

Money Market Funds: Insurance, Liquidity, and Support

September 29, 2008

The past two weeks have seen a continuation or worsening of the market conditions that have challenged money market mutual funds (money funds), as well as their sponsors and advisers, over the past year. Among other things, these events have included the bankruptcy of Lehman Brothers, the downgrading of short term securities issued by various financial services companies, a spike in 1-month and 3-month LIBOR, and unprecedented illiquidity in markets for securities that traditionally have been among the deepest and most liquid. The past two weeks also saw the announcement of The Primary Fund, a series of the Reserve Fund, stating that it is unable to maintain a stable \$1.00 per share net asset value (NAV), and the announcement by at least one other Money Fund that it will liquidate.

Taken together, these developments have raised questions about the ability of many money market funds to satisfy redemptions in the normal course, or in extreme cases, whether other money funds will “break the buck.”¹ This FYI provides an overview of several options that are potentially available to money funds that may be used, alone or in combination, to address these issues:

- Treasury Guarantee Program for Money Funds
- Capital Support Arrangements
- Sale of Portfolio Securities to Affiliates
- Asset Backed Commercial Paper Liquidity Facility

Treasury Guarantee Program for Money Funds

On September 29, the U.S. Treasury Department (the Treasury) announced the opening of the Treasury Temporary Guarantee Program for Money Market Funds (the Guarantee Program). All money funds that are regulated under Rule 2a-7 under the Investment Company Act of 1940 (the 1940 Act), maintain a stable share price of \$1.00 and are publicly offered and registered with the Securities and Exchange Commission (the Commission) are eligible to participate in the Guarantee Program (eligible money market funds). Eligible money market funds must apply by October 8, 2008 for the program using the forms provided on the Guarantee Program webpage.² The Guarantee Program is effective until December 18, 2008, unless extended at the sole discretion of Treasury, but in no event will the Guarantee Program extend beyond September 19, 2009.

The Guarantee Program was established by Treasury action on September 19, 2008, and makes up to \$50 billion available from the assets of the Exchange Stabilization Fund³ in order to guarantee the payment to investors of participating money funds if (1) the NAV of the money fund falls below \$1.00 and (2) the money fund liquidates.

The Guarantee Program provides a guarantee on a fund-by-fund basis, with coverage amounts based on the number of shares a shareholder of record held as of the close of business September 19, 2008. In effect, the coverage amount for a shareholder will be the lesser of: (1) the number of shares owned on September 19, 2008; or (2) the number of shares owned on the first date after September 19, 2008 on which the market-based NAV of the participating money fund is less than \$0.995 (Guarantee Event). These coverage limits apply regardless of whether a shareholder has made additional investments in the participating money fund or withdrawn assets from

the participating money fund between September 19, 2008 and the Guarantee Event. Covered shareholders will receive \$1.00 per covered share upon liquidation of an eligible money market fund, subject to the aggregate \$50 billion in coverage available to all participating money funds under the program.

A participating money fund may apply for recovery under the Guarantee Program once its board of directors has approved the liquidation of the fund and it is determined that shareholders would receive less than \$1.00 per share if the fund does not receive payment under the Guarantee Program. Presumably, prior to recovering under the Guarantee Program, a money fund would be required to exhaust or exercise its rights to any other capital support to which it may be entitled, such as rights under a Capital Support Agreement (discussed below). The Guarantee Program is designed to facilitate an orderly liquidation of participating funds.

