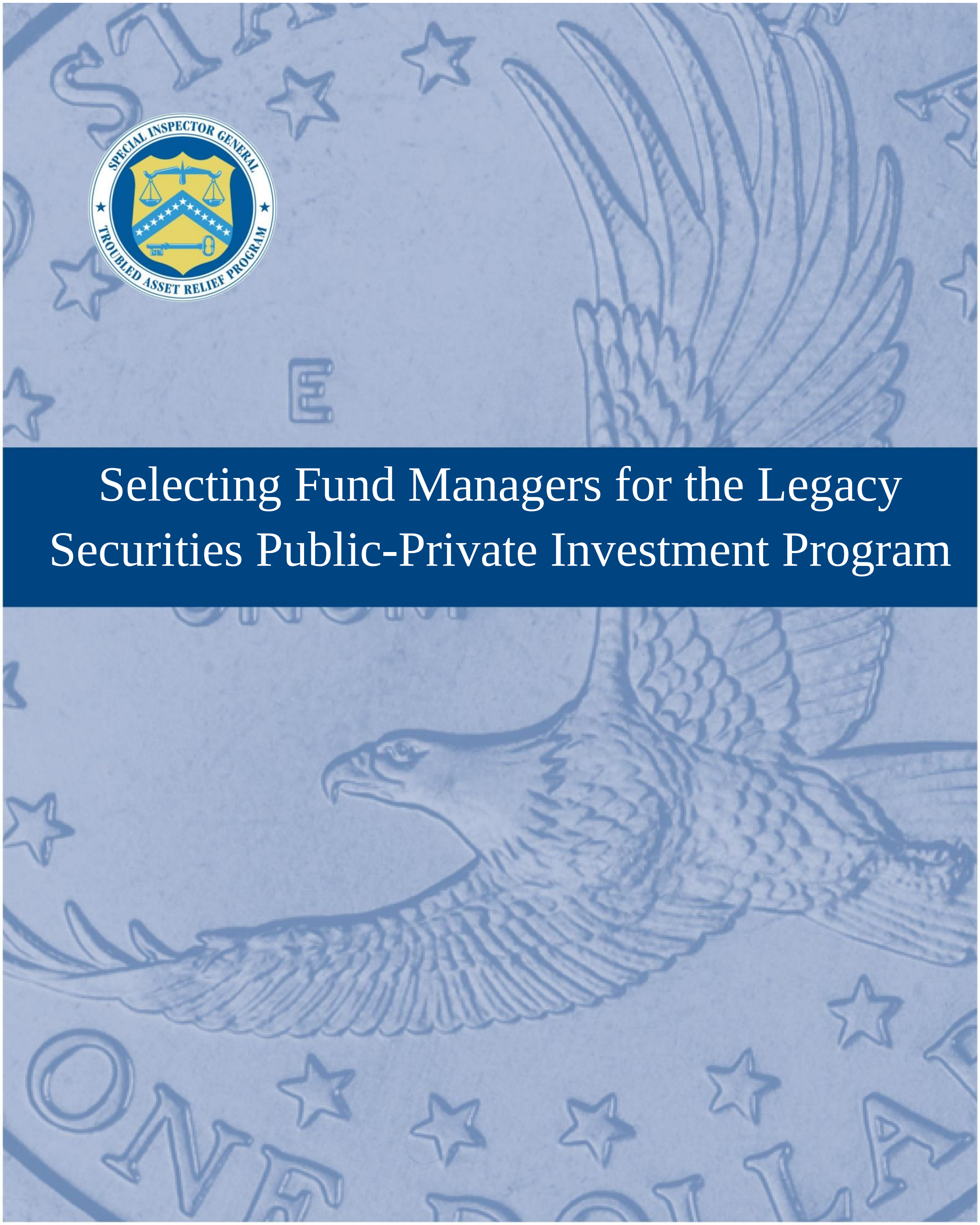

Selecting Fund Managers for the Legacy Securities Public-Private Investment Program

Special Inspector General for the Troubled Asset Relief Program

SIGTARP-11-001

October 7, 2010

SIGTARP

Office of the Special Inspector General for the Troubled Asset Relief Program

Summary of Report: SIGTARP-11-001

Why SIGTARP Did This Study

The Emergency Economic Stabilization Act ("EESA") of 2008 created the Troubled Asset Relief Program ("TARP") and provided the Secretary of the Treasury with authority to take actions to restore liquidity and stability to the U.S. financial system. The Department of Treasury ("Treasury") created the Legacy Securities Public-Private Investment Program ("PPIP") to increase liquidity by purchasing unmarketable securities clogging the books of financial institutions.

The Chairman and Ranking Member of the Subcommittee on Contracting Oversight, Senate Committee on Homeland Security and Governmental Affairs, requested that SIGTARP review Treasury's selection of fund managers for PPIP. This study complements another planned SIGTARP audit that examines PPIP fund managers' compliance programs to prevent fraud, waste, and abuse in executing the program. SIGTARP's reporting objectives for this audit were to determine:

- what criteria Treasury used to select the fund managers and their minority partners;
- whether Treasury consistently applied its criteria in the selection of the fund managers;
- the extent that Treasury performed due diligence reviews on the fund managers and their minority partners; and
- whether financial agreements between Treasury and the successful fund manager applicants were governed by the Federal Acquisition Regulation.

In addition to the information presented in this report, SIGTARP has begun a separate audit to determine whether Treasury has established operational controls to prevent or mitigate conflicts of interest.

In commenting on a draft of this report, Treasury describes the audit's summary of the fund manager selection process as informative and likely to be helpful in explaining that process to the public. Treasury also stated that it strongly disagrees with a number of the statements and conclusions regarding certain details of the fund manager selection process, but provided no detail on what its objections are. Given that Treasury had no material factual objections to the draft audit report, SIGTARP awaits a more detailed description of Treasury's objections. A more complete description of Treasury's response is included in the *Management Comments and Audit Response* section of this report.

October 7, 2010

Selecting Fund Managers for the Legacy Securities Public-Private Investment Program

What SIGTARP Found

The Public-Private Investment Program ("PPIP") is designed to marry private capital with TARP funding to create individual investment funds, known as Public-Private Investment Funds ("PPIFs") that would purchase certain mortgage-backed securities. According to Treasury, the program was intended to "restart the market for legacy securities."

SIGTARP found that Treasury constructed a reasonable architecture to accomplish its objective of identifying larger firms to manage PPIFs. It hired a law firm to assist in designing the application and establishing the selection criteria. In reviewing 141 applications, it received assistance from other Government agencies and from an independent advisor with expertise in evaluating complex investments. Treasury conducted a multi-stage evaluation process, with each stage reducing the number of applicants moving to the next stage, and performed due diligence reviews. It also adequately documented the selection process. Treasury determined, and SIGTARP agrees, that the legal structure of PPIP did not require it to use the Federal Acquisition Regulation in selecting fund managers.

While the selection process ultimately succeeded in creating nine privately managed funds with the means to purchase almost $30 billion in distressed assets, several aspects of the process are noteworthy:

- Treasury' published selection criteria created confusion and uncertainty among applicants. While Treasury published five criteria, it did not state how many of these criteria applicants were required to meet, or make clear how applicants could demonstrate that they met the criteria.
- While Treasury refined its criteria during the selection process, its public statements did not eliminate applicant confusion and its undisclosed change impaired the transparency of the process.
- Treasury's published selection criterion that fund managers have at least $10 billion in assets under management risked unnecessarily discouraging applications from smaller asset managers that might have had significant expertise. The eventual size of PPIP and the fact that two-thirds of the selected managers failed to meet the threshold suggest that it was unnecessary.
- Treasury gave an advantage to larger applicants with respect to the requirement that applicants demonstrate a capacity to raise $500 million in private capital. Of 13 applications that failed to make a statement on whether or not they would be able to raise the capital, Treasury passed the 10 that referenced $7.5 billion or more in total assets under management and rejected the three that referenced between $1 billion and $3 billion in assets. After the application process was completed, Treasury waived the $500 million threshold for the two PPIF managers that could not meet it, putting into question the significance of a criterion that more than half of the applicants were deemed not to have met.

In sum, while Treasury designed and adequately documented a reasonable selection process, the implementation of that process is vulnerable to criticism. First, the initial selection criteria created confusion among applicants, the subsequent clarification failed to remedy that confusion and was arguably misleading, and an undisclosed modification impaired transparency. Second, the emphasis on the size of potential fund managers, while perhaps understandable, not only threatened to discourage qualified applicants from applying but also, given the selections ultimately made, may have been unnecessary. As a result, the taxpayer may have lost the benefit of the participation of qualified, albeit smaller, fund managers because they were avoidably deterred from applying or unnecessarily rejected.

Finally, Treasury encouraged the applicants to form partnerships with small, veteran-, minority-and woman-owned private asset managers, which resulted in the inclusion of one or more minority-owned businesses in eight of the nine selected fund managers. But without guidance from Treasury on either the nature or the extent of the expected role of a minority partner, applicants were left to their own interpretation, which resulted in the minority-owned businesses largely participating to raise capital, with only two actually involved in managing assets, and one firm that appears to provide no assistance whatsoever.

OFFICE OF THE SPECIAL INSPECTOR GENERAL
FOR THE TROUBLED ASSET RELIEF PROGRAM
1801 L STREET, NW
WASHINGTON, D.C. 20220

OCT 7 2010

MEMORANDUM FOR: The Honorable Timothy M. Geithner, Secretary of the Treasury

SUBJECT: Selecting Fund Managers for the Legacy Securities Public-Private Investment Program (SIGTARP-11-001)

We are providing this audit report for your information and use. It discusses the Public-Private Investment Program, the selection of fund managers and minority partners for the program, due diligence performed on the fund managers, and the application of the Federal Acquisition Regulation to the fund manager agreements. The Office of the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP") conducted this audit under the authority of Public Law 110-343, as amended, which also incorporates the duties and responsibilities of inspectors general of the Inspector General Act of 1978, as amended.

We considered comments from the Department of the Treasury when preparing the final report. The comments are addressed in the report, where applicable, and a copy of Treasury's response to the audit is included in the Management Comments Appendix C of this report.

We appreciate the courtesies extended to the staff. For additional information on this report, please contact Mr. Kurt Hyde (kurt.hyde@do.treas.gov, or at 202-622-4633) or Mr. Clayton Boyce (clayton.boyce@do.treas.gov, or at 202-622-9257).

Neil M. Barofsky
Special Inspector General
for the Troubled Asset Relief Program

Table of Contents

Selecting Fund Managers for the Legacy Securities Public-Private Investment Program

SIGTARP 11-001 **October 7, 2010**

Introduction

The Emergency Economic Stabilization Act of 2008 ("EESA") created the Troubled Asset Relief Program ("TARP") and authorized the Secretary of the Treasury to purchase troubled assets from financial institutions[1] in an attempt to restore liquidity and stability to the financial system. Among many efforts to achieve this end, the Department of the Treasury ("Treasury") launched the Public-Private Investment Program ("PPIP") on March 23, 2009. Under PPIP, Treasury matches private capital with TARP funds, and provides additional secured loans for up to 100% of the combined amount of the private and TARP capital investments. On March 23, 2009, Treasury announced that the program was designed to maximize the impact of each taxpayer dollar, share risks and profits with private-sector participants, and create a mechanism to determine market prices for troubled assets held by banks. According to Treasury, PPIP's aim was to "restart the market for legacy securities, allowing banks and other financial institutions to free up capital and stimulate the extension of new credit."

