

25th Annual Windy City Summit

Liquidity and the Money Markets in a Changing Regulatory Landscape

May 19, 2011

Michael Cha, Executive Director, Portfolio Manager
Michael.Cha@morganstanley.com

Confidential: For exclusive use for the 25th Annual Windy City Summit. This is not to be reproduced or redistributed.

Disclosure

The information in this presentation is highly confidential and is being provided solely for informational and educational purposes. It is to be used exclusively at the Windy City Summit on 5/19/11 and may not be reproduced or distributed to any other persons. The information herein does not contend to address the financial objectives, situation or specific needs of any individual investor. In addition, this Presentation is not an offer, or a solicitation of an offer, to buy or sell any security or instrument or to participate in any trading strategy.

Any views expressed are those of the presenter as of the date of the presentation and are subject to change at any time due to changes in market or economic conditions. The views expressed does not reflect the opinions of all portfolio managers at MSIM or the views of the firm as a whole, and may not be reflected in the strategies and products that the Firm offers.

Charts and graphs provided herein are for illustrative purposes only. Any forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass. **Past performance is not indicative of future results.**

All investments involve risks, including the possible loss of principal. There is no assurance that a money market portfolio will achieve its investment objective. **An investment in a money market portfolio is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market portfolio seeks to preserve the value of an investment at \$1.00 per share, if it is unable to do so, it is possible to lose money by investing in a money market portfolio. Accordingly, you can lose money investing in this portfolio. Please be aware that such portfolios may be subject to certain additional risks.** Fixed-income investing is subject to credit and interest-rate risks. For important disclosures and additional risk considerations, please refer to slide 33 and to the product's prospectus.

Please consider the investment objectives, risks, charges and expenses of the portfolios carefully before investing. The prospectus contains this and other information about the portfolios and can be obtained by visiting www.morganstanley.com/im. Please read the prospectus carefully before investing.

Morgan Stanley does not render advice on tax and tax accounting matters to clients. This material was not intended or written to be used, and it cannot be used with any taxpayer, for the purpose of avoiding penalties which may be imposed on the taxpayer under U.S. federal tax laws. Federal and state tax laws are complex and constantly changing. You should always consult your legal or tax advisor for information concerning your individual situation.

©2011 Morgan Stanley. Morgan Stanley Distribution, Inc. serves as distributor for the Morgan Stanley Institutional Liquidity Funds.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

Liquidity and the Money Markets in a Changing Regulatory Landscape

Regulatory Reform and Rates Volatility Impacts the Money Markets

- In recent years the global money markets have experienced considerable change in the context of the regulatory environment.
- The regulatory changes initiated in an attempt to mitigate a variety of risk factors that helped fuel the market dislocation of 2007-2008 have exacerbated the supply/demand equilibrium in the money markets.
- Navigation of this still evolving landscape can prove challenging for various constituents of the money markets including MMF investors, MMF sponsors and borrowers in the global wholesale funding markets.
- Before effectively navigating what lies ahead and assessing how the marketplace moves forward from here, we need to understand how we arrived at this point and how the money markets, and more importantly, the regulators responded to the U.S. and global financial crises.

