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Fed Announces Creation of Money Market Investor Funding Facility

Introduction

On October 21, 2008, the Federal Reserve Board ("Fed") announced the creation of the Money Market Investor Funding Facility ("Facility"), through which the Federal Reserve Bank of New York ("New York Fed") will provide senior secured funding to five special purpose vehicles ("SPVs") to facilitate the purchase of certain assets from certain eligible investors in the money markets.[1] The Facility was created in response to strains in the short-term debt markets caused, in part, by money market mutual funds increasing their liquidity positions in order to meet redemptions by investing in shorter-term, highly liquid assets, most of which (among prime funds) matured in seven days or less.[2]

The purpose of the Facility is to instill confidence in the money markets by facilitating sales of money market instruments so that money market investors will invest in longer-term instruments while still maintaining adequate liquidity positions, which would have a salutary effect on the operation of the credit markets and the broader economy.[3]

Currently, eligible investors authorized to sell certain assets to SPVs participating in the Facility ("Participating SPVs") include U.S. money market mutual funds that seek to comply with Rule 2a-7 under the Investment Company Act of 1940 ("Eligible Investors"), but the class of Eligible Investors may be expanded to include other U.S. money market investors.[4] Assets eligible to be sold to Participating SPVs include U.S. dollar-denominated certificates of deposit, bank notes and commercial paper issued by certain financial institutions with short-term debt ratings of at least A-1/P-1/F1 from two or more nationally recognized statistical rating organizations ("NRSROs") having remaining maturities of 90 days or less ("Eligible Assets").[5] The date on which the

1 Board of Governors of the Federal Reserve System, Press Release (Oct. 21, 2008), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20081021a.htm

2 Federal Reserve Bank of New York, "Money Market Investor Funding Facility: Questions and Answers" (Oct. 23, 2008) ("Questions and Answers"), *available at* http://www.newyorkfed.org/markets/mmiff_faq.html; Investment Company Institute, "Frequently Asked Questions about the Money Market Investor Funding Facility" (Oct. 2008), *available at* http://www.ici.org/funds/abt/faqs_mmiff.html

3 Questions and Answers, *supra* note 2. The creation of the Facility was authorized under Section 13(3) of the Federal Reserve Act, which permits the Fed, in unusual and exigent circumstances, to authorize Federal Reserve Banks to extend credit to individuals, partnerships and corporations that are unable to obtain adequate credit accommodations. Id.

4 *Id.*

5 *Id.*; Federal Reserve Bank of New York, "Money Market Investor Funding Facility: Program Terms and Conditions" (Oct. 22, 2008) ("Terms and Conditions"), available at http://www.newyorkfed.org/markets/mmiff_terms.html

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Facility and the Participating SPVs will begin operations has not yet been announced, and additional operational details regarding the SPVs have not yet been released.

Operation Of The Facility

Participating Special Purpose Vehicle Financing

While the Facility is established by the Fed and funded by the New York Fed, the Participating SPVs will be established and operated by private sector entities.[6] Each Participating SPV will purchase Eligible Assets from Eligible Investors using financing from the Facility and issuing asset-backed commercial paper ("ABCP"). The Eligible Assets will be purchased at prices equal to the selling Eligible Investor's acquisition cost as adjusted for amortization of premium or accretion of discount through the date of its purchase by the Participating SPV ("Purchase Price").[7] When purchasing Eligible Assets, the Participating SPV will borrow up to 90% of the Purchase Price from the Facility and exchange up to 90% of the Purchase Price in cash and at least 10% of the Purchase Price in the form of ABCP for the Eligible Asset from the Eligible Investor.[8] The Participating SPV will then hold the Eligible Assets to maturity. Facility borrowings to finance the purchase of Eligible Assets will be on an overnight basis at the primary credit rate (currently 1.75%), but the commitment to lend up to 90% of the Purchase Price lasts until the maturity of the purchased Eligible Asset ("Facility Loan"). Facility Loans to a Participating SPV will be senior to the Participating SPV's ABCP, with recourse to the Participating SPV and secured by all assets of the Participating SPV.[9] If the primary credit rate rises above 2.25%, the New York Fed's right to receive interest above 2.25% will be subordinated to the rights of the ABCP holders to receive principal and interest, but any accumulated income beyond that necessary to pay such principal and interest will accrue to the New York Fed.[10]