Treasury conducted a multi-stage review of 141 applications for fund manager positions and pre-qualified nine companies to serve as managers of individual Public-Private Investment Funds ("PPIFs"), contingent on the companies each raising at least $500 million in private capital, among other conditions. Subsequently, Treasury dissolved the partnership with one fund manager and liquidated the fund's assets after the departure of the company's Chief Investment Officer. There are currently eight fund managers operating PPIFs, and the combination of capital from the private sector and Treasury has resulted in $29.4 billion in total purchasing power for PPIP, consisting of $7.35 billion of private capital, $7.35 billion of matching TARP capital, and $14.7 billion in non-recourse TARP loans made to the eight PPIFs. By the terms of their agreements with Treasury, the funds will exist for eight years, but under certain circumstances Treasury can terminate them early or extend them up to two additional years. Senator Claire McCaskill, Chairman of the Homeland Security and Governmental Affairs Committee's Subcommittee on Contracting Oversight, and Senator Robert Bennett, Ranking Member of the Subcommittee, raised concerns about Treasury's selection of fund managers and

[1] 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 the United States or any state, territory, or possession of the United States."

their partners. In a joint letter, Chairman McCaskill and Senator Bennett asked SIGTARP to review a number of issues related to the PPIP. Our reporting objectives were to determine:

- what criteria Treasury used to select the fund managers and their minority partners;
- whether Treasury consistently applied its criteria in the selection of the fund managers;
- the extent that Treasury performed due diligence reviews on the fund managers and their minority partners. In addition to the information presented in this report, SIGTARP has begun a separate audit to determine whether Treasury has established operational controls to prevent or mitigate conflicts of interest; and
- whether financial agreements between Treasury and the successful fund manager applicants were governed by the Federal Acquisition Regulation.

For a discussion of our scope and methodology for this audit, see Appendix A.

Background

In the fall of 2008, the U.S. financial markets were in crisis. The dramatic downturn in the housing market led to an abrupt decline in the price of financial assets associated with housing. The value of mortgage-backed securities, particularly those based on subprime loans, declined precipitously as the housing boom ended and the financial crisis unfolded. As loan delinquencies increased and housing prices decreased, mortgage-backed securities began losing value and financial institutions were left holding "toxic" mortgages and/or securities that were increasingly difficult to value, illiquid, and potentially had little worth. Many investors exited the mortgage-backed securities markets as prices continued to decline or became illiquid, freezing the markets for these assets. The banking system was under severe stress as the rapid decline in valuations of the residential and commercial real estate, along with increasing incidents of defaults on those loans, caused sharp decreases in the values of the loans and the related mortgage-backed securities on banks' balance sheets.

Some institutions found themselves so exposed that they were threatened with failure, and some failed, because they were unable to raise needed capital as the value of their portfolios declined. Testifying before Congress in September 2008, then Secretary of the Treasury Henry M. Paulson Jr. stated that the continued failures of these institutions and frozen credit markets threatened "American families' financial well-being, the viability of businesses both small and large, and the very health of our economy." In response to the continuing and growing economic crisis, the U.S. and other governments sought to implement even more aggressive plans to address the stresses on their financial institutions and the turmoil in the global financial markets. The governments of the United Kingdom, Germany, France, Canada, Ireland, and Sweden either provided liquidity or capital injections to their financial institutions.

On September 20, 2008, the Secretary of the Treasury proposed to Congress that Treasury purchase up to $700 billion of distressed assets as a relief measure. On October 3, 2008, the Emergency Economic Stabilization Act of 2008 created the Troubled Asset Relief Program and authorized Treasury to purchase troubled assets from financial institutions in an attempt to restore liquidity and stability to the financial system. EESA also required Treasury to publish procedures for selecting asset managers for these distressed assets, which Treasury did in early October 2008.

Treasury initially proposed a program to use TARP funds to purchase troubled assets directly from financial institutions. On October 6, 2008, Treasury issued a solicitation inviting investment firms to apply for the job of managing the troubled assets that Treasury would seek to purchase through its new authority, with Bank of New York Mellon acting as a financial agent to purchase the assets. To be considered for an asset manager position, investment firms had to have a minimum of $100 billion in assets under management and a track record of at least ten years of experience managing fixed income assets, among other requirements. After reviewing 108 applications, Treasury noted in an internal memo dated October 29, 2008 that it had decided on six companies.[2] Although Treasury subsequently decided not to implement this program, four of the six selected companies were later selected as PPIF managers.[3]

Former Secretary of the Treasury Paulson and Federal Reserve Chairman Ben S. Bernanke explained to SIGTARP that with conditions continuing to deteriorate in late 2008, there was not enough time to spend months purchasing distressed assets as originally intended. Treasury opted instead to provide TARP capital to ailing financial institutions.[4] On November 12, 2008, Secretary Paulson stated:

> During the 2 weeks that Congress considered the legislation, market conditions worsened considerably. It was clear to me by the time the bill was signed on October 3rd that we needed to act quickly and forcefully, and that purchasing troubled assets – our initial focus – would take time to implement and would not be sufficient given the severity of the problem. In consultation with the Federal Reserve, I determined that the most timely, effective step to improve credit market conditions was to strengthen bank balance sheets quickly through direct purchases of equity in banks.

---

[2] Treasury hired Ennis Knupp & Associates ("Ennis Knupp"), a Chicago-based investment consultant, to act as an independent advisor for this process of selecting asset managers, but Treasury terminated the plan to purchase distressed assets before it was implemented. Ennis Knupp ensured that applications and program documents were submitted in a timely fashion and provided input on applicants based on its own database of information on fixed income asset managers. In March 2009, Treasury issued a task order to its existing contract with Ennis Knupp to have the company assist in the PPIP fund manager selection process. The work conducted by Ennis Knupp is discussed in greater detail later in this report.

[3] According to Treasury, none of the Treasury staff members directly involved in PPIP were involved with the original 2008 solicitation and the PPIP selection process was not based on the documents related to this process, although there are many similar characteristics, such as the requirements for past performance of the fund managers.

[4] For more information on the decision to provide capital infusions and the economic crisis of 2007-2008, see SIGTARP's audit report on "Emergency Capital Injections Provided to Support the Viability of Bank of America, Other Major Banks, and the U.S. Financial System," SIGTARP-10-001, October 5, 2009.

The direct purchase of bank equity to which Secretary Paulson referred was the beginning of Treasury's Capital Purchase Program ("CPP"), which directly infused capital into ailing financial institutions. While the injection of TARP funds helped shore up banks' balance sheets, the market for mortgage-backed securities remained illiquid.

On February 10, 2009, Treasury announced a Financial Stability Plan and established PPIP, which, as announced, would facilitate the purchase of up to $1 trillion in distressed assets through a combination of public and private financing. This was different from the original plan to purchase troubled assets using only TARP funds.[5] According to Treasury, private sector participation was a key aspect of the overall Financial Stability Plan. A Senior Advisor to the Secretary of the Treasury told SIGTARP that in the four months following EESA's passage, Treasury concluded that the private sector needed to have "skin in the game" in order to provide an investor base that would establish a true market value for the distressed assets.

Between February 10, 2009, and the beginning of the PPIP fund manager application process on March 23, 2009, Treasury officials held conversations with private investment firms BlackRock, Inc. ("BlackRock"), Pacific Investment Management Company, LLC ("PIMCO"), and The Trust Company of the West Group, Inc. ("TCW") to seek advice on the structure of the planned program that would later be called the Legacy Securities Program.[6] Treasury told SIGTARP that it consulted the companies on the market feasibility of different proposed structures for the Legacy Securities Program, including the size of the program and the amount of capital that could feasibly be raised from the private sector for such an effort, and the relative impact of differently sized programs on illiquid securities markets. Treasury officials told SIGTARP that it contacted these three firms because each had successfully developed distressed asset funds and raised private capital for their own investors similar to the funds Treasury envisioned for PPIP.[7] Treasury did not document its communications with the three firms.

On March 23, 2009, Treasury announced the details of the Legacy Securities PPIP and posted an application form for potential fund managers on its website. Treasury's announcement stated that "By providing the financing the private markets cannot now provide, this will help start a market for the real estate-related assets that are at the center of this crisis. Our objective is to use private capital and private asset managers to help provide a market mechanism for valuing the assets."

---

[5] For the purposes of PPIP, eligible assets are residential and commercial mortgage-backed securities secured directly by actual mortgages, leases, or other assets, and not other securities that were issued before January 1, 2009, and originally rated AAA (or an equivalent rating) by two or more nationally recognized statistical rating organizations.

[6] Treasury originally intended PPIP to purchase both legacy securities and legacy loans from financial institutions; however, it did not implement the legacy loan part of the program. This report focuses on the Legacy Securities part of PPIP and uses the terms PPIP and Legacy Securities Program interchangeably.

[7] All three firms that Treasury consulted in the program design made it to the Finalist Stage (as discussed later in this report) of the PPIP fund manager selection process, with two of them, BlackRock and TCW, being selected and the third, PIMCO, withdrawing its application.

Under the Legacy Securities Program, Treasury would match private capital with TARP funds, and would provide additional non-recourse[8] secured loans for up to 100% of the combined amount of private and TARP capital investment. In other words, for every dollar in private capital raised, TARP would provide $1 in additional capital and up to $2 in debt financing. In its solicitation, Treasury noted that it expected each fund manager to raise at least $500 million in private funds, and to meet other conditions, including governance and fund management requirements. The funds would be used to purchase eligible assets from financial institutions, which were defined as certain residential mortgage-backed securities ("RMBS") and commercial mortgage-backed securities ("CMBS"). For the purposes of PPIP, eligible assets:

- are issued before January 1, 2009 (legacy);
- bear an original AAA rating, or equivalent, from two or more credit rating agencies designated as nationally recognized statistical rating organizations;
- are secured directly by actual mortgages, leases, or other assets, and not other securities (other than certain swap positions, as determined by Treasury);
- are located primarily in the United States (the loans and other assets securing the non-agency RMBS and CMBS); and
- are purchased from financial institutions eligible for TARP participation.

Treasury's March 23, 2009 PPIP announcement stated that PPIP would use $75 billion to $100 billion of TARP funds, alongside capital from private investors to buy legacy assets. In creating PPIP, Treasury announced that the program was intended to:

- maximize the impact of each taxpayer dollar,
- share risks and profits with private-sector participants, and
- create a mechanism to determine market prices for troubled assets held by banks or financial institutions.

According to Treasury, "the investment objective of PPIP is to generate attractive returns for taxpayers and private investors through long-term" investments. Each PPIF has a three-year investment period to use the combined government and private funds to invest and trade in eligible assets on behalf of its private and Government investors. After three years the fund managers may sell the securities or hold them for an additional five years, with the possibility of up to two years of extensions, unless the PPIF is dissolved at an earlier date. Treasury officials told SIGTARP that the "long-term buy and hold strategy" would promote greater stability in the market for commercial and non-agency residential mortgage-backed securities.

[8] Non-recourse indebtedness is generally a type of loan that is secured by collateral but, if the borrower defaults, the lender may only foreclose on the collateral for purposes of repayment and cannot turn to the borrower for any further repayment, even if the value of the collateral does not cover the full value of the defaulted amount.

Treasury received 141 fund manager applications and conducted a multi-stage evaluation of them, whittling down the number of applicants in each successive stage. On July 8, 2009, Treasury pre-qualified the following nine companies to become fund managers, subject to, among other conditions, the ability of each firm to raise $500 million in private capital.

1. AllianceBernstein, L.P. and its sub-advisors Greenfield Partners, LLC and Rialto Capital Management, LLC (“AllianceBernstein”);
2. Angelo, Gordon & Co., L.P. and GE Capital Real Estate; (“Angelo, Gordon/ GE Capital”);
3. BlackRock, Inc. (“BlackRock”);
4. Invesco Ltd. (“Invesco”);
5. Marathon Asset Management, L.P. (“Marathon”);
6. Oaktree Capital Management, L.P. (“Oaktree”);
7. The Trust Company of the West Group, Inc. (“TCW”);
8. Wellington Management Company, LLP (“Wellington”) ; and
9. RLJ Western Asset Management L.P. (“RLJ Western Asset”).[9]

[9] RLJ Western Asset Management L.P. is an entity formed as a joint venture between the RLJ Companies LLC and Western Asset Management Company.

