Money Market Investor Funding Facility

Federal Reserve Announces Creation of the Money Market Investor Funding Facility; SEC Staff Grants Interpretive and No Action Relief to Permit Money Market Funds to Participate in the Program

SUMMARY

On October 21, 2008, the Board of Governors of the Federal Reserve System (the "Board") announced the creation of a new lending facility, the Money Market Investor Funding Facility ("MMIFF"), which will support a private-sector initiative designed to provide liquidity to U.S. money market investors.¹ The MMIFF complements the Board’s previously announced Commercial Paper Funding Facility ("CPFF"), as well as its Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF").

The MMIFF will be a credit facility provided by the Federal Reserve Bank of New York ("FRBNY") to a series of special purpose vehicles established by J.P. Morgan Securities Inc. ("JPMSI") for the purchase of eligible assets (consisting of U.S. dollar-denominated commercial paper, bank notes, and certificates of deposit issued by highly rated financial institutions, having remaining maturities of 90 days or less, and satisfying certain ratings criteria) from eligible investors (U.S. money market mutual funds). Under the MMIFF program (the "Program"), the SPVs will be authorized, in total, to purchase a maximum amount of $600 billion in eligible assets. The SPVs will cease purchasing eligible assets on April 30, 2009, unless the Board extends the MMIFF.

As designed, the MMIFF and related arrangements raise a number of interpretive and other issues under the Investment Company Act of 1940, as amended (the "1940 Act"), and the rules thereunder for open-end management investment companies registered with the SEC under the 1940 Act that hold themselves out as money market funds and are operated in compliance with Rule 2a-7 under the 1940 Act ("money funds").
Today, in light of, among other things, the liquidity issues confronting money funds and the fact that the MMIFF is a temporary measure designed “first and foremost to provide liquidity” to money funds, in response to a request of JPMSI, the SEC’s Division of Investment Management (the “Division”) granted interpretive and no action relief with respect to certain provisions under the 1940 Act and the rules thereunder (the “Response Letter”).

This memorandum summarizes the operational details and terms of the MMIFF, as well as the relief granted by the Division to allow money funds to participate in the Program.

THE MONEY MARKET INVESTOR FUNDING FACILITY

ELIGIBLE ASSETS
Each SPV will purchase U.S. dollar-denominated certificates of deposit, bank notes, and commercial paper with a remaining maturity of 90 days or less. Each of the SPVs will only purchase debt instruments issued by ten financial institutions designated in its operational documents. Each of these financial institutions will have a short-term debt rating of at least A-1/P-1/F1 from two or more major rating agencies.

ELIGIBLE INVESTORS
Eligible investors will include U.S. money funds and over time may include other U.S. money market investors, subject to certain approvals.

PURCHASES OF ELIGIBLE ASSETS
Each SPV will purchase eligible assets at the money fund’s amortized cost of such assets. The purchase price paid to the money funds will be cash borrowed from the FRBNY under the MMIFF (90% of the purchase price) (the “Loans”) and asset backed commercial paper (“Commercial Paper Notes”) of the SPVs (equal to 10% of the purchase price).

Each SPV’s purchases of eligible assets from money funds will be subject to certain issuer and concentration limits. Specifically, each SPV will only purchase eligible assets issued by ten designated financial institutions, and no SPV will purchase securities of a designated issuer if, as a result of such purchase, more than 15% of its assets would, on such purchase date, constitute securities of such issuer.

RISK OF LOSS
Loans advanced by the FRBNY will be on an overnight basis and at the primary credit rate established by the Board. The Loans will be senior to the Commercial Paper Notes, with recourse to the SPV, and secured by all the assets of the SPV.

In the event of a downgrade of an issuer of an eligible asset held by an SPV, the SPV will cease all asset purchases until all of the SPV’s assets issued by the downgraded issuer have matured. In the event of a
default of any asset held by an SPV, the SPV will cease asset purchases and repayments on outstanding Commercial Paper Notes. Proceeds from maturation of the SPV’s assets will be used to repay the FRBNY and, upon maturation of all assets in the SPV, any remaining available cash will then be used to repay principal and interest on the Commercial Paper Notes. In connection with the wind-down process of an SPV, after all of the SPV’s obligations have been paid, to the extent any funds remain in the SPV, a small fixed amount of such funds will be allocated proportionally among the holders of the Commercial Paper Notes, and any remaining funds thereafter will be allocated to the FRBNY.