Treasury press releases issued to date, including the September 29 press release and a Frequently Asked Questions release regarding the Guarantee Program, indicate that the Guarantee Program has the following features:

- Eligible money market funds include both taxable and tax-exempt money market funds. On September 22, 2008, the Internal Revenue Service issued Notice 2008-81 that confirmed that participation in the Guarantee Program will not be treated as a federal guarantee that would otherwise jeopardize the tax-exempt treatment of payments by tax-exempt money market funds.
 - **Note:** Contrary to prior indications, Treasury money funds and government money funds are eligible to participate.
- To participate in the Guarantee Program, Treasury will require eligible money market funds with an NAV per share greater than or equal to \$0.9975 as of the close of business on September 19, 2008, to pay an upfront fee of 0.01 percent (one basis point) based on the number of shares outstanding on that date. Eligible money market funds with an NAV per share of greater than or equal to \$0.995 and below \$0.9975 as of the close of business on September 19, 2008 will be required to pay an upfront fee of 0.015 percent (1.5 basis points), based on the number of shares outstanding on that date. These fees only cover the first three months of participation in the Guarantee Program. Funds with an NAV below \$0.995 as of the close of business on September 19, 2008 may not participate in the Guarantee Program.
 - **Note:** Treasury did not address whether eligible money market funds whose NAV per share is supported at \$0.995 (or higher) by virtue of a capital support arrangement (discussed below) are eligible to participate in the Guarantee Program. However, we believe that existence of a capital support arrangement should not affect eligibility to participate in the Guarantee Program.
 - **Note:** Fund advisers and sponsors should consult with the board of directors regarding the cost of participation in the Guarantee Program. We believe that the cost of participation would be a permissible fund expense. However, the cost could be subject to expense limitation agreements, or might otherwise be more appropriately borne, in whole or in part, by the sponsor or adviser.
- Conditions for payment under the Guarantee Program (the Guarantee Payment), include the following:
 - The Guarantee Event must occur on or before the termination of the Program;
 - The participating money fund must be liquidated within 30 days following the Guarantee Event, unless the period is extended by the Treasury; and
 - The Treasury shall have received written assurances that there is no legal impediment to the disbursement of the Guarantee Payment.

The Treasury release affirmatively requests investors to contact their money fund directly to determine if it is participating in the Guarantee Program.

While the Guarantee Program will allow for shareholders in a money fund to be “made whole” to the extent of their eligibility under the Program, the restrictions imposed under the Program are significant. In particular, recovery

under the Guarantee Program requires that the money fund must liquidate. Existing money funds may find that participation in the Guarantee Program stems the tide of large redemptions, but it is clear that money funds that want to stay in operation must look elsewhere to avoid liquidation or breaking the buck.

Capital Support Arrangements

The Commission staff has issued numerous no-action letters permitting affiliates to provide support related to one or more securities held by money funds. This can take the form of support of either (1) a single security or (2) the NAV of a fund as impacted by one or more securities. In the former, the affiliate would guarantee the value of a security, so to the extent the value of that security dropped below 100 cents on the dollar, the affiliate would make up the shortfall to bring the value back to 100 cents. In the latter, the affiliate would guarantee the NAV of the fund, so that to the extent the value of a security or securities would otherwise cause the NAV of the fund to fall below a pre-determined level, such as below \$0.9975 or \$0.995, the affiliate would makeup the shortfall to bring the NAV back above the agreed upon level. In most cases, a payment would only be required in the event of a realized loss with respect to the covered securities, while the money fund would record a receivable under the arrangement with respect to unrealized losses.

The Commission staff generally has imposed the following conditions, among others, when granting no-action relief:

- The guarantee must be provided or backed by a party having a First Tier rating for purposes of Rule 2a-7. This means that, if support provider does not have a First Tier rating, the credit arrangement must be supported either by a letter of credit from another party having a First Tier rating, or supported by assets held in a segregated account.⁴
- The capital support arrangement must have a stated maximum term, and is usually limited to one year. Extension of the arrangement would require further relief from the Commission staff.
- The capital support arrangements must include several conditions which, if triggered, would require the money fund to sell the covered securities. In such an event, the money fund would realize a loss and the support provider would be required to make a cash contribution to the money fund.

Sale of Portfolio Securities to Affiliates

Ineligible Securities

Rule 17a-9 under the 1940 Act permits affiliates of a money fund to purchase any portfolio security that is no longer an “eligible security” under Rule 2a-7, provided that the purchase is (1) for cash and (2) at the greater of amortized cost or market price (in either case, including accrued interest).

