

Client Alert Financial Markets Developments

The Troubled Asset Relief Program: Issues for Financial Institutions and Other Entities Covered by the TARP

In one of the most closely-watched legislative actions in memory, the House of Representatives on Friday, October 3, reversed its negative vote of four days earlier and approved the version of the Emergency Economic Stabilization Act of 2008 ("EESA") that had been approved by the Senate on October 1. The President then immediately signed EESA into law.

EESA authorizes the Secretary of the Treasury (the "Secretary") to establish the Troubled Asset Relief Program (the "TARP") to purchase, and to make and fund commitments to purchase, troubled assets from financial institutions on such terms and conditions as are determined by the Secretary. The stated purposes of EESA are "to restore liquidity and stability to the financial system of the United States" and ensure that the authority and facilities provided by EESA are used in a manner to protect home values and savings, preserve home ownership and promote jobs and economic growth, maximize overall returns to the taxpayers and provide public accountability.

EESA authorizes the entire US\$700 billion amount originally requested by the Secretary for implementation of the TARP, but with a graduated authorization for asset purchases. The Secretary may immediately use up to US\$250 billion for the TARP and, upon certification by the President that additional funds are needed, an additional US\$100 billion is to be made available. The remaining US\$350 billion may be accessed if the President submits a written report to Congress requesting authority to utilize those funds and Congress does not object, through a joint resolution of disapproval, within 15 days of the request. EESA calls for the TARP to be implemented by the Secretary through an Office of Financial Stability to be established for such purpose within the Office of Domestic Finance of the Department of the Treasury (the "Treasury"), which office is to be headed by an Assistant Secretary of the Treasury.

Highlights of EESA

- **Assets Covered by the TARP.** EESA defines the term "troubled assets" as residential or commercial mortgages, and any securities, obligations, or other instruments that are based on or related to such mortgages, which were originated or issued on or before March 14, 2008, the purchase of which the Secretary determines would promote financial market stability. Additionally, the Secretary is authorized, after consultation with the Chairman of the Federal Reserve Board and upon notice to Congress, to expand the coverage of the TARP to any other financial instrument if he determines that such expansion is necessary for financial market stability.



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■ **Financial Institutions Eligible to Participate in the TARP.**

EESA defines the term “financial institution” 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, and having “significant operations” in, the United States (including US territories and possessions), but excluding any central bank of, or institution owned by, a foreign government.

■ **Purchase Mechanics and Valuations.**

The Secretary is required to make purchases at the lowest price consistent with the purposes of EESA and use market mechanisms for purchases wherever possible, including auctions or reverse auctions. EESA also authorizes the Secretary to act through direct purchases of troubled assets from individual financial institutions if he determines that the use of a market mechanism is not feasible or appropriate, although in such cases the Secretary is required to “pursue additional measures to ensure that prices paid for assets are reasonable and reflect the underlying value of the asset.” In direct purchases, the Secretary is also required to take into consideration the long-term viability of the financial institution in determining whether the purchase represents the most efficient use of funds under EESA.

The critical matter of valuation and pricing of the troubled assets is left within the discretion of the Secretary. However, EESA requires the Secretary to publish program guidelines within two business days after the first purchase of troubled assets under the TARP or the date 45 days after the enactment of EESA (November 17), whichever is earlier, including mechanisms for purchasing troubled assets, methods for pricing and valuing troubled assets, procedures for selecting asset managers and criteria for identifying troubled assets for purchase. EESA also requires the Secretary, in making purchases of troubled assets, to take such steps as may be necessary to prevent unjust enrichment of participating financial institutions, including by preventing the sale of a troubled asset to the Treasury at a price higher than that which the seller paid for the asset (except in cases where the troubled asset was acquired by the selling financial institution in a merger or acquisition or purchased from another financial institution in conservatorship, receivership, or bankruptcy proceedings).

■ **Management and Sale of Assets by the Treasury.**

EESA authorizes the Secretary to manage troubled assets purchased under the TARP (including through the appointment of asset managers) and to sell, or enter into securities loans, repurchase transactions, or other financial transactions with regard to, troubled assets on such terms and conditions and at such prices as may be determined by the Secretary. All revenues and proceeds from the sale of troubled assets by the Treasury, or from the sale, exercise, or surrender of warrants or senior debt instruments acquired by the Treasury from financial institutions participating in the TARP, are required to be paid into the Treasury general fund for reduction of the public debt.