TERMINATION
The SPVs will cease purchasing assets on April 30, 2009, unless the Board extends the MMIFF.

INTERPRETIVE AND NO ACTION RELIEF FOR MONEY FUNDS

BOARD REVIEW REQUIREMENT
At least quarterly, the board of directors or trustees, including a majority of the independent directors or trustees, of each money fund that wishes to rely on the interpretive and no action positions of the Division in the Response Letter, shall review the money fund’s participation in the Program during the preceding quarter, and make a determination whether continued participation in the Program is in the best interests of the money fund and its shareholders. This is a requirement for reliance on any of the Division’s interpretive and no action positions in the Response Letter, including those applicable to all money funds that may wish to participate in the Program described below.

RULE 2A-7 UNDER THE 1940 ACT
Rule 2a-7 under the 1940 Act provides the exemptions from Sections 2(a)(41), 34(b) and 35(d) of the 1940 Act and Rules 2a-4 and 22c-1 thereunder necessary to permit money funds to use the amortized cost method of valuation, which facilitates the ability of money funds to maintain a stable per share net asset value, typically $1.00. In its request letter, JPMSI asserted that a money fund’s investment in Commercial Paper Notes in accordance with the terms of the Program raises two issues concerning Rule 2a-7 requirements.

Treatment of Commercial Paper Notes as an “Asset Backed Security”

Rule 2a-7(a)(3) defines an “Asset Backed Security” as a “fixed income security (other than a Government security [as defined in the Act]) issued by a “Special Purpose Entity”. “Special Purpose Entity” is defined generally as “an entity organized for the sole purpose of issuing securities that entitle their holders to receive payments that depend primarily on the cash flow from Qualifying Assets, but does not include a registered investment company.”

Based on the facts and representations in the request letter, and on the representation that the SPVs will fall within the definition of a Special Purpose Entity except that the principal purpose of the Program is to
provide liquidity to money funds, the Division stated that it will not recommend enforcement action to the SEC under Sections 2(a)(41), 34(b) and 35(d) and Rules 2a-4 and 22c-1 in connection with a money fund’s treatment of the Commercial Paper Notes as “Asset Backed Securities” as defined in Rule 2a-7.

DIVERSIFICATION

Rule 2a-7(c)(4)(i)(A) generally requires that, immediately after the acquisition of any security, a taxable fund (such as those expected to acquire the Commercial Paper Notes) not have invested more than five percent of its “total assets,” as defined in the rule, in securities issued by the issuer of the security. Rule 2a-7(c)(4)(ii)(D)(1) treats the special purpose entity (such as an SPV) as the issuer of an asset backed security and therefore requires that Rule 2a-7’s diversification requirements be met with respect to the special purpose entity. The rule creates an exception to this treatment, however, requiring a fund to "look through" the special purpose entity to any issuer of qualifying assets whose obligations constitute ten percent or more of the principal amount of the qualifying assets of the special purpose entity (“Ten Percent Obligor”). Specifically, a fund must treat each Ten Percent Obligor as if it issued a proportionate amount of the special purpose entity.

In its request letter, JPMSI raised a number of concerns regarding a money fund’s ability to comply with Rule 2a-7’s diversification requirements in connection with its participation in the Program. Specifically, JPMSI noted the following:

• There may be several Ten Percent Obligors for each SPV.
• Because of the nature of the SPVs and the subordinated nature of the Commercial Paper Notes, the holder of a Commercial Paper Note must assume that the entire amount of such security is exposed to the credit risk of each issuer whose securities may be held by the SPV; and
• As a consequence primarily of redemptions, a number of money funds are close to or exceeded the five percent diversification limitations for many of the issuers expected to be designated to an SPV. If the Ten Percent Obligor provisions discussed above are held to apply to the Commercial Paper Notes, the benefits of the Program may be partially available, or not available at all, to many money funds which desire to participate in the Program.