Downgraded or Illiquid Securities

The Commission staff has granted numerous no-action letters to money funds and their affiliates permitting the purchase of downgraded or illiquid securities subject to certain conditions. In all cases the purchase price must be the greater of the amortized cost or market price of the portfolio security. Generally the purchase must be for cash, although the Commission staff has permitted affiliates to issue “First Tier” short-term notes to the affiliated money fund to pay for the downgraded or illiquid security.

The clear benefit of the approaches permitted by Rule 17a-9 and the no-action letters is the immediate removal of an impaired security from a money fund’s portfolio. The obvious drawback is that the money fund’s affiliate may have to make a significant capital outlay.

Most recently, the ICI obtained industry wide no-action relief to permit banks to purchase asset backed commercial paper (“ABCP”) from an affiliated money fund, for cash at amortized cost, which must be greater than or equal to the market price.⁵ This relief was issued in connection with the Lending Facility, described more fully below, which enables banks to borrow money from the Federal Reserve Bank of Boston on a nonrecourse basis if used to purchase certain ABCP from money funds.⁶

Asset-Backed Commercial Paper Liquidity Facility

The Asset-Backed Commercial Paper (ABCP) Money Market Mutual Fund Liquidity Facility (the Lending Facility) is intended to assist money funds in obtaining liquidity by enabling them to sell some of their high-quality secured assets at amortized cost. The Lending Facility will expire on January 30, 2009, unless extended.

In order to facilitate usage of the Lending Facility, the Federal Reserve adopted, on an interim final basis, two rules effective from September 19, 2008 to January 30, 2009, unless extended. The first interim rule increases the capacity of a member bank to purchase ABCP from an affiliated money fund in connection with the Lending Facility. The second interim rule provides a temporary limited exemption from the Federal Reserve's leverage and risk-based capital rules for ABCP held by a state member bank or bank holding company as a result of its participation in the Facility.

If you have any questions or would like more details concerning any of the options mentioned, please contact any of the following Morgan Lewis attorneys:

Philadelphia

Timothy W. Levin	215.963.5037	tlevin@morganlewis.com
Richard W. Grant	215.963.4790	rgrant@morganlewis.com
Sean Graber	215.963.5598	sgraber@morganlewis.com

Washington, D.C.

Thomas S. Harman	202.739.5662	tharman@morganlewis.com
W. John McGuire	202.739.5654	wjmcguire@morganlewis.com
Michael Berenson	202.739.5450	mberenson@morganlewis.com
Christopher Menconi	202.739.5896	cmenconi@morganlewis.com
Monica Parry	202.739.5692	mparry@morganlewis.com
Dianne M. Sulzbach	202.739.5470	dsulzbach@morganlewis.com

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1. A money fund generally is considered to have "broken the buck" if the mark-to-market NAV of the fund drops below 99.5 cents, subject to action being taken by the board of directors of the fund required under Rule 2a-7.
2. <http://www.treas.gov/offices/domestic-finance/key-initiatives/money-market-fund.shtml>.
3. The Exchange Stabilization Fund was established by the Gold Reserve Act of 1934, which authorizes the Secretary of the Treasury, with the approval of the President, "to deal in gold, foreign exchange, and other instruments of credit and securities" consistent with the obligations of the U.S. government in the International Monetary Fund to promote international financial stability. The Exchange Stabilization Fund currently has approximately \$50 billion. The amount of a payment under the Guarantee Program is dependent on the availability of funds in the Exchange Stabilization Fund.
4. Capital support arrangements may raise accounting and valuation issues for the Money Fund, as well as disclosure issues for the affiliate.
5. Investment Company Institute (pub. avail. September 25, 2008).
6. See Board of Governors of the Federal Reserve System, Transactions Between Member Banks and Their Affiliates; Exemption for Certain Purchase of Asset-Backed Commercial Paper by a Member Bank from an Affiliate, Interim final rule with request for public comment (September 19, 2008).