

RECENT DEVELOPMENTS AFFECTING MONEY MARKET FUNDS

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Recent regulatory action by the federal government affecting money market funds is discussed in this article.

There have been three recent regulatory developments affecting money market funds: the Securities and Exchange Commission's ("SEC") rule allowing money market funds participating in the U.S. Department of the Treasury ("Treasury") Temporary Money Market Fund Guarantee Program ("Guarantee Program") to suspend redemptions for longer than seven days upon liquidation, the procedures setting forth how money market funds can participate in the Money Market Investor Funding Facility ("MMIFF"), and revisions to the MMIFF. These developments are discussed in this article.

SEC ADOPTS AN INTERIM FINAL TEMPORARY RULE ALLOWING MONEY MARKET FUNDS PARTICIPATING IN THE TREASURY GUARANTEE PROGRAM TO SUSPEND REDEMPTIONS FOR LONGER THAN SEVEN DAYS UPON LIQUIDATION

On November 26, 2008, the SEC adopted interim final temporary Rule 22e-3T ("Interim Rule") under the Investment Company Act of 1940 (the "Act"). The Interim Rule exempts liquidating money market funds partici-

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pating in the Treasury Guarantee Program from Section 22(e) of the Act. Specifically, the Interim Rule allows participating money market funds liquidating pursuant to the terms of the agreement with Treasury (the "Guarantee Agreement")¹ to suspend redemptions and postpone payment of redemption proceeds for longer than the seven-day limit set forth in Section 22(e).

The Interim Rule is currently in effect until October 18, 2009, but may expire earlier, upon termination of the Guarantee Program.

Background

On September 16, 2008, The Reserve Primary Fund became the first large money market fund open to the general public to break the buck when it announced that it would re-price its securities at \$0.97 per share. In this connection, the fund sought and obtained from the SEC an order permitting it to suspend redemptions and postpone the payment of redemption proceeds.²

To bolster investor confidence in money market funds and protect the stability of the global financial system, on September 19, 2008, Treasury announced the establishment of the Guarantee Program. Under the Guarantee Program, Treasury guarantees for certain shareholders the share price of participating money market funds that seek to maintain a stable net asset value of \$1.00 per share, or some other fixed amount,³ subject to certain conditions and limitations. Most of the nation's money market funds elected to participate in the Guarantee Program by the October 8, 2008 deadline and executed Guarantee Agreements with Treasury and paid the required participation fees. The Guarantee Program was originally scheduled to terminate on December 18, 2008, although on November 24, 2008, Treasury extended the Guarantee Program until April 30, 2009.⁴

Under the terms of the Guarantee Program, Treasury guarantees that, upon the liquidation of a participating money market fund, the fund's shareholders will receive the fund's stable share price of \$1.00 for each fund share owned as of September 19, 2008. Pursuant to the Guarantee Agreement, if a participating money market fund's net asset value per share drops below \$1.00 (a "Guarantee Event"), it is required to commence liquidation within five business days (with an exception under a curing provision). The Guarantee Agreement further requires the fund's board of directors to promptly

suspend the redemption of its outstanding shares “in accordance with applicable SEC rules, orders and no-action letters.”⁵ The fund must be liquidated within 30 days after a Guarantee Event unless Treasury, in its discretion, consents in writing to a later date. These provisions are intended to ensure that the money market fund liquidates in an orderly manner and maximizes the proceeds realized from the disposition of the fund’s portfolio securities.

The Exemption Provided by the Interim Rule

Section 22(e) of the Act prohibits funds, including money market funds, from suspending the right of redemption, or postponing the date of payment or satisfaction upon redemption of any redeemable security for more than seven days, except for certain periods specified in that Section. Although Section 22(e) permits funds to postpone the date of payment or satisfaction upon redemption for up to seven days, it does not permit funds to suspend the right of redemption, absent certain specified circumstances or an SEC order. In the adopting release, the SEC noted that in order for the Guarantee Program to operate as intended, a participating money market fund that experiences a Guarantee Event and must liquidate pursuant to the Guarantee Agreement may need to suspend redemptions and postpone the payment of proceeds beyond the seven-day limit.

The SEC stated that the Interim Rule provides the necessary exemption to permit participating money market funds to take full advantage of the Guarantee Program and initiate the steps necessary to protect the interests of all shareholders during liquidations, including those shareholders not covered by the Guarantee Program. Specifically, the SEC stated that the Interim Rule is designed to facilitate orderly liquidations and help prevent the sale of fund assets at “fire sale” prices. The SEC noted that such a result could lead to substantial losses for the liquidating fund and further depress prices for short-term securities that may be held in the portfolios of other money market funds.