Selecting Fund Managers

This section describes the creation of the PPIP fund manager application, the criteria used to evaluate the applications, how the submitted applications were reviewed, and how firms were selected or rejected.

Between the announcement of the Financial Stability Plan on February 10, 2009, and the formal announcement of the application process for PPIP fund managers on March 23, 2009, Treasury, with the assistance of its external counsel, Simpson Thacher & Bartlett LLP ("Simpson Thacher"),[10] designed the PPIP fund manager application and established the selection criteria. While separate processes, the application and criteria had similarities to the solicitation that Treasury published in October 2008, when it was initially considering the direct purchase of distressed assets. Both solicitations required applicants to provide, among other items, information on their organizational structure, staffing, fund management personnel, total assets under management, past performance in managing funds, references from customers, performance measures, risk management strategies, planned oversight of the fund, and descriptions of real or potential conflicts of interest. Treasury ultimately approved the application's design and the initial selection criteria, and published the PPIP application on its web site on March 23, 2009.

Treasury's PPIP application stated that fund managers would be pre-qualified based upon core criteria "anticipated" to include:

- Demonstrated capacity to raise at least $500 million of private capital;
- Demonstrated experience investing in eligible assets, including performance track records;
- A minimum of $10 billion (market value) of eligible assets currently under management;
- Demonstrated operational capacity to manage the funds in a manner consistent with Treasury's stated investment objective while also protecting taxpayers; and
- Headquarters in the United States.

According to a Treasury official, the asset and capital amounts in the stated criteria were "ballpark" figures that would demonstrate that an applicant had significant experience in raising capital and with managing the assets that would be purchased under PPIP. The PPIP application, at the time of its release, did not state how many of these criteria had to be met or how applicants could demonstrate that they met the criteria. Some applicants told SIGTARP that they found these criteria to be vague or excessive, and that they sent emails to Treasury commenting on the

[10] Simpson Thacher states that it has extensive experience providing legal advice on financial services. On February 20, 2009, Treasury hired Simpson Thacher to assist in constructing the PPIP fund manager application and subsequently conducting legal due diligence on the pre-qualified fund managers.

application's requirements or requesting clarification. For example, a number of potential applicants raised concerns regarding the requirement that they have a minimum of $10 billion in "eligible assets" under management, particularly given the distressed state of the eligible asset markets. These emails included such comments as:

- "After spending a fair amount of time reviewing your application, we determined that we would not qualify to meet the criteria of "a minimum of $10 billion (market value) of Eligible Assets currently under management" [however,] we feel that we have an expertise in managing CMBS and RMBS. We respect the time of the Treasury and we do not want to submit an application if we fall short of this minimum criteria yet we feel strongly that we could be a valuable manager in this program. Would you recommend we fill this application out even though we do not meet the minimum $10 billion threshold?"

- "Could you please provide some indication as to whether the AUM [Assets Under Management] and performance track record relate solely to Eligible Assets or if Treasury would accept a manager with similar asset types … or assets that consist of securities backed by RMBS (Residential Mortgage-Backed Securities) or CMBS (Commercial Mortgage-Backed Securities), such as CDOs (Collateralized Debt Obligations) for purposes of being pre-approved. Also, if a potential fund manager manages less than $10 billion of Eligible Assets, is there any chance that those fund managers would be considered?"

One finalist with less than the required amount of eligible assets under management told SIGTARP that the application was vague. The applicant had "a suspicion that the program was oriented towards two to three large asset management firms" because of the requirement to have $10 billion in eligible assets under management. A fund manager official told SIGTARP that the $10 billion in eligible assets criterion was a "mistake" because, in his opinion, companies of that size had caused the economic crisis in the first place. Ennis Knupp, the contractor Treasury hired to assist it in reviewing the applications, also considered the $10 billion requirement to be an "onerous hurdle to clear." It told SIGTARP that based on its experience as an investment consultant and on the email comments that Treasury received, only a limited number of applicants could meet this threshold.[11] Ultimately, six of the nine selected fund managers did not meet the $10 billion eligible asset threshold.

Treasury officials acknowledged that its selection criteria favored larger asset managers, but explained that they sought managers who had a capacity to raise sizeable amounts of equity from investors, a demonstrated track record of managing distressed assets of a type targeted by the program, and a degree of organizational stability. They added that when they announced the program they had originally planned to select approximately five large fund managers. The original application deadline was April 10, 2009, but by April 6, 2009, Treasury had received

[11] Some of the inquiries expressing concerns about the $10 billion requirement came from firms that ultimately did not apply.

only four applications, two of which were determined to be incomplete and were rejected during the initial stage of review. The other two applications were changed and resubmitted prior to the deadline, and were rejected by Treasury during subsequent stages in the review process. On that same day, Treasury published in its Frequently Asked Questions ("FAQs") that it would review the applications received based on the criteria outlined above and that more than five fund managers may be selected depending on the number of qualified applications it received. Treasury eventually selected nine fund managers.

Treasury also conveyed to applicants in its FAQs that the five criteria would be evaluated with a "holistic" approach in which "failure to meet any one criteria will not necessarily disqualify a proposal." Treasury officials told SIGTARP that as the criteria were inter-related, they allowed applicants to proceed through the selection process on the "holistic" assessment of their abilities rather than the ability to fail or meet a single criterion. The officials added that the fact that some of the applicants were allowed to proceed and were eventually pre-qualified without meeting all five criteria demonstrated Treasury's "holistic" assessment of each application.

In the April 6, 2009 FAQs Treasury also extended the application submission deadline to April 24, 2009. Treasury received a total of 141 fund manager applications by the April 24, 2009, deadline.

Reviewing the Applications

On April 24, 2009, Treasury established a seven-person PPIP Evaluation Committee ("Evaluation Committee") — five voting members and two non-voting members[12] — to review the 141 applications it received from prospective fund managers and make a recommendation to the TARP Investment Committee, which had ultimate authority to approve pre-qualification of a fund manager.[13] On the same day, the Evaluation Committee issued a Legacy Securities Program internal memorandum detailing the stages of the evaluation process to review the applications and a timeline for completing the selection process. Treasury also engaged Ennis Knupp to assist in the review process.

Throughout the fund manager selection process, the Evaluation Committee thoroughly documented its decisions to select or reject applicants in Stage memoranda. The Evaluation Committee conducted a multi-stage evaluation of the 141 fund manager applications, with each

---

[12] The two nonvoting members were Treasury legal and compliance employees. The voting members included three Treasury employees, one employee of the Export-Import Bank and one employee of the Overseas Private Investment Corporation ("OPIC"). OPIC is an agency of the U.S. government that helps U.S. businesses invest overseas, fosters economic development in new and emerging markets, and complements the private sector in managing risks associated with foreign direct investment. According to Treasury, none of the members of the Evaluation Committee or the TARP Investment Committee was involved in earlier discussions with PIMCO, BlackRock and TCW or involved in the design of the Legacy Securities Program before the release of the application.

[13] The TARP Investment Committee includes Treasury's Chief Investment Officer for the TARP, who chairs the committee, as well as top officials on financial markets, economic policy, financial institutions, and financial stability.

stage reducing the number of applicants moving to the next stage. In Stage 1, the Evaluation Committee removed 37 applications that were "duplicates"[14] or were found to be "non-responsive."[15] In Stage 2, the Evaluation Committee excluded 58 of the remaining 104 applicants because they did not meet two or more of the five selection criteria. For Stage 3, the 46 remaining applicants were evaluated "based on relative attractiveness of their applications, based on the five categories of criteria" and placed into one of three tiers. The Evaluation Committee selected 19 of those 46 applicants for the Finalist Stage review.

In the Finalist Stage review, the Evaluation Committee evaluated the 19 remaining applicants against each other in terms of their ability to best fulfill PPIP's investment objectives, which included restoring liquidity and establishing fair market prices for the eligible assets. Throughout the process, the Evaluation Committee and Ennis Knupp reviewed and analyzed the applications and prepared documentation supporting the decisions to select or reject applicants. Following the selection stages, Treasury, Ennis Knupp, and Simpson Thacher conducted due diligence reviews of each of the nine remaining fund managers and their minority partners. These reviews are discussed in the section below on "Due Diligence on Pre-Qualified Fund Managers." Ultimately, Treasury selected nine companies from the 19 remaining applicants to become fund managers, subject to a number of conditions, including that they each raise $500 million in private capital. See Appendix B for an illustration of the stages and timeline for the fund manager selection process. The results of each stage are discussed in more detail below.

Stage 1

Treasury's Legacy Securities Program evaluation process memorandum stated that the purpose of this stage was to identify and exclude applications that were non-responsive or were duplicates, as defined by the Evaluation Committee.[16] On May 1, 2009, the Evaluation Committee completed its Stage 1 review of the 141 fund manager applications and rejected 18 applications as being duplicates and 19 as being non-responsive. For example, over half of the applications that were deemed non-responsive did not contain answers to questions on assets under management, past performance, limited partner references and questions that focused on the applicants' proposed fund structure and investment strategy. The Evaluation Committee accepted 104 applications to move on to the Stage 2 review.

As part of this audit, SIGTARP independently reviewed all 141 applications for non-responsive and duplicate submissions. Following the independent review of these applications, SIGTARP compared its list of non-responsive submissions and notes with Treasury's list to determine if there were discrepancies. Discrepancies were resolved through subsequent SIGTARP meetings

---

[14] A "duplicate" is a submitted application that is the same or very similar to another application from the same applicant. Treasury accepted the duplicate application with the latest date stamp, unless the applicant withdrew its application prior to the submission deadline.

[15] The Evaluation Committee defined "non-responsive" as an application that (1) did not include required information related to the five core criteria by the Evaluation Committee, or (2) was not submitted by the deadline date. Applicants were not allowed to re-submit or remediate their applications subsequent to the deadline date.

[16] In some instances, companies submitted applications in both hard and electronic copies; however, only the latest application received was reviewed by the Evaluation Committee and Ennis Knupp.

with Treasury. SIGTARP confirmed that the 18 applications that Treasury classified as duplicate were submitted at least twice and the 19 non-responsive applications did not contain answers for key information required by Treasury. SIGTARP was satisfied that the remaining 104 submitted applications met the requirements for this stage.

Stage 2

Treasury's Legacy Securities Program evaluation process memorandum stated that in this stage, the Evaluation Committee's aim was to "identify applicants that should be excluded based on a "holistic" review of the criteria." The criteria established in the application and considered in this stage were:

1. Demonstrated capacity to raise at least $500 million of private capital.
2. Demonstrated experience and a performance track record investing in eligible assets.
3. A minimum of $10 billion (market value) of eligible assets under management.
4. Demonstrated operational capacity to manage the funds in a manner consistent with Treasury's stated Investment Objectives while also protecting taxpayers.
5. Headquartered in the United States.

Treasury did not use the term "holistic" in the application forms but rather in responses to FAQs posted on Treasury's website on April 6, 2009. Treasury stated in the FAQs that "These criteria will be viewed on a "holistic" basis and it is anticipated that failure to meet any one (1) [of the above criteria] will not necessarily disqualify [an application]." However, the Evaluation Committee's internal memorandum detailing the stages of the evaluation process stated that "failure to meet any two (2) of the five (5) eligibility criteria shall disqualify an application." Treasury did not disclose this fact to any applicant or the public.