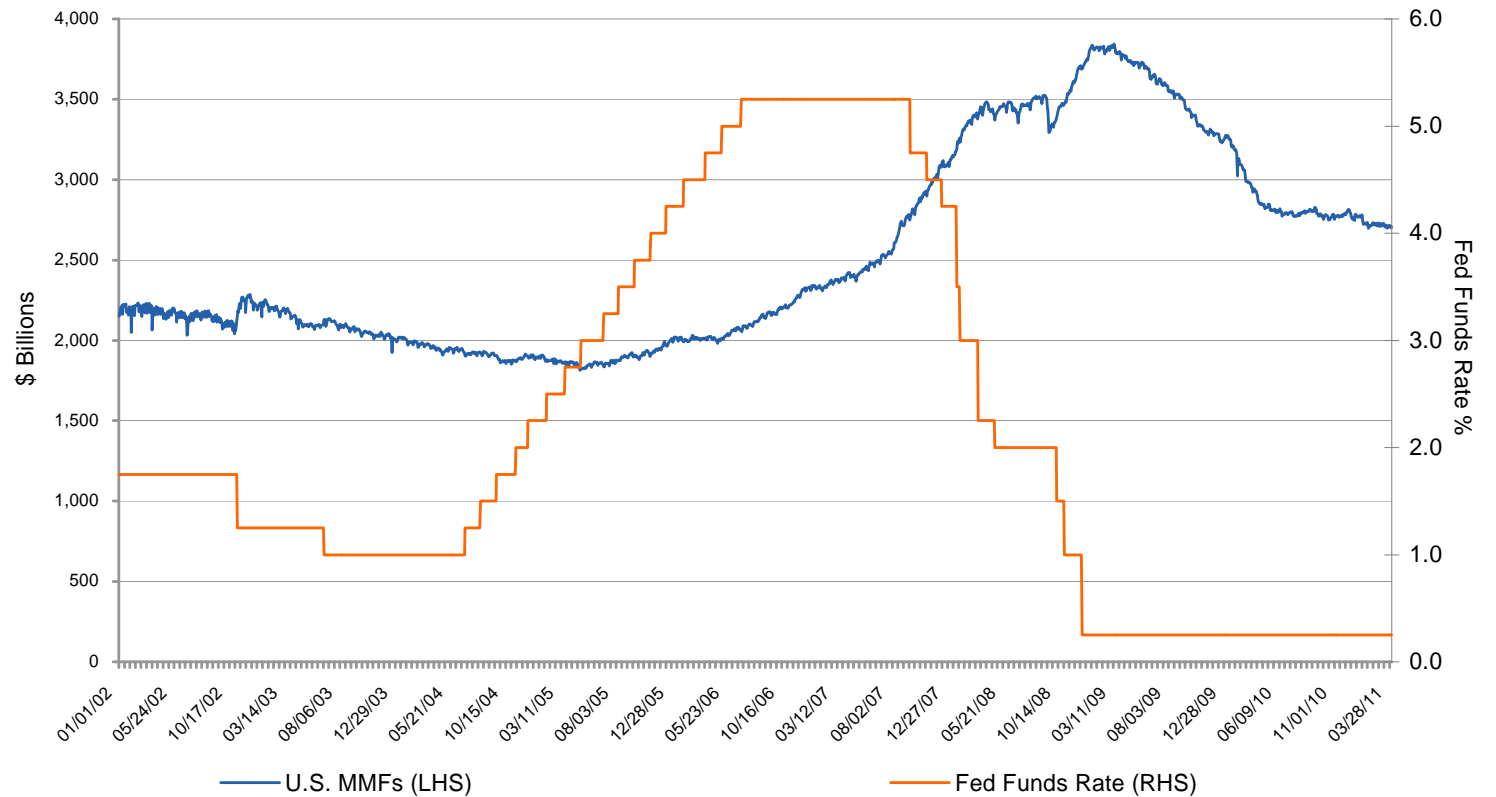
Money Market Funds – A Brief History

- The Role of Money Market Funds in The Global Financing Markets.
- Regulatory Framework for Money Market Funds.
- Money Market Funds and the Global Financial Crisis.

