

IS MY CASH SAFE?

FREQUENTLY ASKED QUESTIONS ABOUT MONEY MARKET FUNDS AND BANK ACCOUNTS

As the credit crisis continues to roil the markets, companies and individual investors alike are fleeing to the relative safety of cash. We say “relative” safety, because recent events have made clear that not all cash investments are alike. Many investors who placed their cash in money market funds were stunned by the announcement on September 16 that the \$62 billion Reserve Primary Fund had “broken the buck,” i.e., its net asset value per share had dipped below \$1.00. Keeping cash at a bank, on the other hand, also began to look risky, especially after the spectacular failures of Washington Mutual and IndyMac, the two largest bank failures in U.S. history.

In response to these events, the U.S. Treasury Department announced that it would temporarily guarantee funds held in money market funds. In addition, the Emergency Economic Stabilization Act of 2008, which was signed into law on October 3, 2008, temporarily raises the amount of insurance provided by the Federal Deposit Insurance Corporation (FDIC) from \$100,000 to \$250,000 per insured depositor. Also, on October 14, 2008, the FDIC announced a new temporary guarantee program that, among other things, guarantees interbank borrowings and provides unlimited coverage for non-interest bearing deposit transaction accounts. In this alert, we answer some of the most frequently asked questions about money market funds and bank accounts, the Treasury’s guarantee program for money market funds, and the FDIC insurance and guarantee programs for bank accounts.

MONEY MARKET FUNDS AND BANK ACCOUNTS

What is a money market fund?

A money market fund is a mutual fund that invests in high-quality, short-term debt instruments, such as government securities, certificates of deposit, commercial paper and bank notes. Although money market funds are not required by law to maintain a \$1.00 net asset value, they are required by Securities and Exchange Commission (SEC) rules to be managed to maintain a stable net asset value. Among other things, SEC rules regulate the credit quality, maturity and diversification of investments held by a money market fund.

- **Credit quality.** A money market fund may invest only in U.S. dollar denominated securities that the fund’s board of directors determines present “minimal credit risks.” In addition, at least 95 percent of the assets of a taxable money market fund must consist of securities that are rated in the highest short-term rating category by two nationally recognized rating agencies (or from one such agency if only one agency

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has rated the security) or securities determined by the fund's board of directors to be of comparable quality. Up to five percent of a taxable money market fund's investments may be in securities that are in the second-highest short-term rating category or of comparable quality.

- **Maturity.** Money market funds are generally permitted to invest only in securities that have a remaining maturity of 397 days or fewer and must maintain a weighted average portfolio maturity of 90 days or fewer.
- **Diversification.** Money market funds generally may invest not more than five percent of their assets in the securities of a single issuer.¹

Although money market funds are regulated by the SEC, the funds themselves are sponsored by fund companies, and, until the Treasury's recent action, they carried no guarantee as to principal.

What are the credit risks of money market funds?

While money market funds historically have been considered relatively safe investments (the Reserve Primary Fund was only the second money market mutual fund to break the buck in the history of such funds), recent events have demonstrated that investments in these types of funds are not without some level of risk. The primary credit risk is that a money market fund will "break the buck" due to a default or downgrade in the credit rating of an underlying security. The Reserve Primary Fund, for example, lost value due to its investments in Lehman Brothers' debt.

What are the liquidity risks of money market funds?

In addition to the risk that a money market fund might break the buck due to a credit default, there is the risk that a fund might suspend redemptions due to a lack of liquidity, thereby denying investors access to their funds. A money market fund must generally pay an investor tendering shares for redemption within seven days of such tender. However, this right of redemption may be suspended in certain emergencies or for such other periods as the SEC may, by order, permit for the protection of the fund's security holders. In the wake of the Reserve Primary Fund's demise, panicked investors withdrew record amounts from their money market funds, forcing funds to quickly dump investments to honor the redemptions. Some funds were allowed to suspend redemptions altogether so that they could achieve a more orderly sale of assets.