Operation of the Interim Rule

The exemption from Section 22(e) provided by the Interim Rule is available to any money market fund that has an effective Guarantee Agreement, and abides by the following two conditions:

- the fund must have delivered to Treasury the required notice indicating that it has experienced a Guarantee Event and will promptly commence liquidation under the terms of the Guarantee Agreement;⁶ and
- the fund must not have cured the Guarantee Event, as provided under the terms of the Guarantee Agreement.⁷

In the event that a participating money market fund experiences a Guarantee Event and commences liquidation in compliance with the terms of the Guarantee Agreement, the fund will be exempt from Section 22(e).

The Interim Rule also provides that the SEC may by order rescind or modify the relief provided by the Interim Rule if necessary to protect the liquidating money market fund's security holders.⁸ This provision permits the SEC to modify the relief if, among other things, a liquidating fund has not devised, or is not properly executing, a plan of liquidation that protects fund security holders. Under this provision, the SEC may modify the relief "after appropriate notice and opportunity for hearing," in accordance with Section 40 of the Act.

In the adopting release, the SEC explained that the Interim Rule was adopted on an interim final basis because the Guarantee Program is already in place and participating money market funds are currently subject to its liquidation provisions.⁹ Moreover, in light of current market conditions, the SEC believed that it is possible that a Guarantee Event could occur for a participating money market fund at any time, and under such circumstances consideration of individual applications for exemptive orders for funds that experience Guarantee Events would be impracticable.

Solicitation of Comments

The SEC requested comments on all aspects of the Interim Rule, particularly with respect to whether:

- the conditions for relief are adequate to protect the interests of security holders;
- the Interim Rule should include additional conditions and, if so, what those conditions should be; and

- the Interim Rule should have a later or earlier expiration date and, if so, what the expiration date should be.

The comment period ended December 26, 2008.

FEDERAL RESERVE BANK OF NEW YORK AND JPMORGAN CHASE PROVIDE ADDITIONAL DETAILS ABOUT PARTICIPATION IN THE MMIFF

The Money Market Investor Funding Facility

On November 10, 2008, the Federal Reserve Bank of New York (“NY Fed”) announced that it would begin funding the purchase of eligible money market fund assets on November 24, 2008, through its previously announced MMIFF. The MMIFF will use “special purpose vehicles” (“SPVs”) in the following ways: (i) to purchase assets from money market funds; (ii) the SEC staff has indicated that the commercial paper issued by the SPVs could be treated as “Asset Backed Securities,” as defined by Rule 2a-7(a)(3) under the Act; and (iii) funds will be able to avoid the “look through” requirement for portfolio diversification purposes under Rule 2a-7 under certain conditions.¹⁰

In addition to announcing that it would begin funding the purchase of eligible assets, the NY Fed briefly mentioned the steps eligible investors can take to participate in the MMIFF, and referred eligible investors to a JPMorgan Chase hotline for further details. Set forth below is a discussion of the information available from JPMorgan Chase and the procedures necessary to apply to participate in the MMIFF.

Information Available from JPMorgan Chase

JPMorgan Chase will serve as the structuring agent and the referral agent for the SPVs, and participating funds can receive procedural information about participation in the program at 212-834-5389. JP Morgan Chase has made the necessary information available on the Web site www.morganmarkets.com (“Morgan Markets”), which is accessible only to funds relying on Rule 2a-7. Eligible funds may call the above number to register an account on the Web site to access the available material. The Web site includes the forms and docu-

ments needed to participate in the MMIFF, along with a description of the assets eligible to be sold to the SPVs. Below is a summary of the information made available by JPMorgan Chase for funds to participate in the MMIFF, including the necessary documentation and the procedural requirements.

Forms and Documents Found on Morgan Markets

- *Fund Representation Letter* (one required for each eligible fund) — Each fund wishing to participate in the MMIFF must provide a Fund Representation Letter (a “Letter”), which serves as a contract between the participating fund and the SPV. The Letter includes an attestation by the participating fund that it understands and accepts the stipulations of participating in the MMIFF, including the conditions and risks of selling to a SPV.
- *Asset Allocation Spreadsheet* — This provides all the information necessary for the SPV to evaluate whether an asset is eligible for sale to the SPV.
- *Private Placement Memorandum (“PPM”) for each SPV* — Notably, the PPMs disclose that if a money market fund’s short-term debt rating is downgraded such that its assets are no longer eligible for the MMIFF (or a fund’s long-term debt rating falls below A+), a SPV holding that fund’s assets may not purchase additional assets from any fund until the troubled fund’s assets have matured, and all repayments on outstanding asset backed commercial paper must cease until the SPV repays its loans from the NY Fed. Similarly, if any asset held by a SPV defaults, the SPV may not purchase additional assets and repayment of the NY Fed takes priority over payment to the fund.
- *Pool Reports* — Updated every morning, these reports list the holdings of each of the SPVs along with their valuations.
- *List of Eligible Assets* — This is a list of the 10 financial institutions designated to sell to each SPV and the eligibility criteria for assets to be sold under the MMIFF, including that the assets must be U.S. dollar denominated certificates of deposit, bank notes or commercial paper having remaining maturities of at least seven, but no more than 90, days issued by financial institutions with short-term debt ratings of at least A-1/P-1/F1