U.S. Money Market Fund AUM Growth

Money Market Fund AUM Compared To Fed Funds Rate

1/1/2002 – 3/31/2011



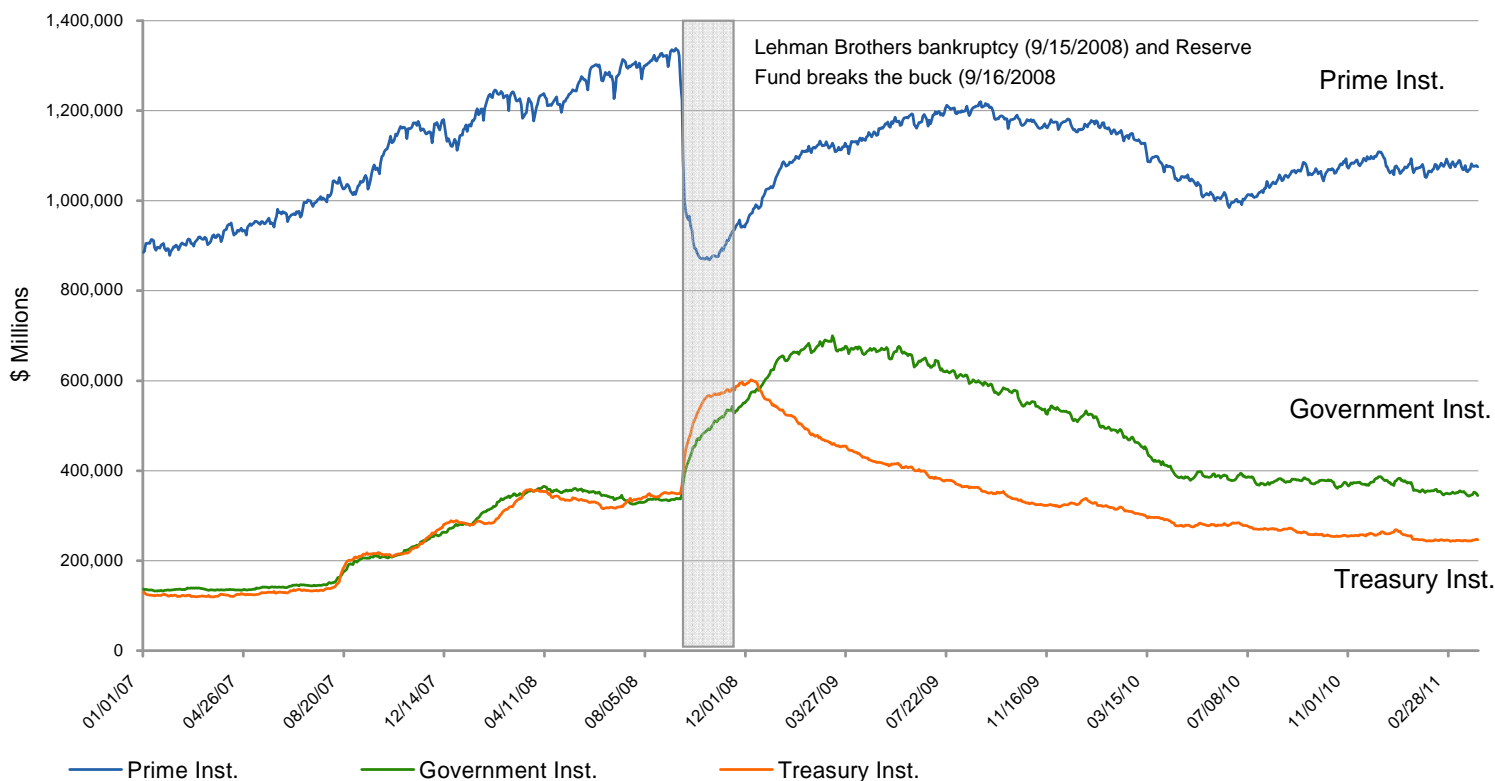
Sources: iMoneyNet, Bloomberg

Institutional Money Market Fund AUM Growth

Prime, Government, and Treasury Institutional Money Market Funds

Daily Institutional MMF Industry Assets

1/1/2007 – 3/31/2011



Source: iMoneyNet

Prime Inst. includes First-tier Inst Funds on iMoneyNet

Government Inst. includes Government Securities-only and Government and Repo Funds