¹ There are exceptions for, among other things, securities issued by the U.S. government or its instrumentalities, and securities that are fully guaranteed (such as through bond insurance or letter of credit enhancements) by entities not controlled by the issuer of the securities. Also, diversification requirements vary for tax-exempt state specific funds.

Are there ways to reduce the risks of investing in money market funds?

There are several measures you can take to reduce your exposure to the credit and liquidity risks of a money market fund:

- **Shift money to a Treasury fund:** Since the primary objective of most investors in a money market fund is preservation of principal, you can reduce your risk by investing in a money market fund that invests solely in U.S. Treasuries. However, you will also likely experience a lower yield.
- **Invest in funds with major sponsors.** You might want to look to funds that are part of a major brokerage house or mutual fund family, because these firms are more likely to have the resources and reputational incentive to provide financial support to a fund when it gets in trouble, so that investors are protected from losses. Although an investment adviser or sponsor has no legal obligation to do so, there have been over 20 instances during the past year in which an adviser or sponsor stepped in to protect securities held in a money market fund.²
- **Check the fund's credit rating.** You should check the rating of the money market fund. Various organizations, including Standard & Poors (S&P) Ratings Services, Moody's Investor Services and Fitch Ratings, provide ratings for money market funds. The ratings generally address a fund's ability to maintain a net asset value of \$1.00 per share and to limit its exposure to losses due to credit, market and liquidity risks. For example, S&P ratings for a money market fund range from 'AAAm' (extremely strong capacity to maintain principal stability) to 'Dm' (failure to maintain principal stability, resulting in a realized or unrealized loss of principal).³
- **Monitor the fund's portfolio quality.** Money market funds are required to send investors semi-annual and annual reports that include information on their holdings. These reports are also filed with the SEC and are often available on the fund's Web site. Also, some money market funds regularly post online updates of their portfolios.
- **Diversify your cash accounts.** You can also consider diversifying your cash accounts by spreading them over several different money market funds at different providers. You should also note that many brokerage firms and mutual fund companies offer, through banking affiliates and subsidiaries, savings and other accounts that are FDIC insured up to certain limits.

² L. Scherzer, "Is Your Money-Market Fund Safe?," Smart Money (Sept. 18, 2008), available at <http://www.smartmoney.com/print/index.cfm?printcontent=/consumer/index.cfm?story=Is>.

³ The 'm' distinguishes S&P's money market fund ratings from S&P's debt ratings, which usually do not include subscripts.

- **Confirm SIPC insurance.** If you hold your money market fund shares through a brokerage firm, check to make sure that your account is SIPC insured. The Securities Investor Protection Corporation (SIPC) provides limited protection for cash and securities held by investors at brokerage firms that are members of the SIPC. Virtually all broker-dealers registered with the SEC are members of the SIPC, and those few who are not must disclose this fact to their customers. Upon failure of a brokerage firm insured by the SIPC, or if investor assets are stolen by a broker from an SIPC-insured account, the SIPC will provide investors up to \$500,000 of protection for cash and securities, such as stocks, bonds, mutual fund shares and other securities registered with the SEC (with a \$100,000 limit for the replacement of cash). The SIPC does not insure against losses of value in particular investments caused by a decrease in their value but generally will replace securities even if their value has increased. There are some investments that are not protected by the SIPC. These include commodity futures contracts, commodity options, fixed annuity contracts, currency, and investment contracts and limited partnership interests that are not registered with the SEC. For more information visit www.sipc.org. You should also note that some brokers provide their customers with “Excess SIPC” insurance that covers amounts greater than the SIPC limits.
- **Confirm your fund’s participation in the Treasury’s temporary guarantee program.** Finally, you should check to see if your money market fund is participating in the Treasury’s temporary guarantee program, which we discuss in greater detail below.

Is a money market mutual fund the same as a money market account?

No. A money market account, or a money market deposit account, is an interest-earning savings account that is offered by a bank or thrift institution and has limited transaction privileges.

Is a “money market-plus” fund or an “enhanced yield” fund the same as a money market fund?