■ **Market Transparency.**

EESA requires the Secretary to post online a description of the types, amounts and pricing of assets acquired under the TARP within two business days of purchase, trade or other disposition.

■ **Equity Participations for the Treasury.**

Financial institutions selling troubled assets to the Treasury are required, subject to a de minimis exception to be established by the Secretary not to exceed US\$100 million, to issue equity or senior debt participations to the Treasury. Financial institutions with securities traded on a securities exchange in the United States are required to issue warrants to the Treasury exercisable for nonvoting common or preferred shares or, as an additional option for the Secretary added to the legislation between its rejection in the House of Representatives on September 29 and its final passage on October 3, voting shares as to which the Secretary is required to waive voting rights. Other financial institutions are required to issue to the Treasury senior debt instruments with a “reasonable interest rate premium” or, as an additional option for the Treasury added in the final version of the legislation, warrants for common or preferred stock. Warrants must have terms and conditions providing the Treasury with “reasonable participation” in equity appreciation, as well as additional protection for taxpayers against losses from the sale of troubled assets by the Treasury and the administrative expenses of the TARP, and must also contain antidilution provisions. The Secretary is authorized to sell, exercise, or surrender warrants or

senior debt instruments as he deems necessary to meet EESA's objectives, with the exercise price for any warrant to be set by the Secretary "in the interest of the taxpayers." The Secretary is also authorized and directed to establish appropriate alternative requirements for any participating financial institution that is legally prohibited from issuing securities and debt instruments.

- **Executive Compensation Limits and Heightened Corporate Governance Standards for Financial Institutions.** According to a number of published reports, the inclusion in EESA of executive compensation and corporate governance standards for financial institutions participating in the TARP was a critical condition to the passage of the legislation. As enacted, these standards vary based upon whether the financial institution sells troubled assets to the Treasury through the auction (or reverse auction) process or through direct sales, as well as based upon the amount of troubled assets sold to the Treasury.

Financial institutions participating in the TARP through direct purchases (in any amount) or a combination of direct purchases and auctions will be required to meet appropriate standards for executive compensation and corporate governance, including (i) limiting incentives for senior executive officers (i.e., the top five executives) to take "unnecessary and excessive risks that threaten the value of the financial institution" during the period in which the Treasury holds an equity or debt position in the financial institution, (ii) providing for recovery of bonuses and incentive compensation paid to senior executive officers on the basis of financial statements that subsequently turn out to be materially inaccurate and (iii) prohibiting "golden parachutes" for senior executive officers during the period in which the Treasury holds an equity or debt position in the financial institution. EESA does not provide standards for the additional corporate governance requirements that these financial institutions will be required to observe, but rather leaves that issue to the discretion of the Secretary.

Financial institutions participating in the TARP exclusively through the auction process and selling troubled assets

to the Treasury aggregating in excess of US\$300 million will be prohibited, during the period that the TARP is in effect, from entering into any new employment contract with a senior executive officer that provides for a "golden parachute" in the event of an involuntary termination, bankruptcy filing, insolvency, or receivership. Financial institutions in this category also will lose (under an expansion of existing "Section 162(m)" rules) the tax deduction for pay above US\$500,000 for executive officers for any applicable tax year and (under an extension of existing golden parachute tax provisions) will be subject to a 20 percent excise tax on certain severance payments received by covered executives while also forfeiting a deduction for such payments.

For financial institutions selling in excess of US\$300 million in troubled assets to the Treasury through a combination of direct purchases and auctions, all of the limitations and requirements discussed above will apply. In contrast, financial institutions selling not more than US\$300 million in troubled assets to the Treasury exclusively through auctions will not be subject to any such limitations and requirements.

For a detailed explanation of the EESA's restrictions on executive compensation for financial institutions participating in the TARP, see the White & Case Financial Markets Developments Client Alert of October 3, *The New Recovery Legislation: The TARP Covers Executive Compensation*.

