ALSTON + BIRD LLP

Financial Services and Products ADVISORY

September 22, 2008

Federal Assistance for Money Market Mutual Funds

Over the past several days, the U.S. Treasury, the Federal Reserve and the other bank regulatory agencies have announced initiatives designed to enhance investor confidence in the stability of money market mutual funds by creating a ground-breaking fund investor guaranty program and instituting a non-recourse asset-backed commercial paper lending facility, which should provide much needed liquidity for money market funds. Since we first reported these developments,[1] Treasury and the Federal Reserve have provided additional information about how these measures will operate, and the Federal Reserve and the Office of the Comptroller of the Currency have issued interim final rules to facilitate bank use of the new lending facility.

The Reserve Primary Fund "Breaks the Buck"

It is exceedingly rare for the net asset value of a money market mutual fund to fall below $1.00 per share — in other words, to "break the buck."[2] Money market funds are not required by any law or regulation to maintain a $1.00 net asset value, but they are required by SEC rules to be managed to maintain a stable net asset value. Among other requirements, money market funds are permitted to invest only in U.S. dollar-denominated securities that "present minimal credit risks" and that have relatively short maturities (generally, individual securities must have maturity of less than 397 days, and the overall portfolio must have a dollar-weighted average maturity of less than 90 days).[3] Although money market funds have not historically been covered by any federal or state insurance program, they have long been perceived by investors as a higher yielding, but safe, substitute for FDIC-insured bank deposits. As a result, investments in money market funds have ballooned over the past few decades, to more than $3.5 trillion.

On Tuesday, September 16, the Reserve Fund's Primary Fund, one of the United States' largest and oldest money market mutual funds, announced that its net asset value had fallen to $0.97 per share, due to losses in its Lehman debt holdings.[4] To stop what was in essence a run on the fund, the Primary Fund announced that it would postpone payment of proceeds from redemptions for up to seven days. On Friday, the Reserve Fund applied to the SEC, on behalf of both the Primary Fund and its U.S. Government Fund, for permission to suspend all redemption rights and to postpone the date of payment of redemption proceeds for up to seven days.[5]

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1 *See* Alston & Bird Advisory, "Federal Responses to the Financial Crisis During the Week of September 14," http://www.alston.com/fisap_Fed_responses_financial_crisis (Sept. 19, 2008).

2 The only other money market fund to break the buck was the $82.2 million Community Bankers Mutual Fund in Denver, Colorado, which liquidated in 1994 because of investments in interest-rate derivatives.

3 *See* Investment Company Act Rule 2a-7, 17 C.F.R. § 270.2a-7, http://edocket.access.gpo.gov/cfr_2008/aprqtr/pdf/17cfr270.2a-7.pdf.

4 *See* http://www.reservefunds.com/pdfs/Press%20Release%202008_0916.pdf (Sept. 16, 2008).

5 *See* http://www.reservefunds.com/pdfs/Press%20Release%20PrimGovt%202008_0919.pdf (Sept. 19, 2008).

In the wake of the Reserve Fund's announcement, other money market funds reported receiving extraordinary levels of redemption demands. Other fund complexes began disclosing their exposure to Lehman debt and, in some cases, disclosed that one or more of their affiliates would provide support for their Lehman holdings.[6] So far, it appears that no other money market funds have fallen below $1.00 a share as a result of the current market crisis.

Treasury and the Federal Reserve Respond

On September 19, to address concerns that the net asset values of other money market funds may fall below $1.00, the Treasury Department announced the establishment of a temporary guaranty program for U.S. money market mutual funds.[7] For the next year, the U.S. Treasury will insure the holdings of any publicly offered eligible money market mutual fund — both retail and institutional — that pays a fee to participate in the program. The amount of the participation fee has not been announced. The new guaranty program will be funded with up to $50 billion from the Treasury's Exchange Stabilization Fund.[8]

Subsequently, on Sunday, September 21, Treasury released further information regarding the guaranty program.[9] Among other clarifications, Treasury stated that the temporary guaranty program "will be designed to provide coverage to shareholders for amounts held by them in such funds as of the close of business on September 19, 2008." Treasury also stated that coverage would be available for both taxable and tax-exempt funds, and that Treasury and the Internal Revenue Service will issue guidance confirming that a fund's participation in the program "will not be treated as a federal guaranty that jeopardizes the tax-exempt treatment of payments by tax-exempt money market funds."

