumstances, as a qualifying investment for "venture capital operating company" (VCOC) purposes. Under the ERISA "plan assets" regulation, as currently promulgated by the Department of Labor, unless (1) participation by U.S. private pension plans is limited to less than 25% of each class of the fund's equity or (2) the fund qualifies as a VCOC for purposes of ERISA (i.e., an entity more than 50% of the assets of which consist of qualifying investments for VCOC purposes), the fund's assets will be considered "plan assets" and will be subject to numerous restrictions pursuant to ERISA. Under the "plan assets" regulation, as currently in effect, investment in a PPIF would not be considered a qualifying investment for VCOC purposes. Accordingly, funds would need to either limit their investment in PPIFs to less than 50% of their assets or restrict investment by U.S. private pension plans to less than 25% of each class of their equity interests.

  - **Investment Company Act:** The materials on the LLP state that the participation of individual investors in the LLP is encouraged and expected. We believe it would facilitate the participation by individual investors in the LLP if the SEC staff were to provide no-action assurance that the nonrecourse financing available through PPIP is not deemed to be a senior security for purposes of Section 18 of the Investment Company Act of 1940. As a practical matter, the only way we believe individual, retail investors could participate to a significant degree in the LLP is through a closed-end fund registered as an investment company. Section 18 of the Investment Company Act limits the use of leverage by registered investment companies. Although Section 18 by its terms literally applies only to the issuance of debt and preferred equity securities by a registered investment company, the SEC staff has interpreted

Section 18 to apply to a variety of derivative trading strategies, including reverse repurchase agreements, firm commitment agreements, standby commitment agreements, short sales, purchase and sales of futures contracts, purchases and sales of certain types of options on securities, and stock indexes, or interest-rate futures contracts, among other things. *See* Registered Investment Company Use of Senior Securities --- Select Bibliography, available at the SEC's Division of Investment Management's website.[1] The SEC staff has indicated, however, that such transactions are permissible if an investment company "segregates" or earmarks assets to "cover" their obligations under the instruments. We understand that the SEC staff has informally advised registered investment companies and their counsel that it views the nonrecourse financing available through PPIP as subject to Section 18, requiring earmarking of assets to cover the financing obligations. We further understand that the SEC staff has reached this position by analogizing the financing available through PPIP as being akin to a reverse repurchase agreement. This has the effect of requiring investment companies to limit their use of PPIP financing so that the investment companies have at least 200% asset coverage. Of course, the nonrecourse financing available through PPIP is one of the features of the program that makes it very attractive to private investors. Denying registered investment companies the opportunity to use the nonrecourse financing to its fullest extent has the unfortunate effect of limiting the utility of the program to retail investors. Because the financing available through PPIP is nonrecourse, so that a private investor's losses are limited to the amount of equity invested, we believe that the SEC staff could provide no-action assurance under which it would agree that the financing is not subject to Section 18's limits. It could do so by analogizing to the purchase of put options by a registered investment company, which do not require the earmarking of assets to cover an obligation. Such a no-action position would facilitate the participation of individual investors in the PPIP, thereby furthering the purposes of the PPIP. (We believe the SEC could also take this position with respect to TALF financings, which would allow broader participation in TALF for both newly-issued ABS and Legacy Securities.)

- **Tax:** There are several tax issues that should be clarified in order to encourage investor participation. See "II. Tax Concerns" below.

---

[1] http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm.

6. What type of auction process facilitates the broadest investor participation? Should we require investors to bid on the entire equity stake of a PPIF, or should we allow investors to bid on partial stakes in a PPIF? If the latter, would a Dutch auction process or some other structure provide the best mechanism for bridging the potential gap between what investors might bid and recoverable value? If multiple investors are allowed to bid through a Dutch auction, or similar process, how should asset management control be determined?

Proposal 1

Many potential investors have noted that there could be strong disincentives to participate in the auction process because participation involves significant expense, time and effort, and the outcome is uncertain in light of the fact that the Participant Bank can reject the winning bid. The speculation that there may be a wide gap between current marks on some Legacy Loans and possible market bids makes it even less likely that sellers will bring pools to market in the absence of indications that an auction will result in acceptable bids. Participant Banks may also feel a strong disincentive to bring pools of assets to auction because of the potential pressure to sell after an auction process, even at prices they feel are inappropriate.