- **Adequacy of Public Disclosure by Financial Institutions.** For any financial institution that sells troubled assets to the Treasury, the Secretary is required to determine whether the institution's public disclosure with respect to off-balance sheet transactions, derivatives instruments, contingent liabilities and "similar sources of potential exposure" is adequate to inform the public of the true financial condition of the financial institution. If not, the Secretary is directed to make recommendations for additional disclosure requirements to the federal financial institution regulatory authorities. Financial institutions that

are reporting companies under the Securities Exchange Act of 1934, as amended, are already subject to certain reporting obligations with respect to off-balance sheet obligations following the Sarbanes-Oxley Act of 2002.

- **Federal Insurance Program for Troubled Assets.** EESA directs the Treasury to create a federal insurance program to guarantee, upon request of a financial institution, the timely payment of principal and interest on troubled assets. Premiums for the insurance are to be paid by financial institutions participating in the insurance program. EESA directs the Treasury to set premiums for participating financial institutions at “a level necessary to create reserves sufficient to meet anticipated claims, based on an actuarial analysis, and to ensure that taxpayers are fully protected,” with premiums to vary according to the credit risk posed by the particular classes of troubled assets being guaranteed.
- **Oversight Authority.** EESA establishes a Financial Stability Oversight Board, comprised of the Chairman of the Federal Reserve Board, the Secretary, the Chairman of the Securities and Exchange Commission (the “SEC”), the Director of the Federal Housing Finance Agency and the Secretary of Housing and Urban Development, to review and make recommendations regarding the exercise of authority under EESA. EESA also establishes an Office of the Special Inspector General for the TARP to conduct, supervise and coordinate audits and investigations of the Secretary’s actions under the Act, as well as a Congressional Oversight Panel to review the state of the financial markets, the regulatory system and the use of the TARP authority.
- **Judicial Review of Treasury Actions.** Actions by the Secretary pursuant to EESA may be set aside by a court only if found to be arbitrary, capricious, an abuse of discretion or not in accordance with law. Injunctive and other equitable relief is not available against the Secretary for actions relating to purchases or insurance of troubled assets, asset management and sales, or foreclosure mitigation efforts, other than to remedy violations of the Constitution. Other requests for equitable relief are to be handled by the court on an expedited basis. Financial institutions selling troubled assets are not permitted to bring actions or claims against the Secretary regarding their participation in the TARP unless expressly permitted in the contract governing the transaction.
- **Termination of TARP Authority.** The authority conferred on the Treasury by EESA to purchase and to guarantee troubled assets terminates on December 31, 2009. The Secretary may extend that authority to no later than October 3, 2010, upon certification of necessity to Congress. The Treasury’s authority to hold any troubled asset purchased under the TARP before the termination date, or to purchase or fund the purchase of a troubled asset under a commitment entered into before the termination date, is not subject to this sunset provision.
- **Recouping of Taxpayer Losses.** EESA provides that if, in five years’ time, the TARP has generated a shortfall, the President is to submit proposed legislation to Congress to recoup amounts from the financial industry generally in order to avoid adding to the deficit or the national debt.
- **Foreclosure Mitigation.** EESA requires the Secretary, in connection with the mortgages, mortgage-backed securities and other assets secured by residential real estate, including multifamily housing, that the Treasury acquires under the TARP, to implement a plan to mitigate foreclosures and to encourage servicers of mortgages to modify loans through the Hope for Homeowners Program and other programs. The Secretary is authorized to use loan guarantees and credit enhancements to prevent avoidable foreclosures. EESA also contains other provisions, including tax relief for homeowners with forgiven mortgage debt and enhancements to the Hope for Homeowners Program to increase eligibility and improve available tools, intended to protect homeowners threatened with foreclosure.
- **Suspension of Fair Value Accounting.** EESA restates the authority of the SEC under the federal securities laws to suspend the application of the mark-to-market accounting standards in Statement Number 157 (“FAS 157”) of the Financial Accounting Standards Board (Fair Value Measurements) for any issuer or with respect to any class or category of transaction if the SEC determines that it

is necessary or appropriate in the public interest and is consistent with the protection of investors. EESA also directs the SEC to study the mark-to-market accounting standards applicable to financial institutions, including (among other things) the effects of those standards on financial institutions' balance sheets and their impact on bank failures and to report its findings to Congress within 90 days.