No. These types of funds have the flexibility to seek higher yields than money market funds by investing in slightly longer duration instruments with less-stringent credit quality requirements. Because they may invest in lower-quality securities, these types of “cash enhanced” products carry greater risks. For example, the Charles Schwab Yield Plus Fund is currently the target of numerous lawsuits claiming that the fund was marketed as a conservative investment alternative to money market funds. The fund, which was down 31 percent for the year ended June 30, 2008, had invested heavily in mortgage-related securities.

Money market-plus funds should not be confused with money market-plus accounts offered by banks and thrifts. Such accounts are typically savings accounts that offer slightly higher interest rates but have limited withdrawal and check writing privileges.

What other types of accounts and investments are offered by banks?

In addition to money market accounts and checking and savings accounts, banks and thrifts often offer other deposit and investment products, including trust accounts, negotiable order of withdrawal (NOW) accounts, individual retirement accounts (IRAs), certificates of deposits (CDs), mutual funds and annuities. We discuss below which of these products are covered by FDIC insurance.

TREASURY'S TEMPORARY GUARANTEE OF MONEY MARKET FUNDS

What is the Treasury's guarantee program?

The Treasury's guarantee program is a plan to protect shareholders who had accounts as of September 19, 2008, in money market mutual funds that enroll in the program, from losses if their money market funds are unable to maintain a \$1.00 net asset value per share.

Which money market funds does the program cover?

The program is available to retail and institutional money market funds that (i) are regulated under Rule 2a-7 of the Investment Company Act of 1940, (ii) are publicly offered and registered with the SEC, (iii) have a policy of maintaining a stable net asset value or share price of \$1.00 per share and (iv) had, as of the close of business on September 19, 2008, a net asset value per share of at least \$0.995. The program is open to both taxable and tax-exempt money market funds. Participation in the program is not automatic. To participate, a money market fund must have applied by October 8, 2008, and paid a fee for participation. As of October 8, the vast majority of eligible funds had applied to participate in the program. You should contact your money market fund directly to determine if it is participating in the program.

Does the program cover all types of shareholders in a participating money market fund?

The program covers all retail, institutional, domestic and foreign shareholders who had accounts on September 19, 2008, in a money market fund that participates in the program.

What is the fee for a money market fund to participate in the program, and who bears the cost of the fee?

For the first three months of the program, participating money market funds will pay an upfront fee of 0.01 percent (one basis point) or 0.015 percent (1.5 basis points) depending upon the net value per share of their assets as of September 19. The fee is based on the number of shares outstanding in the money market fund on September 19, and the fee may be paid from shareholder assets. Some fund sponsors, however, are absorbing all or a portion of the fee on behalf of the fund. Additional fees will be required upon any extension of the program after the first three months.

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How long does the program last?

The program will operate initially for three months, at which time the secretary of the Treasury will review the need, terms and costs of the program. The secretary of the Treasury has the option to extend the program until the close of business on September 18, 2009. Money market funds must re-enroll in the program to remain covered after each extension.

Is there a per-account cap on the amount guaranteed?

No, there is no per-account cap under the program. However, the program provides a guarantee based on the number of shares held at the close of business on September 19. If there is an increase in the number of shares held in an account after the close of business on September 19, those additional shares will not be guaranteed. If the number of shares in an account fluctuates during the period, investors will be covered for the lesser of either the number of shares held as of the close of business on September 19 or the amount of shares in the account when the guarantee is invoked.

When is the guarantee triggered?

The guarantee will be triggered if a participating fund's net asset value falls below \$0.995 after September 19, 2008, but before termination of the program, unless the decline is promptly cured. If the guarantee is triggered, the fund must liquidate within 30 days, although the Treasury can extend the liquidation period. Once the fund has liquidated, the shortfall between the proceeds from the liquidation and \$1.00 per share will be covered by the Treasury, subject to availability of funds under the program.

What assets are used to provide the guarantee?

The Treasury is authorized to use assets from the Exchange Stabilization Fund of up to \$50 billion to guarantee money market funds under the program. The Exchange Stabilization Fund was established by the Gold Reserve Act of 1934, and, historically, its funds have been used to purchase or sell foreign currencies, to hold U.S. foreign exchange and Special Drawing Rights assets and to provide financing to foreign governments. There is currently about \$50 billion in the fund.

