

## SEC Amends Rules for Money Market Funds

The magnitude and severity of the global financial crisis that began in 2007 has prompted regulators around the globe to conduct a full-scale review of their rules and regulations. With the common theme to strengthen oversight and regulation, we anticipate a flurry of regulatory reform.

As a more than \$3 trillion business, money market funds did not go unscathed by the financial crisis. As you may recall, the events of September 2008 may be remembered as the most challenging period in history for the money markets. The government had placed government-sponsored enterprises Fannie Mae and Freddie Mac into conservatorship. Over the three-day period from September 13-15, Bank of America agreed to purchase Merrill Lynch, the future of AIG remained uncertain and Lehman Brothers declared bankruptcy. The culmination of these events

triggered a liquidity crunch across the financial markets. Despite these turbulent times, only one money market fund's net asset value "broke the buck" and fell below one dollar per share.

In response to money market funds increasingly important systemic role and the desire to make funds more resilient in the face of extraordinary market conditions, the Securities and Exchange Commission (SEC) proposed a series of new rules in July 2009. On January 27, 2010, the SEC voted 4-1 to adopt several of their proposals.

The amendments can be characterized into three main groups: risk reducing, enhanced disclosure and operational enhancements. The below chart highlights the changes outlined by the SEC:

### Changes to Rule 2a-7 for Money Market Funds

	Revised SEC Regulations	Current SEC Regulations
<b>Maturity Limits</b>	<ul style="list-style-type: none"> <li>Maximum weighted average maturity (WAM) is 60 days</li> <li>Maximum weighted average life (spread WAM) of 120 days</li> </ul>	<ul style="list-style-type: none"> <li>Maximum weighted average maturity (WAM) is 90 days</li> <li>No spread WAM requirement</li> </ul>
<b>Credit Quality</b>	<ul style="list-style-type: none"> <li>Limit the purchase of Second Tier securities to 3% of fund's assets</li> <li>Limit exposure to any single Second Tier Issuer to 0.5% of a fund's assets</li> <li>Limit the maximum maturity of Second Tier securities to 45 days</li> <li>Funds must designate, at least annually, four (4) Nationally Recognized Statistical Rating Organizations (NRSROs) whose ratings the fund's Board considers to be reliable</li> </ul>	<ul style="list-style-type: none"> <li>Limit the purchase of Second Tier securities to 5% of fund's assets</li> <li>Limit exposure to any single Second Tier Issuer to 1% of a fund's assets or \$1 million</li> <li>Maximum maturity of Second Tier securities is 397 days</li> <li>No ratings designation requirement</li> </ul>
<b>Liquidity</b>	<ul style="list-style-type: none"> <li>At least 10% of assets must meet the daily liquidity standard, and 30% of assets must meet the weekly liquidity standard</li> <li>Limit "illiquid" securities to 5% of a fund's portfolio</li> </ul>	<ul style="list-style-type: none"> <li>No liquidity requirement</li> <li>Limit "illiquid" securities to 10% of a fund's portfolio</li> </ul>
<b>Repurchase Agreements</b>	<ul style="list-style-type: none"> <li>If a fund "looks through" the repurchase agreement, collateral will be restricted to cash or government securities</li> <li>Creditworthiness of the repurchase agreement counterparty must be evaluated</li> </ul>	<ul style="list-style-type: none"> <li>If a fund "looks through" the repurchase agreement, collateral will be restricted to cash, government securities and highly-rated securities</li> <li>No counterparty creditworthiness requirement</li> </ul>
<b>"Know Your Client"</b>	<ul style="list-style-type: none"> <li>Funds must adopt procedures to identify investors whose redemption requests may pose a risk for funds and therefore hold sufficient amounts of liquid securities to meet redemptions</li> </ul>	<ul style="list-style-type: none"> <li>No "Know Your Client" requirement</li> </ul>
<b>Disclosure</b>	<ul style="list-style-type: none"> <li>Monthly website postings of portfolio holdings</li> <li>Monthly reporting to the SEC with detailed portfolio schedules and the fund's "shadow" NAV. This information would be available to the public on a 60-day delay</li> </ul>	<ul style="list-style-type: none"> <li>No disclosure requirement</li> <li>A fund's "shadow" NAV is reported to the SEC semi-annually, with a 60-day delay</li> </ul>
<b>Stress Testing</b>	<ul style="list-style-type: none"> <li>Require funds to examine each month their ability to maintain a stable NAV in the event of shocks</li> </ul>	<ul style="list-style-type: none"> <li>No stress test requirement</li> </ul>
<b>Run Protection</b>	<ul style="list-style-type: none"> <li>All funds and their administrators must be able to process transactions electronically at a price other than \$1.00 per share</li> <li>Permit a fund's Board of directors to suspend redemptions if the fund was to break the buck and decides to liquidate the fund</li> </ul>	<ul style="list-style-type: none"> <li>No processing requirement</li> <li>Board must submit an order to the SEC to suspend redemptions</li> </ul>
<b>Purchase by Affiliates</b>	<ul style="list-style-type: none"> <li>Expand the ability of affiliates of money market funds to purchase distressed assets from funds in order to protect a fund from losses. SEC notification is required if action taken</li> </ul>	<ul style="list-style-type: none"> <li>An affiliate may purchase securities from the fund after a ratings downgrade or default, with SEC approval</li> </ul>

Source: Securities and Exchange Commission Press Release <http://www.sec.gov/news/press/2010/2010-14.htm> and Rule 2a-7 Investment Company Act

The adoption of these rules is a good first step to ensuring that money market funds continue to represent a safe, highly liquid option for investors of cash. More needs to be done, according to Chairman Shapiro. As the Chairman stated, the SEC will engage in pursuing fundamental changes to the structure of money market funds, including but not limited to the introduction of a floating NAV.

The impact on the money market strategies employed by Western Asset Management will be limited. Western Asset has already been adhering to the guidelines

recommended by the ICI in early 2009. The new SEC amendments are, overall, a bit more stringent, but are generally consistent with the ICI proposals.

The SEC amendments will result in a more competitive money market fund yield environment, as the portfolio management investment tools become more limited. However, Western's extensive experience in managing money market funds, in conjunction with our emphasis on credit research and risk management will enable us to continue to provide attractive returns to our investors as the regulatory landscape continues to evolve.

**Please note that an investment in a money market fund is neither insured nor guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the fund.**

The information provided is current as of January 28, 2010 and is not on behalf of any Western Asset or Legg Mason managed product or service. This information was compiled by Western Asset Management utilizing various publically available third party sources. Western Asset cannot guarantee the completeness or accuracy of the information provided. Forecasts and future actions should not be relied upon as an indication of actual future results. This publication should not be forwarded to any other person. Contents herein should be treated as confidential and proprietary information. This material may not be reproduced or used in any form or medium without express written permission.

Legg Mason Investor Services, LLC, and Western Asset Management are subsidiaries of Legg Mason, Inc.

© 2010 Legg Mason Investor Services, LLC, Member FINRA, SIPC