We suggest that the FDIC consider amending its auction procedures to include a variation of the standard practice used in auctions of companies, which we refer to as an "indication of interest" round. In auctions of companies, prior to allowing potential purchasers to meet management or participate in other due diligence, a seller often requires bidders to submit non-binding indications of interest with a purchase price (which may be a range) and any other key terms, which indication is based solely on the marketing materials for the auction (and any other publicly available information the potential purchaser may have consulted). The seller then selects the potential purchasers it wants to allow into the next round to conduct due diligence (or, if the indications of interest are all too low, it may abandon or revise the potential deal altogether).

For the auction process, the FDIC could add an "indication of interest" round in which, based solely on (1) the proposed leverage and other terms currently contemplated to be provided to bidders by the FDIC, (2) the marketing materials and (3) the third party valuation report (assuming that is made available to potential bidders), potential bidders could be asked to submit nonbinding indications of interest with a purchase price (which could be a range). At that time, a Participant Bank could then be shown the bids and, if any of them are in a range that would be an acceptable sales price, could be asked to give a binding commitment to sell if the ultimate bid is within the acceptable range. The bidders would be informed of such binding commitment, and all bidders who wished to enter the next round would be allowed to do so. Only if the ultimate winning bid was not in the previously agreed to range, would the Participant Bank be able to reject the bid.

Although some uncertainty would remain for bidders, we expect that it would be reduced significantly by this type of process, and would result in greater participation from a broader range of investors. Similarly, for the Participant Bank, there may be a greater incentive to participate. In particular, if the gap between the indications of interest and the price at which they are willing to sell is too great, rather than being placed in a position to simply say “yes” or “no”, the FDIC could provide the Participant Bank an opportunity to potentially address that gap through discussions with potential bidders regarding the pool of assets, or suggestions on structures that might work to achieve a price in an acceptable range.

Proposal 2

While the above auction process should serve as the primary process for facilitating sales of troubled assets, we believe the program should have the flexibility to accommodate privately negotiated transactions under some circumstances. We suggest that the FDIC consider adding a process for negotiated bilateral sales between Participant Banks and unaffiliated private investors that may be used to sell pools of loans which meet a stated aggregate size threshold (which, in the case of commercial loans, should be low enough to encompass a relatively small number of large-scale commercial loans or even a single very large commercial loan).

The initial steps in a negotiated sale process would be similar to the initial steps in the auction process, i.e., a Participant Bank, working with its regulator, would identify a suitable pool of Legacy Loans, a third party valuation firm would be selected by the FDIC to provide independent valuation advice, the FDIC would determine the amount and terms of the FDIC guaranteed financing, and any prospective buyer would be subject to preapproval of the FDIC. The Participant Bank would then enter into negotiations with one or more pre-approved prospective buyers, with any resulting binding agreement to be subject to FDIC approval.

Advantages. The negotiated bilateral sales process offers a number of potential advantages as a complement to the standard auction process: (1) because a failed negotiation may not have the same accounting implications as a failed auction that results in a price that is too low to induce the relevant Participating Bank to sell, some Participating Banks may be more likely to use the negotiated process, which will still result in a market price determined on an arms’ length basis, (2) negotiated transactions are likely to take much less time to execute than in the auction process and (3) some large-scale commercial loans, which often involve highly complicated ownership and financing structures, may not be suitable for an auction process at all and some of the most suitable buyers may not be willing to spend the time and money to evaluate and bid on those assets in an auction context.

Possible Expansion to Accommodate Borrower Purchases. We suggest that the FDIC consider an eventual expansion of the Legacy Loan Program to accommodate the possible purchase by borrowers of individual commercial loans above a given size threshold. There would be significant interest among some borrowers in an opportunity to buy in loans on their properties using the favorable financing being offered by the FDIC in the Legacy Loan Program. The negotiated bilateral sales process we have described above could be used to facilitate these sales. The benefits of expanding the program to accommodate borrower purchases would include the following: (1) by lowering the borrower’s effective debt service and reducing the amount of refinancing required upon maturity, a borrower purchase would not only result in getting the loan off the Participant Bank’s balance sheet but it could also avoid an eventual default on the loan that might otherwise result if the loan were sold to a third party, (2) in some cases, it is likely that the borrower might be willing to pay substantially more for a loan by virtue of being in the best possible position to evaluate the relevant property or in order to reduce or eliminate the risk of defaulting on the loan, which could have adverse reputational or tax consequences for the borrower, and (3) sales could be consummated on an accelerated basis because borrowers would not need to conduct due diligence.