- **Other Studies and Reports Required.** Among the various reports called for by EESA, the Secretary is directed to submit a report to Congress by April 30, 2009, analyzing the current state of the regulatory system for US financial markets and its effectiveness in overseeing participants in the financial markets, including the over-the-counter swaps market and government-sponsored enterprises and providing recommendations for improvement. Those recommendations must cover whether there are participants in the financial markets that are not currently regulated but that should be, and enhancement of the clearing and settlement of over-the-counter swaps. Additionally, EESA directs the Comptroller General to undertake a study and to submit a report on margin authority to Congress by June 1, 2009, regarding the extent to which leverage and sudden deleveraging of financial institutions was a factor behind the current financial crisis.
- **Temporary Increase in Deposit Insurance Coverage.** In one of the most significant changes between the version of the legislation rejected by the House of Representatives and the final version of EESA, a new provision was added to raise the FDIC deposit insurance limit from US\$100,000 to US\$250,000 per account until December 31, 2009. EESA also now provides for the same temporary increase for the National Credit Union Share Insurance Fund and temporarily removes the limits on the borrowing authority of the FDIC and the National Credit Union Administration Board at the Treasury.
- **Interest on Bank Reserves.** EESA accelerates the authority of the Federal Reserve to pay interest on reserves held by depository institutions at Federal Reserve Banks, as added by the Financial Services Regulatory Relief Act of 2006, from October 1, 2011 to October 1, 2008.

- **Tax Relief for Banking Organizations that Sell GSE Preferred Stock.** Depository institutions and their companies that held and then sold or exchanged Fannie Mae and Freddie Mac preferred stock within a specified time period are permitted to treat the gain or loss as ordinary income or loss, instead of capital gain or loss, in order to allow losses suffered in connection with the federal bailout of the government-sponsored enterprises to be used to offset ordinary income for tax purposes.

Issues for Financial Institutions and Other Holders of Troubled Assets

EESA contains vastly more detail as to the manner in which the TARP is to function in comparison to the original Treasury proposal from mid-September, which was remarkable for the extent to which the specifics of a US\$700 billion government program were left completely to the discretion of the Secretary. Nonetheless, EESA leaves unanswered a great number of questions as to how the TARP and the related troubled asset insurance program will function and requires the Secretary to promulgate a number of guidelines and regulations in order to carry out EESA's directives. The following is a brief introduction to some of the issues for which additional clarification or guidance will be needed by financial institutions and other entities that hold troubled assets and are considering whether or how to participate in these programs.

Financial Institution Eligibility to Participate

EESA's definition of "financial institution" as any institution "established and regulated" under the laws of the United States should allow US branches and agencies of foreign banks to participate in the TARP and the troubled asset insurance program, although the issue is not entirely free from doubt. Moreover, the import of EESA's additional requirement that the financial institution seeking to participate have "significant operations" in the United States is also unclear—e.g., would that requirement apply to the foreign bank's US operations as a whole, or would the particular US branch or agency seeking to participate in the TARP

or the insurance program have to meet a minimum size requirement? Similarly, the inclusion of the phrase “including, but not limited to” in the definition of “financial institution” should allow for the inclusion of nonbank affiliates of domestic and foreign banks, such as consumer or commercial finance companies, as they are subject to supervision by the Federal Reserve Board under the Bank Holding Company Act. Similar arguments may be available to other types of financial institutions, although significant uncertainty remains.

For a foreign financial institution that is owned by a governmental unit of its home country other than the central government, or that is only partially owned by the home country government, there is a question as to whether the financial institution would be covered by the exclusion from EESA’s definition of “financial institution” for an institution “owned by...a foreign government.” Another type of entity that Congress was reported to have wanted to exclude from participation in the programs—a hedge fund—is not explicitly mentioned in EESA, and presumably the exclusion of hedge funds from the definition of “financial institution” is based upon their unregulated status (i.e., they would not meet the statutory criterion of being established and regulated under US law). The open-ended nature of that statutory definition also leaves open the possibility that a range of entities not mentioned in the nonexclusive list set forth in the definition (“any bank, savings association, credit union, security broker or dealer, or insurance company”) may also be eligible to participate.