Eligible Assets

Each Participating SPV will be limited in its purchases of Eligible Assets to those issued by the ten financial institutions designated in the Participating SPV's organizational documents ("Eligible Issuers"), and no Participating SPV will own assets backed by Eligible Issuers of another Participating SPV absent subsequent corporate mergers or acquisitions.[11] At the time of a Participating SPV's purchase of an Eligible Asset issued by an Eligible Issuer, the Eligible Assets of that Eligible Issuer may not constitute more than 15% of the assets of the Participating SPV. Because the Facility is currently limited to five SPVs, the Participating SPVs, in the aggregate, will be limited to fifty Eligible Issuers.[12] Although Eligible Investors are not limited in the aggregate amount of Eligible Assets that can be sold to a Participating SPV, money market mutual funds will be constrained in that regard by Rule 2a-7 under the Investment Company Act of 1940 ("1940 Act").[13]

If an Eligible Issuer's short-term debt rating becomes downgraded such that its assets are no longer Eligible Assets (or the Eligible Issuer's long-term debt rating falls below A+), any Participating SPV holding that issuer's assets must cease all asset purchases until all of the assets of that issuer held by the Participating SPV have matured.[14] Upon a payment default of any asset held by a Participating SPV, the Participating SPV must cease all asset purchases and repayments on outstanding ABCP and allocate all future proceeds to the repayment of Facility Loans.[15] The remainder

6 Terms and Conditions, *supra* note 5.

7 J.P. Morgan Securities Inc., SEC No Action Letter (Oct. 22, 2008) ("J.P. Morgan Letter").

8 *Id.*; Terms and Conditions, *supra* note 5. Because New York Fed lending from the Facility is limited to $540 billion, the SPVs will be limited in their purchases to $600 billion of Eligible Assets. Questions and Answers, *supra* note 2.

9 Terms and Conditions, *supra* note 5.

10 Questions and Answers, *supra* note 2.

11 Terms and Conditions, *supra* note 5; J.P. Morgan Letter, *supra* note 7.

12 The Eligible Issuers were "chosen by representatives of the U.S. money market mutual fund industry," but are among the largest issuers of highly rated short-term liabilities held by money market mutual funds (including "most of the largest global North American and European financial institutions"), and will be geographically diversified with respect to each SPV. Questions and Answers, *supra* note 2.

13 *See* Rule 2a-7(c)(4).

14 Terms and Conditions, supra note 5; J.P. Morgan Letter, *supra* note 7.

15 *Id.*

of the proceeds upon maturation of the assets can then be used to pay principal and interest on the Participating SPV's ABCP, and any excess will be allocated as described in the section below on Asset-Backed Commercial Paper.

Securities and Exchange Commission Staff Interpretive Guidance

In a no-action letter dated October 22, 2008, the SEC staff addressed issues connected with participating money market funds ("Participating Funds") selling Eligible Assets to Participating SPVs.[16] Specifically, the staff agreed that Participating Funds could treat ABCP of Participating SPVs as "Asset Backed Securities" as defined in Rule 2a-7(a)(3), even though the Participating SPVs will not be "organized for the sole purpose of issuing asset-backed securities," because one of the purposes of the Facility and the Participating SPVs is to provide liquidity to the money markets. Additionally, Participating Funds will be able to rely on the J.P. Morgan Letter in order to avoid the "look through" requirement for portfolio diversification purposes under Rule 2a-7 provided that: (1) a Participating Fund does not acquire ABCP of a Participating SPV if it would result in the ABCP of all Participating SPVs held by that Participating Fund to exceed 2.5% of the Participating Fund's total assets (as defined in Rule 2a-7(a)(25)); (2) all ABCP acquired by the Participating Fund is a First Tier Security, as defined in Rule 2a-7(a)(12), at the time of acquisition; (3) if a Participating Fund wishes to purchase additional securities of an Eligible Issuer where that Eligible Issuer is one of the ten issuers specified in the organizational documents of a Participating SPV, the Participating Fund must add the value of the Participating SPV's ABCP and any other securities of such Eligible Issuer held by that Participating Fund for diversification purposes;[17] and (4) securities of Eligible Issuers and the value of Participating SPV ABCP are similarly aggregated for diversification purposes when a Participating Fund purchases such ABCP in the secondary market.[18]