FDIC INSURANCE PROGRAM

What is the FDIC?

The FDIC is a corporation of the United States Government that was created to protect consumers against loss of insured deposits if they have an account at a bank or a thrift institution (such as a savings and loan association) that has FDIC insurance and fails.

What does FDIC insurance cover?

FDIC insurance covers all types of deposits received at an insured bank or thrift, including deposits in checking accounts, savings accounts, trust accounts, money market deposit accounts, NOW Accounts, IRAs and CDs. Accounts are covered dollar for dollar up to the insurance limit and include principal and accrued interest through the date of the closing of the insured bank or thrift.

What does FDIC insurance not cover?

FDIC insurance does not cover money invested in stocks, bonds, mutual funds, life insurance policies, annuities or municipal securities, even if they were bought from an insured bank or thrift. FDIC insurance also does not cover safe deposit boxes or their contents and does not cover U.S. Treasury bills, bonds or notes.⁴ These instruments are backed by the United States government.

How much coverage does FDIC insurance provide?

The Emergency Economic Stabilization Act of 2008 temporarily increased the amount of insurance provided by the FDIC from \$100,000 to \$250,000⁵ per depositor, per insured bank or thrift. This temporary increase extends until December 31, 2009. Despite this limit, multiple accounts may be maintained at the same bank or thrift, but in different categories of legal ownership, for an aggregate amount of FDIC insurance coverage at a single bank or thrift that exceeds the basic coverage limits. For instance, a married couple would have up to \$1,500,000⁶ of FDIC insurance coverage at a single bank if the couple maintained the following five accounts, each of which is in a different category of legal ownership: (1) a joint checking account (each owner is covered up to \$250,000), (2) a separate checking or savings account for the wife (\$250,000 coverage), (3) a separate checking or savings account for the husband (\$250,000 coverage), (4) a CD held in the wife's name, payable on death to the husband (\$250,000 coverage) and (5) a CD held in the husband's name, payable on death to the wife (\$250,000 coverage).

What are the categories of legal ownership recognized by the FDIC?

There are eight categories of legal ownership recognized by the FDIC: (1) single accounts, (2) joint accounts, (3) revocable trust accounts (including payable-on-death accounts), (4) irrevocable trust accounts, (5) self-directed retirement accounts, (6) employee benefit plan

⁴ Even though Treasury securities are not covered by FDIC insurance, any payments of principal and interest on Treasury securities that are deposited into an account at an insured institution are covered by FDIC insurance up to the applicable insurance limit.

⁵ Certain retirement accounts (including IRAs), which were already insured up to \$250,000, will remain at that coverage limit.

⁶ This amount will be reduced to \$600,000 and the references to \$250,000 in this example will be reduced to \$100,000 after December 31, 2009, when coverage is scheduled to revert back to \$100,000 per depositor.

accounts, (7) business/organization accounts and (8) government/public unit accounts. The FDIC provides an online resource known as the Electronic Deposit Insurance Estimator (EDIE) that allows investors to calculate insurance coverage for each FDIC-insured bank where an investor has deposit accounts. EDIE is available at www.fdic.gov/edie.

What funds are available to cover losses?

The FDIC's Deposit Insurance Fund had approximately \$45 billion as of the end of the second quarter of 2008. Last week, the FDIC proposed doubling the fees it charges to banks and thrifts in order to boost the fund. The FDIC also has available a \$30 billion line of credit with the Treasury.

Are there alternatives for insuring deposits that exceed the limits for FDIC insurance?

FDIC insurance limits are calculated per financial institution. One way to obtain additional FDIC insurance is to deposit funds in multiple banks or financial institutions. In addition, some banks and financial institutions participate in a program known as the Certificate of Deposit Account Registry Service (CDARS). This program eliminates the need for investors to place money in multiple banks or institutions by allowing an investor to sign an agreement with one participating bank or institution that divides the money among other participating banks and institutions and makes sure that no accounts exceed the applicable FDIC insurance limits. Investors may deposit up to \$50 million under this program. For a list of banks and institutions that participate in CDARS, visit their website at www.cdars.com.