Resales by a US branch or agency of a foreign bank of troubled assets held by the foreign bank’s head office or other non-US office (including, e.g., a Cayman branch) reportedly would not be covered by the TARP, although it might be helpful in this regard if the assets had been originated by the US branch or agency. If such resales are not covered, however, how would that position be squared with EESA’s apparent lack of any specified holding period for financial institutions seeking to sell troubled assets, which would seemingly allow a participating financial institution to sell troubled assets to the Treasury that were purchased from an excluded holder of such assets? A related question involving excluded holders of

troubled assets, such as hedge funds: although it should be possible for a participating financial institution to structure a swap or other over-the-counter derivative transaction with an excluded holder to allow such party to receive at least some of the benefits of participating in the TARP, will the Treasury require participating financial institutions to represent and warrant that they are not doing so and not otherwise acting with or on behalf of excluded holders, as a condition to the Treasury agreeing to purchase the institution’s troubled assets?

Financial institutions, financial industry trade associations and other holders of troubled assets may wish to consider submitting their views to the Treasury regarding some of these issues and other issues of these types, as well as regarding the standards for determining an institution’s “long-term viability” (which must be taken into consideration by the Secretary in connection with direct purchase transactions from individual financial institutions), in order for those views to be taken into consideration by the Treasury in the adoption of its implementing guidelines and regulations.

Assets Covered by the TARP and the Insurance Program

What makes an asset “troubled” and therefore eligible for sale to the Treasury or for inclusion in the troubled asset insurance program? Although the concept is central to this entire governmental endeavor, all that EESA provides in this regard is that the Secretary must determine that the purchase of the asset would “promote financial market stability.” Presumably the implementing Treasury regulations will provide some guidance on this issue, although there has been little in the way of public pronouncements by Treasury officials to date indicating the approach they are likely to adopt.

Additionally, will there be any significance to the requirement in the definition of “troubled assets” that the asset have been “originated or issued on or before March 14, 2008,” other than to exclude from the TARP’s coverage any mortgages and mortgage-related securities, obligations, or other instruments that may have been originated or issued in recent months in anticipation of being sold to the Treasury under the TARP or that are originated or issued after EESA was enacted into

law? Will the Treasury's implementing regulations seize upon that date to impose a troubled asset holding period, i.e., by requiring that troubled assets have been on the books of a financial institution since March 14, in order to be eligible for purchase or guarantee by the Treasury?

Valuation and Pricing of Troubled Assets

Many of the most significant of the unresolved issues for the TARP relate to the valuation and pricing of troubled assets, particularly in direct purchases from individual financial institutions. As noted above, this is largely left to the discretion of the Secretary and presumably the Treasury's implementing guidelines and regulations will shed some light in this area.

Some of these issues may affect even those financial institutions that do not plan on participating in the TARP. For example, given that prices have been unavailable for many of the troubled assets held by financial institutions, would the price at which the Treasury purchases assets of a particular class and quality become the de facto market price, and would financial institutions retaining comparable assets on their books then be required, under fair value accounting standards, to revalue those assets based upon the Treasury's purchase price?

Equity Participation and Executive Compensation Provisions

For US branches or agencies of foreign banks seeking to participate in the TARP, will the Treasury require that the foreign bank's head office issue warrants for common or preferred stock to the Treasury, or will the Treasury rather accept a senior debt obligation of the US branch or agency participating in the program? Similarly, will the Treasury apply the executive compensation limitations only to the senior executive officers of the US branch or agency participating in the TARP, or will they instead be applied to the senior executive officers of the foreign bank as a whole? If the Treasury were to take the latter approach, how would the tax provisions relating to executive compensation paid by participating financial institutions be applied to

compensation paid by the foreign bank's head office to its top personnel based in the bank's home country?