The Evaluation Committee's internal memorandum on Stage 2 provided additional grading guidelines for the evaluators to assign passing grades for each of the five criteria. These guidelines were also not disclosed to the applicants. The grading guidelines stated:

- **Criteria 1 —** Demonstrated capacity to raise at least $500 million of private capital.
  - Applicant must demonstrate ability to timely raise $500 million either through fundraising track record or a proposed plan.
  - Applicant cannot state it will be unable to raise $500 million.[17]
- **Criteria 2** — Demonstrated experience investing in eligible assets, including through performance track records.

[17] This was a new guideline that the Evaluation Committee, in conjunction with discussions with Ennis Knupp, used to evaluate and implement Criteria 1.

- Applicant must provide specific examples of relevant experience investing in a substantial amount[18] of eligible assets (e.g., track record, description of prior investment experience, investment process, etc.).

- **Criteria 3** — A minimum of $10 billion (market value) of eligible assets (as defined in the fund manager application) under management.
  - Applicant must provide evidence of meeting this minimum threshold (e.g., by stating the value of eligible assets in the application).
- **Criteria 4** — A demonstrated operational capacity to manage the funds in a manner consistent with Treasury's stated investment objective while also protecting taxpayers.
  - Applicant must have a total of at least $1 billion of assets under management, including but not limited to eligible assets.[19]
  - Applicant must describe its organization with respect to risk management, compliance and investment strategy consistent with eligible assets and/or Treasury's stated investment objective.
- **Criteria 5** — Headquartered in the United States.
  - Applicant must be established, licensed, and maintain a presence in the United States. However, applicants' ultimate parent company need not be headquartered in the United States.

Although Treasury's application required applicants to provide details on their fundraising track records or credible plans to raise $500 million, in practice it deemed this criteria had been met as long as an applicant did not affirmatively confirm that it would be *unable* to raise a minimum of $500 million. This meant that firms that did not specifically state that they were unable to meet this criterion, as long as they responded to the fundraising criterion, were deemed in compliance and allowed to pass this stage of the selection process, while those that disclosed that they would be unable to raise that sum of money were rejected. For example, one applicant, that stated that it "would endeavour to raise approximately $250 million," passed this criterion.

The Evaluation Committee's Stage 2 memorandum specified that in order to demonstrate operational capacity (criterion 4), an applicant must have at least $1 billion in total assets under management. This was the first mention of the $1 billion total assets requirement; it was not in the application and Treasury did not disclose this criterion to applicants in its published FAQs. Furthermore, the Evaluation Committee deemed that any applicant who failed to meet this criterion would automatically be rejected because it would also not meet the separate criterion of at least $10 billion in eligible assets under management. Thus, all applicants that passed Stage 2 had at least $1 billion in total assets under management and any applicant that failed to meet this threshold was rejected. Evaluation Committee members told SIGTARP that this threshold was

---

[18] The Evaluation Committee did not quantify its term "substantial amount."

[19] This was a new part of criterion that was not listed in the application. Over 40% (43 of 104) of the applicants reviewed in this stage had total assets under management of less than $1 billion.

established because $1 billion was the minimum amount that would be managed if an investment firm were pre-qualified to manage a PPIF (*i.e.*, the sum of $500 million that fund managers are required to raise and $500 million matched by Treasury). Treasury told SIGTARP that in consultation with Ennis Knupp, Treasury determined that there was a significant risk to providing capital that would, at a minimum, double the size of firms that did not have a history of managing this level of capital or raising capital of this magnitude.

For this audit, SIGTARP independently assessed whether each of the 104 applicants that advanced to Stage 2 had met Treasury's five criteria. SIGTARP compared its findings with the Evaluation Committee's Stage 2 results, highlighted any grading discrepancies, and sought clarification from the Evaluation Committee. SIGTARP asked the Evaluation Committee how they evaluated the applicants' responses relative to its selection criteria. Based on SIGTARP's independent review and conversations with the Evaluation Committee, SIGTARP found that the Evaluation Committee's assessment of applications involved considerable subjective judgment. While several of the criteria, such as the amounts of eligible assets under management, could be objectively evaluated, other criteria were not clearly defined. This left members of the Evaluation Committee broad discretion in deciding whether an applicant advanced to the next stage. According to Treasury, it used Ennis Knupp, an expert fund advisor consultant with extensive experience in evaluating fund managers to provide input and advice with respect to rendering these decisions. Treasury added that a decision was made by the five Evaluation Committee members with input from Legal and Compliance members as well as Ennis Knupp.

SIGTARP indentified an area in Stage 2 where Treasury appears to have given an advantage to larger applicants with respect to the requirement that applicants demonstrate an ability to raise $500 million in capital. In practice, Treasury generally deemed applicants that affirmatively stated that they could raise at least $500 million in capital for the PPIF to have passed this criterion, while failing those that affirmatively stated that they would be unable to do so. Thirteen applicants considered in Stage 2 were not covered by this practice because they failed to make a statement on the subject one way or the other. Ten of the 13 applications referenced at least $7.5 billion in assets under management while the other three referenced between $1 billion and $3 billion in assets. [20] In the absence of governing guidance or practice, Treasury deemed the 10 largest applicants to meet this criterion while finding that the three smallest did not. One of these 13 applicants stated in its application that it "has a long history of raising assets within the public marketplace in a timely fashion," but unlike the other 12 applicants, it did not provide any information directly addressing, even generally, its capacity to raise $500 million in private capital. As a result, it appeared more clearly than any of the other 12 to fail Treasury's Criterion 1, both as described in the application and as refined in Treasury's internal Stage 2 guidance. Nonetheless, the Evaluation Committee passed the applicant on this criterion based on its assessment that "the size of the firm and scope of fundraising resources indicate that the applicant has the capacity to raise $500 million in private capital for the PPIP program," even though the Committee noted in its memorandum that the applicant did not specifically state how much capital it could raise. In other words, while the applicant failed to provide information

[20] One of the ten applications that referenced at least $7.5 billion included a proposed partnership between two firms with $1.3 billion and $27 billion in total assets under managements, respectively.

demonstrating its capacity to raise $500 million in private capital, Treasury, on its own, concluded that the applicant had that capacity based chiefly on the applicant's size. Treasury informed SIGTARP that it viewed its passing this applicant on this criterion is an example of its use of the "holistic" assessment approach, where it concluded the applicant warranted further consideration due chiefly to its large size (more than $400 billion in assets under management).[21]

On May 1, 2009, the Evaluation Committee completed its Stage 2 review and approved 46 of 104 applicants to advance to Stage 3. Treasury did not notify the other 58 applicants that they were rejected until December 2009.

Stage 3

In Stage 3, the Evaluation Committee was "to evaluate the remaining applications and segment them into three tiers based on relative attractiveness" of the information provided on the application in response to the criteria listed below:

1. Qualifications and performance history — organizational background, relevant expertise of its personnel, assets under management, expectations for fundraising from private investors, past performance investing eligible assets, references for the three largest limited partners that invested in their funds, custodians for their assets, and their status as a small business, or a business owned by minorities, women or veterans.
2. Fund structure and terms — proposed fund structure, summary of terms of the fund, the extent that they were interested in receiving debt financing from Treasury, proposed fees for managing the fund, and tax consequences for private investors.
3. Investment strategy — asset management strategies[22] and their risk management strategies.[23]
4. Governance and management —
    - Safeguards to ensure that its PPIF would not acquire eligible assets from its affiliates.
    - Conflicts of interest mitigation philosophies.
    - Methods to minimize waste, fraud, and abuse.
    - How they would ensure that its views on the program are aligned with Treasury's.

[21] It should be noted that while Treasury passed this company out of Stage 2, the company was later rejected in Stage 3 because it "did not provide sufficient examples of its experience fundraising."
[22] Asset management strategy is a company's plan for acquiring, monitoring, and disposing of eligible assets to maximize profit.
[23] Risk management strategy is a company's plan for mitigating risks that would negatively affect the value of the assets, including risks caused by interest rate changes, prepayment, leverage, liquidity, pricing, and counterparty and servicer risks.

- Risk oversight.
- Proving that they and their affiliates have paid their taxes and resolved any regulatory and legal actions against them.
- Due diligence processes for assessing potential investors.

5. Valuation, monitoring and reporting — methodologies for determining fair market value of the PPIF's eligible assets, monitoring acquisitions and dispositions of eligible assets, and the format for reporting information to Treasury.

Evaluation Committee members and officials from Ennis Knupp told SIGTARP that the Stage 3 evaluation criteria required more subjective judgments than in Stage 2 because the information evaluated was qualitative rather than quantitative. There were 10 individuals that reviewed parts of each application: five from the Evaluation Committee and five from Ennis Knupp. The Evaluation Committee and Ennis Knupp reviewed the applicant responses to the five categories and assigned one of the following ratings for each criterion:

- **Exceeds —** Response adequately addresses all criteria in category while exhibiting identifiable strengths relative to other applicants.
- **Acceptable —** Response adequately addresses all criteria in category.
- **Marginal —** Response includes some deficiencies/weaknesses.
- **Unacceptable —** Response has many deficiencies/weaknesses/omissions and/or presents unacceptable risks to Treasury.

Each of the five criteria was rated by a different team of two reviewers, consisting of one person from the Evaluation Committee and one from Ennis Knupp. The teams ranked the companies based on the responses. If the two reviewers on a team could not agree on a rating, the Evaluation Committee as a whole made the final rating assessment.

During this review stage, the Evaluation Committee concluded that applicants' responses to three of the assessment categories — (2) fund structure and terms, (4) governance and management, and (5) valuation, monitoring and reporting — were similar and did not provide meaningful information to differentiate among the 46 applicants.[24] The Evaluation Committee, therefore, placed greater weight on the two remaining categories — (1) qualifications and performance history, and (3) investment strategy — than on the other three categories. The Evaluation Committee's memorandum on this stage stated that these two criteria provided a better measure of whether an applicant could meet Treasury's program goals.

The Evaluation Committee evaluated each of the 46 applicants in Stage 3 and placed the applicants into one of three tiers:

---

[24] As part of this audit, SIGTARP independently confirmed Treasury and Ennis Knupp officials' finding that many of the applicant responses to these sections were similar to each other.

Tier 1: Applicants judged sufficiently attractive to warrant further consideration. Applicants placed in Tier 1 received a rating of "exceeds" in at least one of the two more heavily weighted categories. Ten applicants were placed in Tier 1.

Tier 2: Applicants judged to be less compelling in terms of their past performance and investment strategy than those in Tier 1, but still deserving further consideration. Applicants that received no better than acceptable in the more heavily weighted categories were placed in Tier 2. Nine applicants were placed in Tier 2.

Tier 3: Applicants that provided information that was not compelling, had unacceptable ratings in any of the five categories of criteria, or were considered high risk. Applicants that fell short of acceptable in one of the heavily weighted categories were placed in Tier 3. Twenty-seven applicants were placed in Tier 3.

On May 20, 2009, the Evaluation Committee completed its review and approved the 19 applicants from Tiers 1 and 2 for the Finalist Stage.

Finalist Stage

In the finalist stage, the Evaluation Committee's assessment was based on evaluating the remaining applicants against each other, specifically focusing on their qualifications, performance history, and investment strategy. As discussed below, the top 14 applicants were invited to make in-person presentations to the Evaluation Committee and to complete preliminary legal and compliance due diligence questionnaires. The Evaluation Committee also held discussions with the finalist applicants' limited partner references that were included in the original application. At the outset of this stage, five Tier 2 applicants were rejected for the following reasons:

Applicant 1: Concerns about the numerous and substantial changes to the applicant's organizational structure over recent years, including the applicant's conversion to a bank holding company, and the concern of staff turnover among the fixed income professionals likely to be managing the PPIF.