In the Response Letter, the Division gave its assurance that it will not recommend that the SEC take enforcement action under Sections 2(a)(41), 34(b) and 35(d) and Rules 2a-4 and 22c-1 if money funds investing in the Commercial Paper Notes comply with Rule 2a-7’s diversification requirement through an alternative method. Under the alternative method, money funds would not “look through” the SPVs in applying the Rule 2a-7 diversification test in connection with acquisitions of Commercial Paper Notes in accordance with the Program, if the following conditions are met:

• A money fund may not acquire Commercial Paper Notes issued by SPVs if it would result in such securities collectively (i.e., Commercial Paper Notes issued by all SPVs to the money fund added together) exceeding more than 2.5% of the money fund’s Total Assets (as defined in Rule 2a-7(a)(25));

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All Commercial Paper Notes must be “First-Tier Securities” as defined in Rule 2a-7(a)(12) when acquired by a money fund; and

For purposes of the money fund making additional purchases of securities of an issuer (where that issuer is one of the 10 issuers the securities of which may be held by a SPV), the money fund must add the entire value of the Commercial Paper Notes it holds to the value of other holdings of securities of the issuer held by the money fund for diversification purposes.

If a money fund purchases Commercial Paper Notes in the secondary market (i.e., not in connection with a sale of eligible assets to an SPV pursuant to the Program), it must treat such Commercial Paper Notes as set forth in the bullet directly above for purposes of the diversification requirements of Rule 2a-7 (i.e., prior to such purchase it must consider the entire value of each Commercial Paper Note as additional exposure to each of the issuers whose securities may be held by the SPV that issued the Commercial Paper for diversification purposes).

SECTION 12(D)(3) OF THE 1940 ACT AND RULE 12D3-1

Section 12(d)(3) of the 1940 Act generally prohibits a registered fund from investing in securities issued by or any other interest in the business of any person who is a broker, a dealer, is engaged in the business of underwriting, or is either an investment adviser of an investment company or an investment adviser registered under the Investment Advisers Act. Rule 12d3-1 under the 1940 Act provides exemptions from such prohibition, but is not available to permit a registered fund to acquire securities issued by the fund’s principal underwriter, investment adviser or any affiliated person of any such person.

In its request letter, JPMSI asserted that while the securities of the SPVs will not be issued by affiliated persons of any fund’s investment adviser or principal underwriter, many funds are advised by affiliated persons of financial institutions that have significant securities related businesses and are also major issuers of eligible assets. It stated that it could be argued that by investing in Commercial Paper Notes issued by an SPV that holds eligible assets issued by an affiliated person of its investment adviser or principal underwriter, a fund is engaging in a transaction that implicates the prohibition in Section 12(d)(3).

Without agreeing with the legal analysis, the Division agreed that it would not recommend enforcement action to the SEC against a money fund under Section 12(d)(3) in connection with its participation in the Program. In reaching its position, the Division relied on the facts and representations in the request letter, and in particular the fact that the Program is a temporary measure designed to provide liquidity to money funds.

RELIEF RELATING TO MONEY FUNDS ADVISED BY AFFILIATES OF JPMSI

The Division also granted no action relief under Sections 10(f), 17(a)(2), 17(d) and 17(e) of the 1940 Act and Rule 17d-1 thereunder in connection with any future purchases of Commercial Paper Notes by money funds advised by affiliated persons of JPMSI (the “Affiliated Funds”). Such relief was requested because of the various services to be provided by JPMSI and an affiliate to the SPVs, including the fact that JPMSI, as placement agent for each SPV, will intermediate all sales of eligible assets to the SPVs.
and the related purchases of Commercial Paper Notes by SPVs, as principal in accordance with operational practice in the commercial paper market. In the Response Letter, the Division noted that the relief provided was based on the facts and representations in the request letter, including in particular the fact that the Program is a temporary measure designed first and foremost to provide liquidity to money funds, the terms on which the Affiliated Funds would participate in the Program, the representation that the manner of selection of JPMSI to structure and implement the Program, and the selection of JPMSI and its affiliate to provide services in respect of the Program, and the structure of JPMSI’s and such affiliate’s compensation for providing such services, were made without any regard to whether the Affiliated Funds would participate in the Program, and the representation that JPMSI expects the vast majority of the money funds participating in the Program to be money funds that are not Affiliated Funds.

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ENDNOTES


2 J.P. Morgan Securities Inc. (available October 22, 2008). Sullivan & Cromwell LLP submitted the request for such interpretive and no action relief.
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