from two or more nationally recognized statistical ratings organizations.¹¹

- *Operating Procedures* — Before a fund may sell to a SPV, it must file with JPMorgan Chase a signed Letter, a Tax ID, an IRS Form W-9, and a Fund Prospectus. To sell its assets, a fund must submit an Asset Allocation Spreadsheet, with the information regarding the assets it wishes to sell, by 1:00 p.m. on any day it wishes to sell assets to a SPV. The information is then reviewed by JPMorgan Chase,¹² an independent service named GSS, and the NY Fed for final approval of purchase.

FEDERAL RESERVE BOARD CHANGES MMIFF

On January 7, 2009, the Board of Governors of the Federal Reserve System (the “Board”) announced two changes to the MMIFF.¹³ First, the set of institutions eligible to participate in the MMIFF was expanded to include not only money market mutual funds, but other types of money market investors. The newly eligible investors include funds that are managed or owned by a U.S. bank, insurance company, pension fund, trust company, SEC-registered advisor or a U.S. state or local entity that: (i) maintains a dollar-weighted average portfolio maturity of 90 days or less; (ii) holds the funds until maturity; and (iii) only holds assets that, at the time of purchase, are rated by an NRSRO in one of the top three long-term investment-grade rating categories or one of the top two short-term investment-grade rating categories. Newly eligible investors also include any U.S. dollar-denominated cash collateral reinvestment fund, account, or portfolio associated with securities lending transactions that is managed or owned by a U.S. bank, insurance company, pension fund, trust company, or SEC-registered investment advisor. Eligible investors are subject to approval by the NY Fed, which may subject investors to debt and deposit rating criteria. Second, to allow the MMIFF to remain a viable source of liquidity at very low money market interest rates, the Board set the minimum yield on assets eligible to be sold to a SPV at 60 basis points above the primary credit rate at the time of purchase.

The program was originally scheduled to expire on April 30, 2009, but on February 3, 2009, the Board extended the MMIFF through October 30, 2009. The Board deemed the extension necessary “in light of continuing substantial strains in many financial markets.”¹⁴

NOTES

¹ A form of the Guarantee Agreement is available at: http://www.treas.gov/offices/domestic-finance/key-initiatives/money-market-docs/Guarantee-Agreement_form.pdf.

² In the Matter of The Reserve Fund, Investment Company Act Release No. 28386 (Sept. 22, 2008) (order).

³ Most money market funds seek to maintain a stable net asset value per share of \$1.00, but a few seek to maintain a stable net asset value per share of a different amount, e.g., \$10.00. For convenience, the discussion will simply refer to the stable net asset value of \$1.00.

⁴ See Press Release, U.S. Dep't of the Treasury, Treasury Announces Extension of Temporary Guarantee Program for Money Market Funds (November 24, 2008), <http://www.treas.gov/press/releases/hp1290.htm>.

⁵ Section 7(a)(ii) of the Guarantee Agreement.

⁶ Rule 22e-3T(a)(2). See also Section 2(c) of the Guarantee Agreement.

⁷ Rule 22e-3T(a)(3). See also Section 1(i) of the Guarantee Agreement.

⁸ Rule 22e-3T(b).

⁹ The Administrative Procedure Act ("APA") generally requires an agency to publish notice of a proposed rulemaking in the Federal Register. This requirement does not apply, however, if the agency "for good cause finds...that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest." The APA also generally requires that an agency publish an adopted rule in the Federal Register 30 days before it becomes effective. This requirement also does not apply, however, if the agency finds good cause for making the rule effective sooner. The SEC adopted the Interim Rule without taking any of these steps because it believed that the fact that the Guarantee Program is already in operation, and that due to current market conditions, there was good cause to act immediately adopt the Interim Rule on an interim final temporary basis.

¹⁰ J.P. Morgan Securities, Inc., SEC No-Action Letter (October 22, 2008).

¹¹ Federal Reserve Bank of New York, "Money Market Investor Funding Facility: Frequently Asked Questions" (Nov. 10, 2008) ("Frequently Asked Questions"), available at http://www.newyorkfed.org/markets/mmiff_faq.html.

¹² The SPVs are subject to type and quantity restrictions on the assets eligible for purchase.

¹³ Federal Reserve Bank of New York, "Money Market Investor Funding Facility: Program Terms and Conditions" (Jan. 7, 2009), available at http://www.newyorkfed.org/markets/mmiff_terms.html.

¹⁴ Press Release, Board of Governors of the Federal Reserve System (Feb. 3, 2009), available at <http://www.federalreserve.gov/newsevents/press/monetary/20090203a.htm>.