Applicant 2: The concentration of a high percentage of assets under management from one client, which raised concerns about the applicant's ability to operate independent of influence from that client.

Applicant 3: The recent departure of company officers, which raised concerns about its organizational stability and continuity.

Applicant 4: Concern about forming a long-term partnership with a company that had been in existence for only a few years, and a lack of clarity as to how much of the applicant's assets under management were eligible assets.

Applicant 5: An applicant's performance loss that was especially poor compared to other applicants.

At this point, 14 applicants remained: ten from Tier 1 and four from Tier 2. From May 13 to May 19, 2009, the Evaluation Committee invited the remaining 14 applicants to Washington, D.C., to present their case for selection. Among other items, the Evaluation Committee asked the applicants to:

- introduce their investment team, including their planned use of small businesses and veteran-, minority-, and women-owned businesses to assist them in managing the fund,
- provide updated information on eligible assets,
- discuss their investment thesis and process, and
- present a model fund portfolio, including proposed leverage and expected fund returns.

After being asked to present, three of the 14 remaining applicants withdrew over concerns about potential changes to the program's compliance rules. Officials from one finalist that withdrew told SIGTARP that Treasury had "no rules of the road" and worried that Treasury could change the parameters of the program at any time without input from the fund managers. Another finalist told SIGTARP that it withdrew because of concerns that it might be required to wall-off personnel that were already working for other clients. The third finalist withdrew its application after giving its presentation in Washington. This company informed SIGTARP that it withdrew because working with Treasury increased its compliance costs, the private sector offered more opportunities than PPIP, and investment uncertainty and risk could increase if Treasury's rules changed.

After the presentations, the Evaluation Committee rejected two other applicants, leaving nine finalists. The Evaluation Committee's Finalist Stage memorandum stated that the two applicants were rejected for the following reasons:

- **Rejected Finalist 1 —** The Evaluation Committee's concerns with this finalist related more to its investment strategy than its qualifications and performance history. While the finalist held significant eligible assets, a high percentage were held by the applicant's parent company and were not managed for private investors. Additionally, several key members of the finalist's investment team were new to the firm, having joined from firms that had experienced significant financial distress from missteps related to investments made in eligible assets. Moreover, the Evaluation Committee had concerns about the company's ability to raise private capital.

  A principal reservation that the Evaluation Committee held for this finalist was its proposed high degree of leverage and the application of this leverage to potentially highly volatile securities. The company proposed using the highest degree of leverage of any finalist and indicated it would apply this leverage to a portfolio that favored collateral from subprime[25] and Alt-A[26] borrowers. The Evaluation Committee's memorandum on

[25] Subprime borrowers have some credit impairment, limited or no documentation about income and assets, high loan-to-value ratios, or high payment-to-income ratios.

this stage stated that the company also failed to provide satisfactory responses to a number of important questions, including its ability to verify its process (i.e., provide documentation of its analysis for the past year to see the consistency of application); identify competitive advantages; or identify an unleveraged yield on its model portfolio. The finalist indicated that it had not conducted an analysis of its model portfolio's unleveraged yield. The Evaluation Committee's memorandum stated that this was unsatisfactory and that it raised questions as to whether the company would manage the fund to protect taxpayers' interests.

- **Rejected Finalist 2 —** This applicant proposed a partnership between it and another company, and described the partnership as being split 50/50 "top to bottom." The scope of the other company's role in the venture concerned the Evaluation Committee because the company had a relatively low amount in total assets under management compared to other finalists and employed fewer than 10 investment professionals. The company noted that it would need to hire additional staff if it became a fund manager, raising additional concerns about its ability to scale its resources to properly manage the fund. Further, the Evaluation Committee considered that its presentation failed to demonstrate the company's expertise in managing RMBS, which was to be its primary role in the joint venture. The finalist indicated that it expected to play a meaningful role in the selection of RMBS assets for the fund. However, during its in-person interview, the Evaluation Committee concluded that the finalist failed to demonstrate expertise or an advantageous investment strategy in this area. Moreover, the Evaluation Committee ranked its investment strategy lower than those of other finalists.

On July 8, 2009, Treasury announced that it had pre-qualified nine companies to be fund managers. The companies had 12 weeks to raise the required $500 million in private funds before Treasury would match the private capital investment, provide debt financing, and allow the company to begin purchasing distressed assets. The nine companies were:

1. AllianceBernstein, L.P. and its sub-advisors Greenfield Partners, LLC and Rialto Capital Management, LLC;
2. Angelo, Gordon & Co., L.P. and GE Capital Real Estate;
3. BlackRock, Inc.
4. Invesco Ltd.
5. Marathon Asset Management, L.P.;
6. Oaktree Capital Management, L.P.;
7. The Trust Company of the West Group, Inc.;
8. Wellington Management Company, LLP ; and

---

[26] Alt-A borrowers are characterized by a stronger credit history than subprime borrowers but with less-traditional features, such as reduced documentation, low down payment, or non-owner occupier.

9. RLJ Western Asset Management L.P..

Treasury Relaxes Requirement to Raise $500 Million in Private Capital in 12 Weeks

In various announcements and FAQs, Treasury emphasized that each pre-qualified fund manager was required to raise a minimum of $500 million in private capital within 12 weeks before it could participate in a closing of the fund and begin to purchase eligible assets. Moreover, it rejected applicants that indicated that they would be unable to raise such funds in addition to their failure to meet an additional criterion. In a letter to Marathon on November 25, 2009, Treasury's Assistant Secretary for Financial Stability waived the requirement to raise $500 million and substituted the requirement to raise a minimum of $400 million in private sector funds. Similarly, in a letter to Oaktree on December 18, 2009, the Assistant Secretary waived the $500 million requirement and substituted a $450 million requirement for private capital. Based on these changes, and with each company having raised these new minimums, Marathon was allowed to begin purchasing eligible assets on November 25, 2009 and Oaktree on December 18, 2009. Additionally, seven of the nine fund managers were allowed to take more than 12 weeks after the July 8, 2009, prequalification announcement to raise the minimum amount of private capital, as shown in Table 1.

Table 1: Capital Contributions and Closing Dates of the 9 Fund Managers

Company	Initial Private Capital Raised for PPIF	Initial Fund Closing Date	Days after 12 week deadline (September 30) taken to close fund
Invesco	$506,000,000	Sept. 30, 2009	-
TCW	625,000,000	Sept. 30, 2009	-
Wellington	771,633,000	Oct. 1, 2009	1 day
AllianceBernstein	642,475,000	Oct. 2, 2009	2 days
BlackRock	522,696,000	Oct. 2, 2009	2 days
Angelo Gordon GE Capital	516,110,000	Oct. 30, 2009	30 days
RLJ Western Asset	505,199,334	Nov. 5, 2009	36 days
Marathon	400,000,000	Nov. 25, 2009	56 days
Oaktree	455,805,000	Dec. 18, 2009	79 days

Source: Treasury-Fund Manager Limited Partnership Agreements, FinancialStability.gov

Both Marathon and Oaktree told SIGTARP that they had investor contributions fall through just prior to closing their funds and that this capital would have helped them meet the initial $500 million threshold. Marathon said that prior to closing, it had offered another fund manager the opportunity to contribute $100 million to the fund and participate as a co-manager of its PPIF, which would have enabled it to meet its threshold. However, the Evaluation Committee rejected this proposal because Marathon had not identified this firm as a partner in its application, as required. An Evaluation Committee official told SIGTARP that the firm was going to contribute $100 million in private capital and manage it separately from the $400 million in private capital that Marathon raised. The official added that this structure would have created two PPIFs, and thus, an additional oversight issue for OFS in terms of vetting personnel and fund controls and management. Oaktree told SIGTARP that it lost potential investors who had expressed concerns about "headline risk" — having their companies perceived negatively because they were involved in a TARP program. Treasury officials told SIGTARP that senior Treasury officials allowed Marathon and Oaktree to proceed with their initial closings because:

- The ability to raise $500 million in private capital was not indicative of the investment capabilities of the two companies, as their backgrounds in distressed assets and capital raising demonstrated that they had significant capabilities that could help meet the program's objectives.
- Having nine companies as opposed to seven companies would create a deeper pool of fund managers and investors and add additional liquidity to the markets. The increase in fund managers would also spread the risk across more managers.
- Senior Treasury officials determined it was also unlikely that all of the private capital raised by Oaktree and Marathon would be reallocated to the other funds if the two companies were not allowed to participate. This would have reduced the amount of capital in the program, which Treasury sought to avoid.

TCW Withdraws as a Fund Manager

During the formation of PPIP, in a June 10, 2009 letter, SIGTARP recommended that Treasury adopt strict "key person" provisions in its fund manager agreements, consistent with industry practice. Treasury included in its fund manager agreements such a provision, which requires the company to list key personnel in its application and allows Treasury to terminate a fund under certain circumstances when a "key person" no longer runs the fund or leaves the company. As reported in SIGTARP's January 30, 2010, Quarterly Report to Congress ("the January 2010 Quarterly Report"), Jeffrey Gundlach left TCW on December 4, 2009, triggering a "key person event" under TCW's agreement with Treasury. Mr. Gundlach served as TCW's Chief Investment Officer and the lead portfolio manager of its PPIF, which had already begun purchasing assets. As a result, Treasury froze TCW's PPIF and halted all fund transactions.

On January 4, 2010, TCW entered into a winding-up agreement with Treasury under which it liquidated all assets purchased through its PPIP fund. As reported in the January 2010 Quarterly Report, TCW liquidated $477.8 million in securities held by its PPIF. According to the agreement, Treasury permitted TCW's private investors to re-allocate their commitments to a different PPIF of their choice. Treasury officials told SIGTARP that former TCW investors reallocated $44.5 million of the funds raised by TCW, with $26.9 million reallocated to Angelo Gordon/GE Capital and $17.6 million to Wellington. On January 13, 2010, TCW repaid its outstanding $200 million loan to Treasury, plus interest of $342,200. It also repaid Treasury's equity investment of $156.3 million, plus a $20.1 million profit and a share of Treasury's legal expenses.

Treasury Encourages Fund Managers to Partner with Small Businesses and with Firms Owned by Minorities, Women, and Veterans

This section discusses the process for selecting minority partners to assist the fund managers and the due diligence performed on the firms and key managers.

EESA requires that, in instances where Treasury elected to waive any provision of the Federal Acquisition Regulation ("FAR") pertaining to minority contracting, the Secretary of the Treasury "develop and implement standards and procedures to ensure, to the maximum extent practicable, the inclusion and utilization" of minority- and women-owned businesses, as defined in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. As we discuss later in this report, the PPIP structure did not require the application of the FAR, rendering application of this EESA provision inapplicable. Nonetheless, Treasury stated in the fund manager solicitation that it encouraged prospective fund managers to involve not only minority-owned and women-owned private asset managers, but also small businesses and veteran-owned businesses, and to identify these firms in their applications. Treasury labeled all such businesses "minority partners." It did not require or provide guidance on how applicants should select their minority partners or what role they should play in the PPIF. In practice, the selected partners were generally not responsible for making the investment decisions on behalf of the PPIF, but had other roles, as described below. Evaluation Committee members told SIGTARP that they extended the deadline for applications, in part, to allow the formation of these minority partnerships. Evaluation Committee members said it also allowed fund managers to form partnerships after submitting their applications, which was also clarified in the FAQs.

Further, Evaluation Committee members told SIGTARP that among the factors considered in Stage 3 and the Finalist Stage of the review of fund manager applications was how applicants presented their plan to use minority partners in the fund. They added that applicants were not disqualified for excluding this information or for not forming minority partnerships but applicants were encouraged to form them. For example, when it interviewed fund manager finalists in Washington, the Evaluation Committee asked them to discuss progress made to formalize partnership roles and responsibilities with other firms, including small businesses and veteran-, minority-, and women-owned businesses. Table 2 lists each of the fund managers, their primary minority partners and the role the minority firms play in the funds.