Treasury Inst. includes Treasury-only and Treasury and Repo Funds

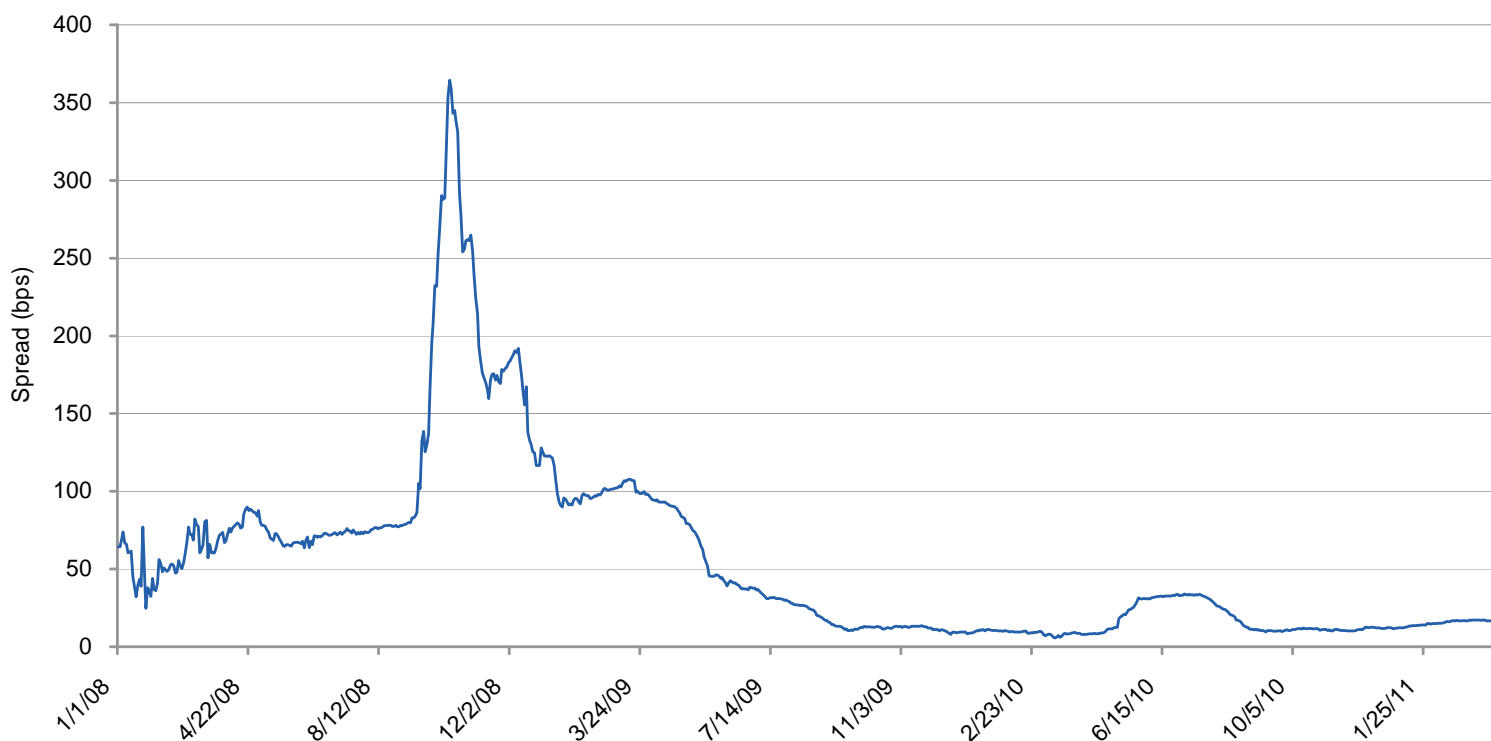
LIBOR-OIS Spread

LIBOR-OIS Spread is a proxy for liquidity risk in the financial system

- 3M Libor – Overnight Index Swap Rate

LIBOR-OIS Spread

1/1/08- 3/31/11



Source: Morgan Stanley Research

TED Spread

TED Spread is representative of perceived credit risk in the overall economy

- 3M Libor – 3M T-Bills

TED Spread

1/1/08- 3/31/11



Source: Morgan Stanley Research

Government Response to the Financial Crisis

Key Actions Taken to Improve Market Liquidity

Program Name	Authority	Purpose	Peak Utilization
Asset-Backed Commercial Paper Money Market Liquidity Facility (AMLF)	Federal Reserve	Liquidity	\$145.9 Billion ¹
Temporary Guarantee Program for Money Market Mutual Funds	U.S. Treasury	Guarantee	\$3,355.3 Billion ²
Commercial Paper Funding Facility (CPFF)	Federal Reserve	Liquidity	\$349.9 Billion ³
Temporary Liquidity Guarantee Program (TLGP)	U.S. Treasury/ FDIC	Guarantee	\$834.5 Billion ⁴
Money Market Investor Funding Facility (MMIFF)	Federal Reserve	Liquidity	\$0 ⁵