Additionally, if a financial institution that has participated in the TARP were to be acquired by or merged into an unaffiliated financial institution that had not participated, would EESA's executive compensation limitations then be applicable to the surviving institution? If the Treasury were to take that approach in its implementing regulations or in practice, that could deter financially-sound institutions from acquiring weaker institutions that have had to avail themselves of the TARP.

Another issue for financial institutions to consider regarding EESA's equity participation requirements: if the Treasury requires the issuance of voting stock by a financial institution participating in the TARP, the Treasury is required by statute to agree not to exercise voting rights; however, if the Treasury then sells that voting stock to a third party, as it is authorized to do under EESA, presumably the transferee would be entitled to exercise those voting rights.

Troubled Asset Insurance Program

EESA's equity participation requirements and executive compensation limitations represent, and no doubt were intended by Congress to represent, a substantial price to be paid by financial institutions for participating in the TARP. Those statutory provisions appear not to apply, however, to financial institutions participating only in the troubled asset insurance program, under which the Treasury would guarantee the timely payment of principal and interest on troubled assets, thereby allowing the participating financial institution to revalue those assets at par value. Financial institutions holding substantial amounts of troubled assets will have to weigh the financial and other costs of the equity participation and executive compensation requirements for participation in the TARP against the cost of the risk-based premiums to be charged by the Treasury for the insurance program in order to determine which program is most desirable.

Market Transparency

As noted above in the summary of EESA, the Secretary is required to post online a description of the types, amounts and pricing of assets acquired under the TARP within two business days of purchase, trade or other disposition. It is possible that these disclosures will also reveal the identity of the financial institution from which the troubled assets were purchased. If the Treasury takes that approach in its disclosures, the attendant stigma for the selling financial institutions would represent yet another cost of participating in the TARP and may deter some institutions from participating.

Adequacy of Public Disclosures by Financial Institutions

As noted in the summary of EESA above, the Secretary is required to determine whether the public disclosure by a financial institution participating in the TARP relating to off-balance sheet transactions, derivatives instruments, contingent liabilities and “similar sources of potential exposure” is adequate to inform the public of the true financial condition of the financial institution; if the Secretary determines that it is inadequate, he is directed to make recommendations for additional disclosure requirements to the federal financial institution regulatory authorities. The adoption of any such additional disclosure requirements could expose the financial institution, under the disclosure requirements and standards of the federal securities laws, to claims relating to inadequate disclosure of complicated derivatives, contingent liabilities or off-balance sheet structures. Financial institutions weighing the costs and benefits of participating in the TARP should include in their evaluation a careful consideration of these disclosure issues and their current disclosure practices.

Fair Value Accounting

Any action by the SEC to suspend the application of fair value accounting would create new financial reporting complications and considerations for financial institutions that would have to be analyzed in detail. White & Case will be posting a new

client alert in the near future with recommendations for companies under the new mark-to-market FAS 157 accounting guidance under EESA and the recent clarifications by the SEC and Financial Accounting Standards Board.

Additionally, financial institutions may wish to consider submitting their views to the SEC on the issue of the application of the mark-to-market accounting standards as applicable to financial institutions and the effects of those accounting standards on financial institutions’ balance sheets and their impact on bank failures, in connection with the report on that topic that the SEC is required to submit to Congress by early January, 2009.

Other Studies and Reports Required

As discussed above, the Secretary is directed to submit a report to Congress by April 30, 2009, analyzing the current state of the regulatory system for US financial markets and its effectiveness in overseeing participants in the financial markets, including the over-the-counter swaps market and government-sponsored enterprises, and providing recommendations for improvement. Those recommendations are to cover whether there are participants in the financial markets that are not currently regulated but that should be, and enhancement of the clearing and settlement of over-the-counter swaps. Financial institutions and other financial markets participants, particularly active participants in the over-the-counter derivatives markets and unregulated entities such as hedge funds, may wish to consider submitting their views to the Secretary on these issues.

Additionally, EESA directs the Comptroller General to undertake a study and to submit a report on margin authority to Congress by June 1, 2009, regarding the extent to which leverage and sudden deleveraging of financial institutions was a factor behind the current financial crisis. Securities firms and other financial institutions may wish to consider submitting their views to the Comptroller General on these issues.

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