The fact that the guaranty program would cover only those funds held on September 19 has some interesting consequences. First, investors in the Reserve Primary Fund, whose net asset value fell below $1.00 per share on September 16, will not be covered with respect to those losses. Second, investors in money market funds after September 19 will not be covered for these new amounts. We understand that this limitation was put in place at the behest of the banking industry, which was concerned that coverage for new investments would encourage migration from FDIC-insured bank deposit accounts to money market funds.

Simultaneously with Treasury's announcement of the temporary guaranty program, the Federal Reserve announced that it would extend non-recourse loans to U.S. depository institutions and, notably, bank holding companies (which are not usually eligible to borrow from the Federal Reserve) to finance purchases of high-quality asset-backed commercial paper (ABCP) from money market mutual funds.[10] This measure is intended

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6 For example, Northwestern Mutual and Wachovia both announced that they would support the value of Lehman credit held in various of their affiliated money market funds. See http://www.russell.com/us/documents/Market_update_Lehman_Brothers.pdf and http://www1.evergreeninvestments.com/eicom/pub/updates.go?class=render&loc=public/news/feature_205.jsp.

7 *See* "Treasury Announces Guaranty Program for Money Market Funds," http://www.treas.gov/press/releases/hp1147.htm (Sept. 19, 2008).

8 The Exchange Stabilization Fund was established by the Gold Reserve Act of 1934. As amended in the 1970s, the Gold Reserve Act authorizes the Treasury Secretary, with the approval of the President, to "deal in gold, foreign exchange, and other instruments of credit and securities the Secretary considers necessary." 31 U.S.C. § 5302(b).

9 *See* "Treasury Provides Greater Clarity For Guaranty Program for Money Market Funds," http://www.treas.gov/press/releases/hp1151.htm (Sept. 19, 2008).

10 *See* http://www.federalreserve.gov/newsevents/press/monetary/20080919a.htm (Sept. 19, 2008).

to help money market mutual funds that hold asset-backed commercial paper fund investor redemptions. The program will be in effect from September 19, 2008, until January 30, 2009, but loans made before January 30, 2009, will remain outstanding for the remaining term of the ABCP that is financed.

According to the Federal Reserve's "Questions and Answers" fact sheet,[11] the new "Asset-Backed Commercial Paper (ABCP) Discount Window Facility" will be administered by the Federal Reserve Bank of Boston, which will make loans in all twelve Reserve Bank districts. The program will allow any U.S. depository institution, bank holding company or U.S. branch or agency of a foreign bank to borrow on a non-recourse basis from the Reserve Bank's discount window at the primary crediting rate (currently 2.25 percent), in order to fund the purchase of ABCP from Rule 2a-7 qualified money market mutual funds. Only ABCP (1) that is purchased from a qualifying money market mutual fund at its "amortized cost" by a depository institution or bank holding company on or after September 19, 2008, (2) that is issued by a U.S. issuer under a program in existence on September 18, 2008, (3) that is denominated in U.S. dollars and (4) that qualifies as a "rated Security" and a "First Tier Security" under the SEC's Rule 2a-7 (generally, those that are rated in the highest short-term rating category) may serve as collateral. ABCP purchased by a depository institution or bank holding company before September 19 is ineligible.

As authority for the program, the Federal Reserve has invoked both its general authority under Section 10B of the Federal Reserve Act to make advances to depository institutions and its authority under Section 13(3) of the Federal Reserve Act to authorize Reserve Banks, in "unusual and exigent circumstances," to extend credit to individuals, partnerships and corporations that are unable to obtain adequate credit accommodations.

The Federal Reserve has also issued two interim final rules in connection with the new program that are intended to "facilitate participation by depository institutions and bank holding companies in this special lending program as intermediaries between the Federal Reserve and money market mutual funds."[12] The first rule provides a temporary limited exception from the Federal Reserve's leverage and risk-based capital rules for bank holding companies and state member banks.[13] Under this rule, ABCP purchased by the banking organization as a result of its participation in the new facility will be assigned a zero percent risk weight under the Federal Reserve's risk-based capital rules for state member banks and bank holding companies, and will be excluded from average total consolidated assets — the denominator of the leverage ratio. The Office of the Comptroller of the Currency has also issued an interim final rule to substantially the same effect for national banks,[14] and the Federal Deposit Insurance Corporation and the Office of Thrift Supervision are expected to follow suit for state non-member banks and thrift institutions.