- (1) Total Lending: October 8, 2008 (Source: SIGTARP)
- (2) Theoretical Exposure to Money Market Funds: September 29, 2008 (Source: SIGTARP)
- (3) Total Facility Holdings: January 21, 2009 (Source: SIGTARP)
- (4) Total Amount Guaranteed: December 31, 2009 (Source: FDIC)
- (5) No loans were made under the MMIFF (Source: The Federal Reserve Board)

The Regulators' Response to Crisis: SEC Rule 2a-7 Amendments

- Rule 2a-7, A Brief History
- Rule 2a-7, The Revisions
- The Impact of Rule 2a-7 Amendments



On February 23, 2010 the SEC issued its final Money Market Fund Reform rules, adopting changes to Rule 2a-7.

SEC Amendments to Rule 2a-7

- **Shortened Maturity Limits**
 - Restrict maximum WAM of a money market fund (MMF) to 60 days (vs. previous limit of 90 days).
 - Restrict maximum WAL of a fund's portfolio to 120 days (vs. no prior limits).
- **Improved Liquidity**
 - Reduce "illiquid securities" bucket to a maximum of 5% of portfolio assets¹ (vs. previous limit of 10%).
 - Taxable funds must have at least 10% of assets liquid within one day, and all funds must have at least 30% liquid within one week.
- **Higher Credit Quality**
 - MMFs are restricted to investing a maximum of 3% of portfolio holdings in Tier II securities, with a concentration limit of 0.5% in any one issuer. (Previously, MMFs could invest 5% of their assets in Tier II paper, with a maximum of 1% of assets per issuer.)
- **Periodic Stress Tests**
 - Require fund managers to examine a fund's ability to maintain a stable net asset value per share in the event of market turbulence and changes in the credit quality of the portfolio.
- **Monitor Shareholder Concentrations**
 - Require MMFs to develop procedures to identify those large shareholders whose redemption requests may pose liquidity problems for the fund.
- **Provide Enhanced Disclosure of Portfolio Securities**
 - Require MMFs to post their portfolio holdings on their Web sites each month.
 - MMFs must report their portfolio holdings to the SEC each month in a format that the SEC can use to create an interactive database. Results from this will be a "shadow" NAV calculation that will be disclosed to the public on a 60-day lag.
- **Suspension of Redemptions**
 - Allow a fund's board of directors to authorize the suspension of redemptions if the fund were to "break the buck" and decide to liquidate.
- **Electronic Processing**
 - Require that all MMFs and their administrators be able to process purchases and redemptions electronically at a price other than \$1 per share. The requirement would facilitate share redemptions if a fund were to "break the buck."
- **Purchases by Affiliates**
 - Expand the ability of affiliates of MMFs to purchase distressed assets from funds in order to protect a fund from losses.

1. Illiquid securities are those defined as any security that cannot be sold or disposed of within 7 days at carrying value. This summary is for informational purposes only. Morgan Stanley is not commenting on the SEC's changes. These changes may not represent the views of Morgan Stanley as a whole.

Source:
"Money Market Fund Reform." Securities and Exchange Commission. Final Rule. February 23, 2010.

<http://sec.gov/rules/final.shtml>

The Regulators' Response to Crisis: Basel III

- Basel III – A Brief History
- Basel III - Liquidity Ratios
- The Impact of Basel III on Supply of CP and Government Securities
- The Impact to Supply/Demand Dynamics

BASEL III – Liquidity Proposals

Minimum Global Standard for Liquidity

Liquidity Coverage Ratio

$$\frac{\text{Stock of high quality liquid assets}}{\text{Net cash outflows over a 30-day time period}} \geq 100\%$$

- Designed to ensure that a bank maintains an adequate level of unencumbered, high quality assets which may be converted to cash to meet liquidity needs over a 30-day horizon under an acute liquidity stress scenario specified by supervisors