10. Would it be preferable for the selling bank to take a note from the PPIF in exchange for the pool of loans and other assets that it sells? Alternatively, what would be the advantages and disadvantages of structuring the program so that the PPIF issues debt publicly in order to pay cash to the selling bank? Would a public issuance of debt by the PPIF limit its flexibility compared to the issuance of a note to a selling bank?

We believe that it would definitely be preferable for the selling bank to take a note from the PPIF from the point of view of simplicity and speed of execution. We do not believe that the public issuance of debt by the PPIF concurrently with consummation of a purchase is practical from either a regulatory or commercial perspective.

17. Should data used by the independent valuation consultant, as well as results of such consultant's analysis, be made available to potential bidders? Should it be made available to potential sellers prior to their decision to submit assets to bid?

We believe it will enhance the efficiency and transparency of the bidding process for the independent valuation and underlying data to be made available to potential bidders.

II. Tax Concerns

As noted above, we recommend that the Treasury clarify, by issuing additional targeted guidance, how certain tax rules would apply in the context of the LLP. This would help to create both a level playing field among bidding investors (or investor groups) and greater certainty as to how after-tax returns on capital will be shared between the private investors and the Treasury, which will in turn encourage participation.

- **Taxable Mortgage Pool Rules:** Investors will likely structure a PPIF as a limited partnership or limited liability company that would elect to be taxable as a partnership. It is not clear, however, whether under certain circumstances a PPIF structured in this way would run afoul of the "taxable mortgage pool" rules of Section 7701(i) of the Internal Revenue Code, which would result in the entity being taxable as a corporation. For example, it may often not be clear whether a PPIF may rely on the exemption for "impaired loans" that is set forth in the regulations under Section 7701(i) of the Internal Revenue Code. We would therefore recommend that Treasury issue a revenue procedure clarifying that the "taxable mortgage pool" rules would not be applied to a PPIF (or any investment vehicle that invests all or substantially all of its assets in one or more PPIFs).

- **REIT Foreclosure Rules:** It is possible that investors will structure their investment vehicle through which they will invest in one or more PPIFs (themselves structured as partnerships for tax purposes) in the form of a "real estate investment trust" (REIT). A REIT must satisfy strict income and asset composition tests. The REIT rules also encompass the so-called "foreclosure rules" which are intended to preserve REIT status even though the REIT forecloses on one or more of its mortgages. A REIT is not entitled to such relief, however, if the REIT invests in a mortgage at a time when the REIT knew or had reason to know that a default would occur. Since it is likely that the loan pools that will be auctioned off under the LLP will include mortgage loans that will go into foreclosure, it is not entirely clear whether a REIT would be entitled to relief. We would therefore recommend that Treasury issue a revenue procedure clarifying that a REIT that, directly or indirectly, participates in the LLP will be entitled to the benefits of the special foreclosure rules in respect of any mortgage loan acquired through the LLP.

- **Foreign Investors:** In circumstances involving foreign private investors, it is unclear whether the so-called "securities trading safe harbor" under Section 864(b)(2) of the Internal Revenue Code would apply in a situation where the foreign investor invests in debt securities (including loans) with a view to a potential debt workout (a not unlikely scenario under the LLP). We understand that the Internal Revenue Service is currently reviewing whether debt workouts are subsumed within the securities trading safe harbor. Given the significance of the LLP for the U.S. economy as a whole, we would recommend that Treasury issue a revenue procedure clarifying that it would not challenge the eligibility of foreign investors in PPIFs structured as partnerships to claim the securities trading safe harbor with respect to any profits derived from debt workouts.

Thank you for your consideration. Please contact Roger Turner (212-474-1668), Julie Spellman Sweet (212-474-1572) or Ralph Currey (212-474-1932) if you have any questions regarding the foregoing generally or Andrew Needham (212-474-1440) regarding the tax issues.

Cravath, Swaine & Moore LLP

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429