FDIC GUARANTEE PROGRAM

What is the FDIC's new guarantee program?

On October 14, 2008, the FDIC announced a new Temporary Liquidity Guarantee Program (the "FDIC Guarantee Program") that is designed to (1) unlock interbank credit markets by guaranteeing new senior unsecured debt issued by banks, thrifts and eligible holding companies and (2) stabilize banks and thrifts by guaranteeing non-interest bearing deposit transaction accounts without regard to amount.

What institutions are eligible to participate in the FDIC Guarantee Program?

The FDIC Guarantee Program is available to FDIC-insured depository institutions, U.S. bank holding companies, U.S. financial holding companies and U.S. savings and loan holding companies that engage only in activities that are permissible for financial holding companies to conduct under Section 4(k) of the Bank Holding Company Act.

How do eligible institutions enroll in the program?

Initially, all such eligible institutions are automatically covered by the FDIC Guarantee Program for a period of 30 days. Prior to the end of the 30-day period, an eligible institution must inform the FDIC if it wants to opt out of the program. If an eligible institution opts out, the guarantees

provided by the program will expire at the end of the 30-day period. Institutions that participate in the program will be subject to enhanced supervisory oversight to prevent rapid growth and risk-taking. Institutions will be charged a fee to participate, as discussed in more detail below.

What does the FDIC Guarantee Program cover?

The FDIC Guarantee Program will guarantee—

- All newly issued senior unsecured debt issued by a participating institution on or before June 30, 2009. This includes promissory notes, commercial paper, inter-bank funding and any unsecured portion of secured debt. The maximum amount of debt covered by the guarantee is 125 percent of the participating institution's debt that was outstanding as of September 30, 2008, and that was scheduled to mature before June 30, 2009. The guarantee ends on June 30, 2012, even if the maturity of the debt extends beyond that date.
- Funds in non-interest bearing transaction deposit accounts held by participating FDIC-insured banks until December 31, 2009.

Why is the FDIC providing the FDIC Guarantee Program?

The FDIC's guarantee of new bank debt is one of several federal initiatives intended to help free up the credit markets. Due to the uncertainty about the value of mortgage assets, banks have been particularly reluctant to lend to each other. The FDIC's guarantee should facilitate both term and overnight funding of banks, thereby freeing up funds for banks to make loans to businesses and consumers.

The FDIC's guarantee of non-interest bearing transaction deposit accounts is intended to help stabilize such accounts, which are often used by businesses for processing payroll and other expenses. Because these accounts frequently exceed the \$250,000 limit on FDIC insurance, many businesses have moved their accounts from smaller banks to much larger competitors that are believed to be more likely to withstand the financial turmoil.

What are the fees for participating in the FDIC Guarantee Program?

Fees under the program are waived for the first 30 days. Thereafter, the following fees will be charged—

- For all newly issued senior unsecured debt, an annualized fee equal to 75 basis points multiplied by the amount of debt issued under the program
- For non-interest-bearing transaction deposit accounts, a 10 basis point surcharge will be applied to non-interest bearing transaction deposit accounts not otherwise covered by the existing deposit insurance limit of \$250,000. This surcharge will be added to the participating bank's existing risk-based deposit insurance premium paid on these deposits.

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What assets will be used to provide the guarantee?

The FDIC Guarantee Program will be paid for by the user fees discussed above. If the cost of the program exceeds the fees collected, the FDIC has authority under the systemic risk exception of the FDIC Improvement Act of 1991 to impose a special assessment on the banking industry to cover any deficiency. The FDIC Guarantee Program does not rely on the Deposit Insurance Fund, which provides FDIC insurance coverage for deposits at banks and thrifts.

For additional information related to the Treasury Program, visit the United States Department of Treasury at www.treas.gov.

For additional information related to FDIC insurance visit www.fdic.gov.

For additional information related to the FDIC Guarantee Program, visit <http://www.fdic.gov/news/news/press/2008/pr08100b.html>.

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