Table 2: Minority Partnerships and Services Provided

Fund Manager	Primary Partner(s)	Service Provided by Partner	City
AllianceBernstein	Altura Capital Group	Capital raising, investment sourcing	New York, NY
Angelo Gordon / GE Capital	CastleOak Securities	Broker dealer, capital raising, advisory, and asset sourcing	New York, NY
	Park Madison Partners	Capital raising and advisory	New York, NY
BlackRock	Utendahl Capital Management	Asset management (manages 5% of portfolio)	New York, NY
Invesco	Jackson Securities, LLC	Capital raising	Atlanta, GA
	Muriel Siebert & Co	Capital raising	New York, NY
	The Williams Capital Group	Capital raising	New York, NY
Marathon	Blaylock Robert Van	Capital raising	New York, NY
Oaktree	Arctic Slope Regional Corporation	None to date	Barrow, AK
Wellington	Advent Capital Management	Capital raising and asset management	New York, NY
	The Williams Capital Group	Cash management	Durham, NC
RLJ Western Asset	The RLJ Companies (51% minority-owned fund management joint venture)	Capital raising and advisory services. General partner.	Bethesda, MD
TCW	None		

Source: U.S. Department of the Treasury

Officials from Invesco, for example, told SIGTARP that it selected three minority partners (Muriel Siebert& Co, Jackson Securities, LLC, and The Williams Capital Group) to satisfy Treasury's program objective. Other fund managers told SIGTARP that they thought that listing a minority-owned firm in their proposal would increase the possibility that their firm would be selected. Officials from two minority firms told SIGTARP that they sought to participate in PPIP because it might provide opportunities for them to work with the U.S. Government in the future. One fund manager, TCW, did not involve a minority-owned business in its PPIF. A TCW official said that TCW was able to directly access the market to raise capital, making an intermediary unnecessary. Officials from AllianceBernstein told SIGTARP that without Treasury's "suggestion that the fund manager take on minority partners, it was unlikely" that it would have partnered with a minority firm or any company.

Some fund managers told SIGTARP that they conducted a full minority partner selection process, soliciting applications for the position, conducting onsite inspections and due diligence, and holding in-person interviews with key individuals. Some fund managers selected minority partners with whom they had previous business relationships. For example, Utendahl, a minority-owned business, told SIGTARP that it had previously used some of BlackRock's analytics as a client, and Park Madison, a women-owned business, was a long-time investor in Angelo Gordon's financial products.

Some fund managers and minority firms told SIGTARP they had long-standing "personal relationships" with each other that served as catalysts to partnership, although the paired firms had not previously worked together. For example, the managing principal and managing director from Oaktree had previously worked at a law firm with the CEO of Arctic Slope Regional Corporation ("Arctic Slope"), a minority-owned business, and saw the opportunity to partner with Arctic Slope on PPIP. An Oaktree official told SIGTARP that Oaktree "understood and embraced the mission" to select a minority partner for PPIP. Arctic Slope is the only minority partner without financial services experience, and which, at the time of our audit, had provided no service to the PPIF.

Of the minority partners, most of their roles were limited to raising capital for the funds. Other services performed by the minority partners include the following:

- Utendahl specializes in providing fixed income investment management to the institutional and wealth management community. BlackRock officials told SIGTARP that it selected Utendahl as its minority partner because it believed that having a minority-owned firm included in its application would increase the chances that their application would be approved. Utendahl officials noted that it is unique among minority partners in the PPIP program as it manages 5% of the assets in BlackRock's PPIP fund. BlackRock officials told SIGTARP that, in its view, a minority partner should be meaningfully involved in the PPIP and it therefore agreed to this relationship. Utendahl clears each trade through Bank of New York Mellon, the PPIP custodian/administrator, then marks each trade in BlackRock's trading platform, and ultimately reports it separately to Treasury.
- CastleOak is a minority-owned and run investment banking boutique with offices in New York, Atlanta, and Chicago. The firm serves as a minority partner for Angelo, Gordon/GE Capital. Prior to serving in this capacity, CastleOak had a strong business relationship with GE Capital, having underwritten a number of GE Capital's bond offerings. CastleOak identifies/sources assets for the PPIF to purchase and holds daily conversations with the fund managers about the status of the markets. Additionally, CastleOak raised $100 million out of the $1.243 billion raised by Angelo, Gordon/ GE Capital's PPIF.
- RLJ is the 51% owner of a joint fund-management venture with Western Asset Management Company. According to RLJ, it provides strategic investments in a diverse portfolio of companies, while focusing specifically on "undiscovered or underserved

markets." RLJ currently serves in a compliance role for the PPIF, overseeing Western Asset to ensure that it meets Treasury's partnership requirements. Additionally, as the general partner in the RLJ-Western limited partnership agreement with Treasury, RLJ is responsible for submitting quarterly reports to Treasury. RLJ officials told SIGTARP that the company also contributed a portion of the $20 million that Treasury required the fund managers to contribute to their PPIFs.

- Arctic Slope is a private, for-profit, Alaska Native-owned corporation that is involved in engineering, financial management, oil and gas support, petroleum refining and distribution, civil construction, and communications. An Arctic Slope official told SIGTARP that it saw the opportunity to serve as a minority partner to Oaktree as a new financial opportunity. Arctic Slope has a contract with Oaktree that establishes the financial and non-financial relationships of the companies. Arctic Slope invested $10 million in the PPIF. Arctic Slope is similar to the other fund investors except it does not pay a management fee to Oaktree. Oaktree told SIGTARP that it also agreed to mentor Arctic Slope shareholders and teach them investment management expertise that Arctic Slope says may provide longer-term benefits. During SIGTARP's meeting with an Arctic Slope official, she said the mentoring relationship was still being defined. Subsequently, Arctic Slope told SIGTARP that it has begun interviewing shareholders to be mentored at Oaktree's headquarters in Los Angeles in connection with the PPIF. Aside from this arrangement, Arctic Slope has not provided services to Oaktree or Treasury as of the completion of our audit, and its involvement has been limited to being one of Oaktree's investors in the fund.

Due Diligence on Pre-Qualified Fund Managers

This section discusses the due diligence that Treasury performed on finalists in the fund manager selection process.

After selecting the nine fund managers, Treasury engaged in the following due diligence reviews of the approved fund managers prior to executing their agreements and allowing them to purchase eligible assets:

- For those applicants selected as finalists, Treasury hired Simpson Thacher to assist it with the conduct of legal due diligence, among other things.
- Treasury also hired Ennis Knupp to perform investigative research/background checks to identify potential issues with respect to key individuals in the finalist group of fund managers as well as selected minority partners.
- The Evaluation Committee and other Treasury professionals conducted site visits to each pre-qualified fund manager to identify its ability to follow Treasury's compliance rules as well as to evaluate each firms' organizational structure and operations.

Legal Due Diligence by Simpson Thacher & Bartlett LLP

On May 24, 2009, subsequent to the selection of the PPIP fund manager finalists, Treasury contracted with Simpson Thacher to perform legal due diligence on the nine fund manager finalists. Treasury, with assistance from Simpson Thacher, developed an initial legal due diligence questionnaire consisting of 20 questions that focused on potential conflicts of interest, legal actions, and Securities and Exchange Commission ("SEC") violations by the applicant firm, its employees, and affiliates, and sent the questionnaire to the finalists. Based on Simpson Thacher's and Treasury's analysis of the initial questionnaire responses, Simpson Thacher requested additional information from the companies, as needed.

The scope of Simpson Thacher's work was limited to review of the self-reported information contained in the applicants' responses to the initial and follow-up questionnaires, and it relied on the accuracy and completeness of these self-disclosures. According to a Simpson Thacher official, the company put together a legal team to collectively review the applications and identify issues that it believed would be of interest to Treasury.

On September 14, 2009, Simpson Thacher submitted its report to the Evaluation Committee summarizing the results of its analysis. Simpson Thacher noted that nearly all applicants disclosed multiple actions that had been brought against them. These included the following:

- An investment firm disclosed that it was facing a lawsuit against it and its directors and officers alleging improprieties in connection with sponsored mutual funds prior to 2004.

- An applicant provided documents relating to regulatory matters, including an inquiry by a state securities commission.
- Another applicant disclosed that it was named as a co-defendant in federal and state class action lawsuits by a beneficiary of a Prepaid Affordable College Tuition Program. The lawsuits sought damages for potential losses that may be suffered by the program and program participants.

Although Simpson Thacher's summary report to the Evaluation Committee highlighted certain items that the firm believed to be particularly noteworthy, it emphasized that it should not be relied upon as a complete listing of all disclosures in the questionnaire responses by the applicants that the firm deemed might be of interest to Treasury. However, Simpson Thacher provided the Evaluation Committee with copies of all of the questionnaire responses. The Evaluation Committee told SIGTARP it reviewed the Simpson Thacher report and all of the questionnaire responses, performed follow-up visits to each of the pre-qualified fund managers, and checked with key clients of the fund managers. Based on the review of Simpson Thacher's work, the Evaluation Committee said it was satisfied that none of the pre-qualified companies should be disqualified.

Open-Source Investigations by Ennis Knupp & Associates, Inc.

On July 13, 2009, Treasury contracted with Ennis Knupp to perform background checks on identified PPIP fund managers, and selected minority partners. The task order required Ennis Knupp to:

- Identify risks and relevant facts to help protect the Treasury's "interests and reputation," and
- Research available data bases, paper records, and other sources relevant to the firm's or individual's history, including but not limited to employment histories, personal credentials, court records, corporate records, regulatory filings and records, news media searches, and reference checks and interviews.

Ennis Knupp, in turn, subcontracted with two firms to conduct the investigations: First Advantage Investigative Services ("First Advantage") and Bishops Services, Inc. ("Bishops"). First Advantage completed 71 background investigations of key employees of the prospective fund managers. Bishops Services completed 14 background investigations of minority partners. According to the Evaluation Committee, the list of key employees was principally obtained from information provided in the fund managers' original applications. First Advantage and Bishops prepared separate reports on the results of each of their background investigations which it submitted to Ennis Knupp.

According to officials from the two subcontractors, their reports were factual representations of their investigative results, and did not contain evaluations of the information. They added that the scope of their investigations was comparable to other investigations they perform and there were no scope limitations imposed on them by Ennis Knupp. Upon receipt of final background reports from First Advantage and Bishops, Ennis Knupp reviewed the reports for issues of concern, reportedly using the following questions in evaluating the reports.

- Would knowing this piece of information have any bearing on an investor's willingness to invest with this entity?
- Does this issue have any potential to embarrass or otherwise reflect poorly upon investors that choose to do business with this entity?

According to Ennis Knupp, its review team held conference calls periodically during the process with the Evaluation Committee to discuss issues that surfaced in the First Advantage and Bishops reports. If both Ennis Knupp and the Evaluation Committee agreed that an issue was immaterial and/or a routine course of business event, it was not considered further. If either the Evaluation Committee or Ennis Knupp determined that an issue had the potential to be of concern, the issue was documented and added to the formal background investigation summary memoranda that Ennis Knupp submitted to the Evaluation Committee. According to the Evaluation Committee, it followed up on these issues with the fund managers and the minority partners involved.

Treasury officials told SIGTARP that they did not receive the written reports of First Advantage or Bishops or relevant backup documentation for each due diligence check. Rather, on September 23, 2009, Ennis Knupp provided Treasury list of items it considered material in nature and that may require additional review by Treasury. According to Treasury, members of the Evaluation Committee and officials from the Treasury's Offices of the General Counsel and Risk Management reviewed Ennis Knupp's findings. None of the pre-qualified fund managers or their partners were disqualified as a result of these reviews.