Asset-Backed Commercial Paper Issued by Participating Special Purpose Vehicles

The ABCP issued by the Participating SPVs will have a maturity equal to the maturity of the exchanged Eligible Asset and will be rated at least A-1/P-1/F1 by two or more NRSROs. The interest rate of the ABCP will be at least 25 basis points (0.25%) below the interest rate of the exchanged Eligible Asset. When a Participating SPV is wound down, however, "it is likely that each [Eligible Investor] will receive a contingent distribution of funds, to the extent there is available accumulated income in the [Participating SPV] that will increase the yield on the ... ABCP up to 25 basis points above the yield on the [Eligible Assets] sold to the [Participating SPV]."[19] The ABCP, in addition to being subordinated to the Facility Loans, will absorb "approximately the first ten percent of any losses incurred by the [Participating SPV]" and "[a]ny excess spread earned by the [Participating SPVs] will be retained as a further buffer against loss[es]."[20]

Termination and Wind-down Process

Unless the Facility is extended by the Fed, the Participating SPVs will cease purchasing Eligible Assets and begin the wind-down process on April 30, 2009, but "[t]he New York Fed will continue to fund the [Participating SPVs] after such date until the [Participating SPVs'] assets mature."[21] Proceeds from the maturation of Participating SPV assets are first allocated to the payment of principal and interest on Facility Loans, then to the principal and interest on ABCP maturing on that day. Of the proceeds that remain in a Participating SPV, a "small fixed amount" will be allocated proportionally among Eligible Investors holding the Participating SPV's ABCP, and the rest will be remitted to the New York Fed.[22]

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16 J.P. Morgan Letter, *supra* note 7.

17 To illustrate, the J.P. Morgan Letter provides the following example, adjusted for consistency with terms defined herein:

> [I]f 4.5% of a [Participating] Fund's net assets are accounted for by securities of XYZ, and it acquires [ABCP] issued by an [sic] [Participating] SPV (where one of the securities that may be held by the [Participating] SPV is XYZ) equal to 1% of the [Participating] Fund's net assets, the [Participating] Fund would have a 5.5% exposure to XYZ and be precluded from making additional purchases of XYZ securities unless and until its percentage exposure (including the exposure from the [Participating SPV's ABCP]) to XYZ is reduced below 5%.

18 *Id.*

19 Questions and Answers, *supra* note 2.

20 *Id.*

21 *Id.*

22 Terms and Conditions, *supra* note 5.

OTHER PROGRAMS

The Facility complements two other Fed programs intended to add liquidity to the money markets: the Commercial Paper Funding Facility ("CPFF") and the Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF"). The AMLF began financing the purchases of ABCP from money market mutual funds on September 19, 2008. The CPFF began financing the purchases of highly rated U.S.-dollar denominated three-month unsecured asset-backed commercial paper directly from U.S. issuers on October 27, 2008.[23]

CONCLUSION

The creation of the Facility is another significant step by the Fed to restore liquidity and confidence to the credit markets, although the success of this and other Fed efforts towards the goal of stabilizing the financial system remains to be seen. Additional issues may arise, however, as the Facility and the Participating SPVs began operations and further details become available.

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[23] More information about these programs is available at http://www.federalreserve.gov/newsevents/press/monetary/20081007c.htm (regarding the CPFF); and http://www.frbdiscountwindow.org/mmmf.cfm?hdrID=14 (regarding the AMLF). These programs were previously discussed in Dechert OnPoint: Special Alert (Oct. 2008) and Dechert OnPoint, Issue 28 (Sept. 2008), respectively.

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