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11 "Asset-Backed Commercial Paper (ABCP) Discount Window Facility Questions and Answers," http://www.federalreserve.gov/newsevents/press/monetary/monetary20080919a1.pdf.

12 *See* http://www.federalreserve.gov/newsevents/press/monetary/20080919c.htm (Sept. 19, 2008).

13 Interim Final Rule: Risk-Based Capital Guidelines; Leverage Capital Guidelines, http://www.federalreserve.gov/newsevents/press/monetary/monetary20080919b2.pdf.

14 *See* "OCC Approves Interim Final Rule on Bank Purchases of ABCP from Money Market Mutual Funds," http://www.occ.gov/ftp/release/2008-110.htm (Sept. 19, 2008); Interim Final Rule: Risk-Based Capital Guidelines — Money Market Mutual Funds, http://www.occ.gov/ftp/release/2008-110a.pdf.

The second rule provides a temporary limited exception from Sections 23A and 23B of the Federal Reserve Act and the Federal Reserve's Regulation W, which would otherwise limit the ability of a depository institution to purchase ABCP from money market mutual funds advised by an affiliate.[15] Under the new exception, purchases of ABCP from an affiliated money market mutual fund in connection with the new loan facility between September 19, 2008 and January 30, 2009, will be exempt from the quantitative limits, collateral requirements and low-quality asset prohibitions of Section 23A and the market-terms requirements of Section 23B.

Both of the Federal Reserve's interim rules will expire on January 30, 2009, the same date that the ABCP facility expires, unless extended by the Federal Reserve. Although the Section 23A and 23B relief may not need to be extended beyond January 30, the Federal Reserve may need to extend its capital requirements relief to accommodate loans in existence on January 30, 2009.

Industry Reactions

The Treasury and Federal Reserve actions were greeted with relief by the mutual fund industry, which feared continued loss of investor confidence in the stability and liquidity of money market funds and consequent heavy redemption demands. However, representatives of the banking industry have decried the de facto extension of the federal deposit insurance safety net to cover all money market mutual funds (not even limited to $100,000 per account, as with FDIC insurance coverage). The American Bankers Association sent a letter to Secretary Paulson and Chairman Bernanke expressing concern that this action "runs the risk in the long run of profoundly changing the nature of our financial system and, specifically, undermining the nation's banking system."[16] Of particular concern is the potential that this new program would place money market mutual funds, which historically have paid higher dividends than rates on bank deposits but enjoyed no insurance protection, "in a significantly superior market position to FDIC-insured bank deposits."

The ABA and other commentators have identified a number of significant policy issues raised by the Treasury's temporary guaranty program, notwithstanding Treasury's assurances that the program will cover only investor account balances as of the close of business on September 19. However temporary this program may be, will Treasury's action foster a perception that money market funds enjoy an implicit federal guaranty (such as that enjoyed by Fannie Mae and Freddie Mac prior to their conservatorships)? For that matter, how does the Treasury anticipate being able to withdraw this guaranty at the end of two years? Will funds that choose not to participate, and therefore avoid paying a participation fee, nonetheless enjoy public perception of government support? Since participation by individual money market funds is voluntary, will only the weakest of funds choose to participate, thereby increasing the risk that participation fees will be inadequate to cover anticipated losses? Should the mutual fund industry be required to fund the new program, as depository institutions must do with the FDIC? Will participation fees vary based on the riskiness of the fund's portfolio, as FDIC insurance premiums today vary based on the health of depository institutions? Will participating money market funds be subject to enhanced safety and soundness supervision and examination?

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15 Interim Final Rule: Transactions Between Member Banks and Their Affiliates: Exemption for Certain Purchases of Asset-Backed Commercial Paper by a Member Bank from an Affiliate, http://www.federalreserve.gov/newsevents/press/monetary/monetary20080919b1.pdf.

16 Letter, dated September 19, 2008, http://www.aba.com/aba/documents/press/LetterGuarantyProgramMoneyMarketFunds091908.pdf.

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