Treasury Site Visits to Fund Managers

Between July 13 and August 25, 2009, Treasury conducted 10 site visits with the nine pre-qualified fund managers, and the one minority firm, Utendahl, that would be independently investing and managing a portion of PPIP assets. According to Treasury, each site visit was led by one of its investment specialists along with representatives of Office of Financial Stability's Operations, and Risk Management and Compliance. A member of Ennis Knupp also participated in the meetings.

On September 22, 2009, Treasury prepared a record of its site visits to the fund managers. The record stated that each site visit included a presentation by the fund manager's investment, operations, and compliance personnel, followed by extensive discussions and question and answer sessions. Treasury noted that during the site visits, the Treasury team closely scrutinized the firm's organizational and operational structure as well as the ability and willingness of each fund manager to abide by Treasury's ethical standards, rules, and regulations, which had been issued on July 8, 2009. Specifically, Treasury's memorandum stated that key areas of inquiry included:

- Pre-qualified Fund Managers' compliance with the Ethical Standards and Conflicts of Interests Standards and Rules
- Creating and updating a Watch List of Eligible Assets and establishing a secure website to make it available to Treasury
- Know-Your-Customer/Client, and anti-money laundering policies and procedures; and
- Controls to prevent the Fund Managers from acquiring Eligible Assets from prohibited entities (e.g., other Fund managers, affiliates, sub-advisors).

Application of the Federal Acquisition Regulation

The section discusses the application of the Federal Acquisition Regulation in the selection of the fund managers.

The Federal Acquisition Regulation ("FAR") governs how executive agencies purchase goods and services. At its core, the FAR intends to preserve the public's trust in how the Government uses its money and seeks to:

- promote competition;
- efficiently manage costs, quality, and timeliness of goods or services provided to the Government;
- encourage integrity, fairness, and openness in how the Government does business;
- minimize administrative operating costs; and
- fulfill public policy goals, such as transparency and accountability.

All executive agencies are required to comply with the FAR when they purchase goods or services with appropriated funds, unless a statutory or regulatory exception applies. Further, the FAR applies to the entire acquisition process, beginning at the point when an agency recognizes a need to make a purchase. Although EESA includes an exception to the FAR, contracting under EESA is not automatically exempt from the FAR. Section 107(a) of EESA provides that the Secretary of the Treasury can waive provisions of the FAR upon a determination that urgent and compelling circumstances make compliance with that provision contrary to the public interest.

Treasury determined that it was not required to comply with the FAR when it selected firms to manage PPIP funds. According to Treasury, it designed the fund manager selection processes to employ "best practices" that were in the "spirit of the FAR." In support of their statement that the FAR is not applicable, Treasury officials explained that pursuant to EESA there are three types of commercial parties with which Treasury may interact: counterparties and co-investors, contractors, and financial agents. They further explained that interaction with counterparties is controlled by section 101(a) of EESA; interaction with contractors is controlled by section 101(c)(2) of EESA and the FAR; and interaction with financial agents is controlled by section 101(c)(3) of EESA. Treasury officials concluded the PPIP fund entities are "investment counterparties <u>receiving equity investments and loans from the $700 billion</u>." Accordingly, they are not contractors or financial agents being paid for goods or services, and were not selected under the FAR authority or a financial agent process (emphasis appears in the original).
In other words, Treasury officials determined that transactions with PPIP fund managers do not constitute an acquisition of goods or services, nor do they involve the delegation of sovereign functions. Rather, they characterize each transaction as a commitment to purchase a troubled asset under EESA for the PPIF pursuant to a TARP program and a troubled asset determination

made by the Secretary of the Treasury pursuant to his authority under Section 101(a)(1) of EESA, not a procurement of services governed by the FAR.

For purposes of EESA, the phrase “troubled asset” includes any “residential or commercial mortgages and any securities, obligations, or other [equity or debt] instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability.” Treasury’s limited partnership interests in the PPIFs serve as financial instruments, which Treasury has deemed necessary to promote financial market stability. Thus, according to Treasury, the FAR does not apply to Treasury’s selection of the asset managers with whom Treasury co-invests through the PPIFs, because the interests in the PPIF itself — the limited partnership — is a “troubled asset” of which Treasury is authorized to purchase an equity interest under EESA. According to Treasury, any services that the PPIF fund managers provide are incidental to, but part of, the limited partnership agreement. SIGTARP agrees that the limited partnership structure that Treasury uses to implement the PPIP does not require the application of FAR.

Current PPIP Fund Status

This section provides the current status of the PPIP funds, the amount of private capital invested in the funds and the federal contribution in terms of equity and debt investments.

The size of the PPIP program has dramatically decreased in size from when the program was initially announced as a way to facilitate the purchase of up to $1 trillion in distressed assets. The eight remaining fund managers completed their private capital raises[27] of a total of $7.4 billion of private-sector equity capital, which Treasury matched for total equity capital of $14.7 billion. Treasury also provided $14.7 billion of debt capital, resulting in total purchasing power of $29.4 billion ($22.1 billion of which are TARP funds). As publicly reported by Treasury, as of September 30, 2010, the PPIFs have drawn-down approximately $18.6 billion of total capital (63 percent of total purchasing power), which has been invested in eligible assets and cash equivalents pending investment.

The assets were purchased through an intermediary broker or dealer, from banks, insurance companies, mutual funds, pension funds, and other eligible sellers, as defined in ESSA. For further information on the assets the PPIP managers are purchasing and the performance of individual funds, see SIGTARP's Quarterly Report to Congress, July 21, 2010.

Table 3: Equity and Debt Invested Under PPIP ($ in billions)

Fund Manager	Private-Sector Equity Capital	Treasury Equity	Treasury Debt	Total Purchasing Power
AG GECC PPIF Master Fund, L.P.	$1.2	$1.2	$2.5	$5.0
AllianceBernstein Legacy Securities Master Fund, L.P.	1.2	1.2	2.3	4.6
BlackRock PPIF, L.P.	0.7	0.7	1.4	2.8
Invesco Legacy Securities Master Fund, L.P.	0.9	0.9	1.7	3.4
Marathon Legacy Securities Public-Private Investment Partnership, L.P.	0.5	0.5	0.9	1.9
Oaktree PPIP Fund, Inc.	1.2	1.2	2.3	4.6
RLJ Western Asset Public/Private Master Fund, L.P.	0.6	0.6	1.2	2.5
Wellington Management Legacy Securities PPIF Master Fund, LP	1.1	1.1	2.3	4.6
Totals as of 6/30/10	**$7.4**	**$7.4**	**$14.7**	**$29.4**

Note: 1.Numbers affected by rounding

Source: Treasury "Legacy Securities Program Update- Month Ending 6/30/2010," received 7/15/10

[27] Oaktree and Marathon, the two successful fund manager applicants that had not raised $500 million in private capital before their initial closings, have since raised $1.61 billion and $475 million, respectively.

Conclusions

Four months after injecting $25 billion of capital into the country's largest banks under TARP, Treasury announced PPIP, a program that would marry private capital with TARP funding to create individual investment funds run by private managers that would purchase certain mortgage-backed securities. According to Treasury, the program was intended to "restart the market for legacy securities, allowing banks and other financial institutions to free up capital and stimulate the extension of new credit." Before beginning the process to select the managers to run the individual PPIFs, Treasury officials consulted three large investment firms—BlackRock, PIMCO and TCW—to gather information on how to best design PPIP. After incorporating feedback from these companies in the program design, Treasury published selection criteria that favored larger asset managers, such as the ones Treasury consulted in designing the program, although the program was open to all companies. In fact, all three firms that Treasury consulted in the program design made it to the Finalist Stage of the PPIP fund manager selection process, with two of them, BlackRock and TCW, being selected and the third, PIMCO, withdrawing its application.

SIGTARP found that Treasury constructed a reasonable architecture to accomplish its objective of identifying larger firms to manage PPIFs. It established an Evaluation Committee to review the 141 applications, and this committee included members not just from Treasury but from the Export-Import Bank and the Overseas Private Investment Corporation. It hired a law firm to assist in designing the application and establishing the selection criteria, and an independent advisor with expertise in evaluating complex investments to assist in reviewing applications. It conducted a multi-stage evaluation process, with each stage reducing the number of applicants moving to the next stage, and also performed on-site due diligence reviews as part of the process. SIGTARP also found that Treasury adequately documented the selection process, contributing to our ability to conduct this review. SIGTARP agrees with Treasury's explanation that the legal structure of the PPIP did not require it to use the Federal Acquisition Regulation process.

On March 23, 2009, Treasury published an application to be used by fund managers seeking to participate in the program. Treasury's PPIP application listed five criteria that it "anticipated" would be used to prequalify fund managers:

1. Demonstrated capacity to raise at least $500 million of private capital.
2. Demonstrated experience and a performance track record investing in eligible assets.
3. A minimum of $10 billion (market value) of eligible assets[28] under management.

[28] For the purposes of PPIP, eligible assets are residential and commercial mortgage-backed securities secured directly by actual mortgages, leases, or other assets, and not other securities that were issued before January 1, 2009, and originally rated AAA (or an equivalent rating) by two or more nationally recognized statistical rating organizations.

4. Demonstrated operational capacity to manage the funds in a manner consistent with Treasury's stated Investment Objectives while also protecting taxpayers.
5. Headquartered in the United States.

While the selection process ultimately succeeded in creating nine privately managed funds with the means to purchase almost $30 billion in distressed assets, several aspects of the process are noteworthy:

- Treasury's published selection criteria created confusion and uncertainty among applicants. While Treasury published five criteria, it did not state how many of these criteria applicants were required to meet, or make clear how applicants could demonstrate that they met the criteria. The application introduced further uncertainty with the caveat that Treasury only "anticipated" using the five criteria, suggesting that the criteria might change after the applications were submitted. After receiving only four applications, and dozens of requests for clarification from potential applicants, Treasury responded that it would use a "holistic" approach in which "failure to meet any one criteria [would] not necessarily disqualify a proposal." Internally, Treasury interpreted this modification to mean that all applicants had to meet four of the five stated criteria in order to be considered, though it did not reveal that interpretation to applicants.

- Treasury refined its criteria during the selection process in a way that impaired the transparency of the process. In order for an applicant to be deemed to meet the fourth criterion listed above (related to operational capacity to manage funds consistent with Treasury's investment objective), Treasury imposed an absolute requirement that each applicant demonstrate that it had a minimum of $1 billion in total assets under management. Treasury did not, however, disclose this change to applicants. This single, undisclosed requirement had the effect of reducing the applicant pool by more than 40%. While perhaps technically compliant with its public statement that no one criterion would result in disqualification, this new undisclosed threshold had the additional consequence that any applicants that failed to meet it would also automatically fail to meet the $10 billion threshold for eligible assets (Criterion 3), so that one strike instantly became two, and with two strikes they were out.

- Treasury's published selection criteria risked unnecessarily discouraging applications from smaller asset managers. Smaller companies that might have had significant expertise and experience still could not realistically meet the application requirement that they have at least $10 billion of eligible assets under management, a threshold that Treasury's contractor Ennis Knupp commented was an "onerous hurdle to clear" and that only a limited number of applicants could meet. While this criterion undoubtedly dissuaded certain applicants from applying, it ultimately was not heavily weighted by Treasury, with two-thirds of the selected managers failing to meet the threshold. Indeed, the eventual size of PPIP suggests that the $10 billion criterion was unnecessary. The total purchasing power of the entire PPIP is $30 billion spread across eight managers.

- Treasury also gave an advantage to larger applicants with respect to the requirement that applicants demonstrate a capacity to raise $500 million in capital. Treasury's practice was, generally, to deem applicants that affirmatively stated that they could raise at least $500 million to have passed this criterion, while failing those that affirmatively stated that they could not. But Treasury passed one applicant on this criterion, even though the applicant failed to address either its capacity or its intention to raise that sum, based chiefly on the applicant's size. For those 12 other applications that also did not affirmatively state whether or not they were able to raise $500 million in capital for the PPIF, size again appeared to matter. Treasury deemed the nine applications that referenced at least $7.5 billion in assets under management to meet this criterion, while concluding that all three applicants that had between $1 billion and $3 billion in assets under management did not. As a result, in effect, Treasury's "holistic" approach favored larger companies that otherwise failed to meet its standard. Furthermore, after the application process was completed, Treasury waived the $500 million threshold for the two PPIF managers (Oaktree and Marathon) that could not meet it, putting into question the significance of a criterion that more than half of the applicants were deemed not to have met, and also likely deterred otherwise qualified applicants from seeking to participate in the program.

In sum, while Treasury designed and adequately documented a reasonable selection process, the implementation of that process is vulnerable to criticism. First, the initial selection criteria created confusion among applicants, the subsequent clarification failed to remedy that confusion and was arguably misleading, and an undisclosed modification impaired transparency. Second, the emphasis on the size of potential fund managers, while perhaps understandable, not only threatened to discourage qualified applicants from applying but also, given the selections ultimately made, may have been unnecessary. As a result, the taxpayer may have lost the benefit of the participation of qualified, albeit smaller, fund managers because they were avoidably deterred from applying or unnecessarily rejected.

Finally, Treasury encouraged the applicants to form partnerships with small, veteran-, minority-, and woman-owned private asset managers, but provided no guidance to applicants on either the nature or the extent of the expected role of a minority partner. Treasury's encouragement resulted in the inclusion of one or more minority-owned businesses in eight of the nine selected fund managers. But without guidance from Treasury, applicants were left to their own interpretation, which resulted in the minority-owned businesses largely participating to raise capital, with only two actually involved in managing assets and one firm, Arctic Slope, that appears to provide no assistance whatsoever. While not required by law to do so, had Treasury taken greater steps to clarify the expected role of the minority-owned businesses, these partners might well have a more meaningful role in the administration of the funds, and avoid the appearance, in at least one case, of being mere window dressing for the application and the program.

Management Comments and Audit Response

Treasury responded preliminarily to a draft of this report by letter dated October 4, 2010, which is reproduced in Appendix C. In its response, Treasury describes the audit's summary of the fund manager selection process as informative and likely to be helpful in explaining that process to the public. Treasury also states that it strongly disagrees with many of SIGTARP's statements and conclusions regarding certain details of the fund manager selection process that SIGTARP believes were not sufficient. Treasury added that it will continue to review the report and may respond more fully at a later date.

SIGTARP looks forward to Treasury's more complete response to the report. It is important to Note that Treasury was provided an opportunity to review a discussion draft of the report and Provide comments. Treasury did so, changes were made to the report as appropriate, and, at the End of that process, Treasury offered no material factual objections to the draft audit report. Treasury might not agree with how the audit's conclusions portray the Treasury's decision-making process on the selection of fund managers for the Legacy Securities PPIP, but Treasury has not challenged the essential underlying facts upon which those conclusions are based.

Appendix A — Scope and Methodology

Senator Claire McCaskill, Chairman of the Homeland Security and Governmental Affairs Committee's Subcommittee on Contracting Oversight, and Senator Robert Bennett, Ranking Member of the Subcommittee, raised concerns about Treasury's selection of fund managers and their partners. In a joint letter, Chairman McCaskill and Senator Bennett asked SIGTARP to review a number of issues related to the PPIP. Our reporting objectives were to determine:

- what criteria Treasury used to select the fund managers and their minority partners;
- whether Treasury consistently applied its criteria in the selection of the fund managers;
- the extent that Treasury performed due diligence reviews on the fund managers and their minority partners. SIGTARP has begun work to determine whether Treasury has established controls to prevent or mitigate conflicts of interest in a separate audit; and
- whether financial agreements between Treasury and the successful fund manager applicants were governed by the Federal Acquisition Regulation

To determine the criteria for this audit, we interviewed the Treasury officials involved in the selection process to gain Treasury's rationale for how it selected applicants throughout the process. We examined memoranda on the discussions and approval of final selection criteria along with the fund manager application guidelines that were posted on Treasury's website.

In reviewing Treasury's selection process, we conducted two independent reviews of each of the 141 fund manager applications alongside the selection criteria described in the Evaluation Committee memoranda. We then compared our findings with the Evaluation Committee's assessments to determine the extent that criteria were consistently applied. During our review of each stage, we sought clarification from Treasury officials on individual applicants and the process in general.

To determine how Treasury selected fund managers, we reviewed Treasury's finalist selection process, including presentation outlines and notes taken by officials during the presentations to assess the extent that Treasury consistently applied qualitative judgments on selection criteria. Following our analysis of the pre-qualification process, we contacted each of the fund managers and their minority partners.

To determine the due diligence processes performed by Treasury, we reviewed the PPIP internal controls memoranda. We contacted Simpson Thacher and Ennis Knupp, the firms responsible for conducting the compliance and legal diligence reviews to determine the extent that Treasury provided oversight on the processes.

To determine whether the FAR governed financial agreements negotiated between Treasury and the fund managers, we reviewed the agreements between Treasury and the fund managers. We also interviewed Treasury officials to determine the extent to which, if any, the FAR was applied to the process, and if not, the reasons it did not apply.

We conducted this performance audit in accordance with generally accepted government auditing standards from November 2009 to September 2010. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Internal Controls

We did not review the internal controls established by the PPIP fund managers to manage their respective funds. This issue will be addressed in a complementary SIGTARP audit of fund manager internal controls and compliance programs.

Use of Computer-Generated Data

The information used in the conduct of this audit was, for the most part, not computer-generated, although some of the information used by fund managers to prepare reports, such as their applications, would likely have come from audited financial statements. Any computer-generated data was either a minor part of this audit or was generated from audited financial statements and, therefore, considerate sufficiently reliable for our use.

Appendix B — Selection Process Timeline

March	**(March 23):** Treasury publishes the PPIP Fund Manager Application on website.
April	**(April 6):** Treasury publishes Frequently Asked Questions which state that applications will be evaluated on "holistic" basis. Failure to meet only one criterion will not disqualify application.
May	**Stage 1 (April 24-May 1):** Treasury receives 141 applications and removes 37 that were "non-responsive" or duplicates. **Stage 2 (May 1):** Treasury internally publishes guidelines for 5 selection criteria for this stage but does not notify applicants of the guidelines. Treasury completes its evaluation of 104 applicants and removes 58 for failure to meet at least 4 of 5 selection criteria. **Stage 3 (May 1- May 13):** Treasury internally decided to focus on Qualifications and Investment Strategy. Treasury did not notify applicants of these changes. Treasury evaluates 46 applicants based on their responses to 5 categories of criteria and selected 19 for the finalist review stage. Treasury internally publishes a memorandum on this stage on May 20, 2009. **Finalist Stage (May 1- May 13):** Treasury removes 5 of the 19 applicants principally based on their experience managing eligible assets and quality of their organizations compared to the other applicants.
June	**Finalist Stage (May 13-June 16):** Treasury invites 14 applicants to present in Washington, D.C.; 2 applicants withdraw prior to the presentations. Following the presentations, 1 applicant withdraws and Treasury removes 2 others. As a result, Treasury selects nine fund managers for pre-qualification.
July	**July 8:** Treasury announces the pre-qualification of 9 fund managers.
August	
September	**Due Diligence reviews (May 24-Sept. 23)** Treasury and Ennis Knupp conduct on-site, background, compliance, operational and business due diligence. Treasury and Simpson Thacher conduct legal due diligence reviews.
October	
November	
December	**Initial Fund Closings (Sept. 30-Dec. 18):** TCW and Invesco are the first to close on their funds. Marathon closes with $400 million in private capital and Oaktree is the last fund manager to do so, after raising $456 million.

Appendix C—Management Comments

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

October 4, 2010

Neil M. Barofsky
Special Inspector General
Office of the Special Inspector General for the Troubled Asset Relief Program
1500 Pennsylvania Ave., NW, Suite 1064
Washington, D.C. 20220

RE: SIGTARP Official Draft Report

Dear Mr. Barofsky:

Thank you for providing us the opportunity to review and comment on your audit report on selecting fund managers for the Legacy Securities Public-Private Investment Fund (PPIF). This letter provides the Department of the Treasury's comment on the official draft report.

We are pleased that your report concludes that we constructed a reasonable architecture for selecting the PPIF managers. Your report describes how this involved a multi-stage review process, assistance from other government agencies and an independent advisor with expertise in evaluating complex investments and extensive due diligence. You also note how this was "adequately documented". Your summary of our evaluation process is informative, and we believe your report should be helpful in explaining to the public the thoroughness of the process for selecting the final PPIF managers.

The Public-Private Investment Program has had a positive effect on our financial system. The announcement and subsequent implementation of the program created a market for the legacy securities and bolstered their value (by reducing any discount due to difficulty of resale). This encouraged financial institutions to begin trading and selling their holdings of these assets, which in turn contributed to a recovery in security prices. This ultimately benefited consumers and businesses by helping to make new credit available.

While we have conducted only a preliminary review of the report at this time, we strongly disagree with a number of your statements and your conclusions regarding certain details of the fund manager selection process that you believe were not sufficient. We will continue to review it in detail and may respond more fully to your findings at a later date.

Thank you again for the opportunity to review your report. We look forward to continuing to work with you and your team as we continue our efforts to stabilize our financial system.

Sincerely,

Timothy G. Massad
Acting Assistant Secretary for Financial Stability

Appendix D—Audit Team Members

This report was prepared and the review was conducted under the direction of Charles Thompson, Supervisory Management Auditor, Office of the Special Inspector General for the Troubled Asset Relief Program.

The staff members who conducted the audit and contributed to the report include:

Jonathan Evans

Joshua Moses

Amy Poster

Appendix E — Acronyms

Acronym	Definition
CDO	collateralized debt obligation
CMBS	commercial mortgage-backed securities
EESA	Emergency Economic Stabilization Act of 2008
FAR	Federal Acquisition Regulation
FAQ	Frequently Asked Questions
FDIC	Federal Deposit Insurance Corporation
PPIF	Public-Private Investment Fund
PPIP	Public-Private Investment Program
RMBS	residential mortgage-backed securities
SEC	Securities and Exchange Commission
SIGTARP	Special Inspector General for the Troubled Asset Relief Program
TARP	Troubled Asset Relief Program
TCW	The Trust Company of the West Group, Inc.

SIGTARP Hotline

If you are aware of fraud, waste, abuse, mismanagement, or misrepresentations associated with the Troubled Asset Relief Program, please contact the SIGTARP Hotline.

By Online Form: www.SIGTARP.gov *By Phone:* Call toll free: (877) SIG-2009

By Fax: (202) 622-4559

By Mail: **Hotline: Office of the Special Inspector General**
for the Troubled Asset Relief Program
1801 L Street, NW
Washington, D.C. 20220

Press Inquiries

If you have any inquiries, please contact our Press Office:

Kristine Belisle
Director of Communications
Kris.Belisle@do.treas.gov
202-927-8940

Legislative Affairs

For Hill inquiries, please contact our Legislative Affairs Office:

Lori Hayman
Director, Legislative Affairs
Lori.Hayman@do.treas.gov
202-927-8941

Obtaining Copies of Testimony and Reports

To obtain copies of testimony and reports, please log on to our website at www.sigtarp.gov.