Net Stable Funding Ratio

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} > 100\%$$

- Designed to promote medium- and long-term funding of the assets and activities of banks over a one year time horizon

Outstanding Commercial Paper Levels Have Fallen

Commercial Paper Outstanding Seasonally Adjusted

Commercial Paper Outstanding

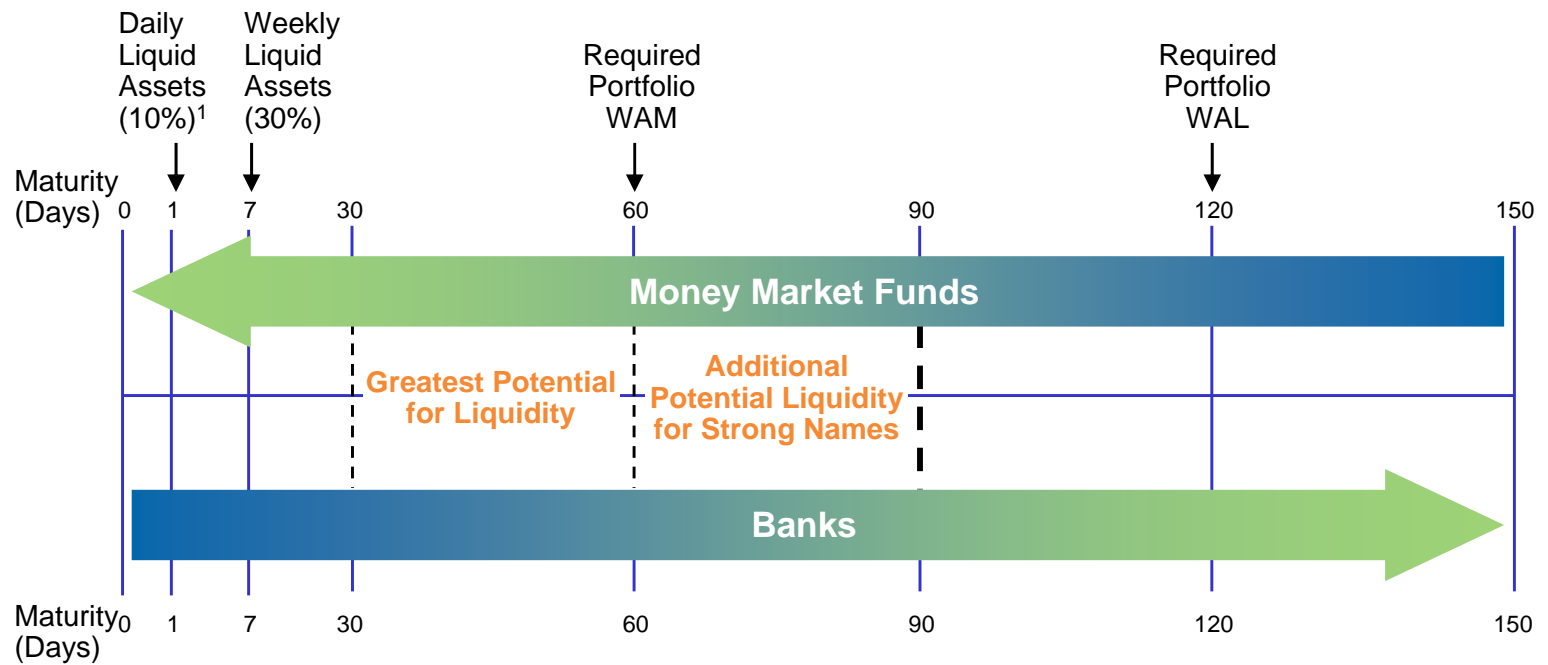
Weekly Data as of March 31, 2011



Note: Commercial Paper Outstanding consists of Financial Commercial Paper, Nonfinancial Commercial Paper, and Asset Backed Commercial Paper.

Source: The Federal Reserve

Impact of Regulatory Reform On the Short-Term Market



Source: Morgan Stanley Investment Management

1. Tax-exempt money market funds do not have to comply with the Daily Liquid Asset requirement.

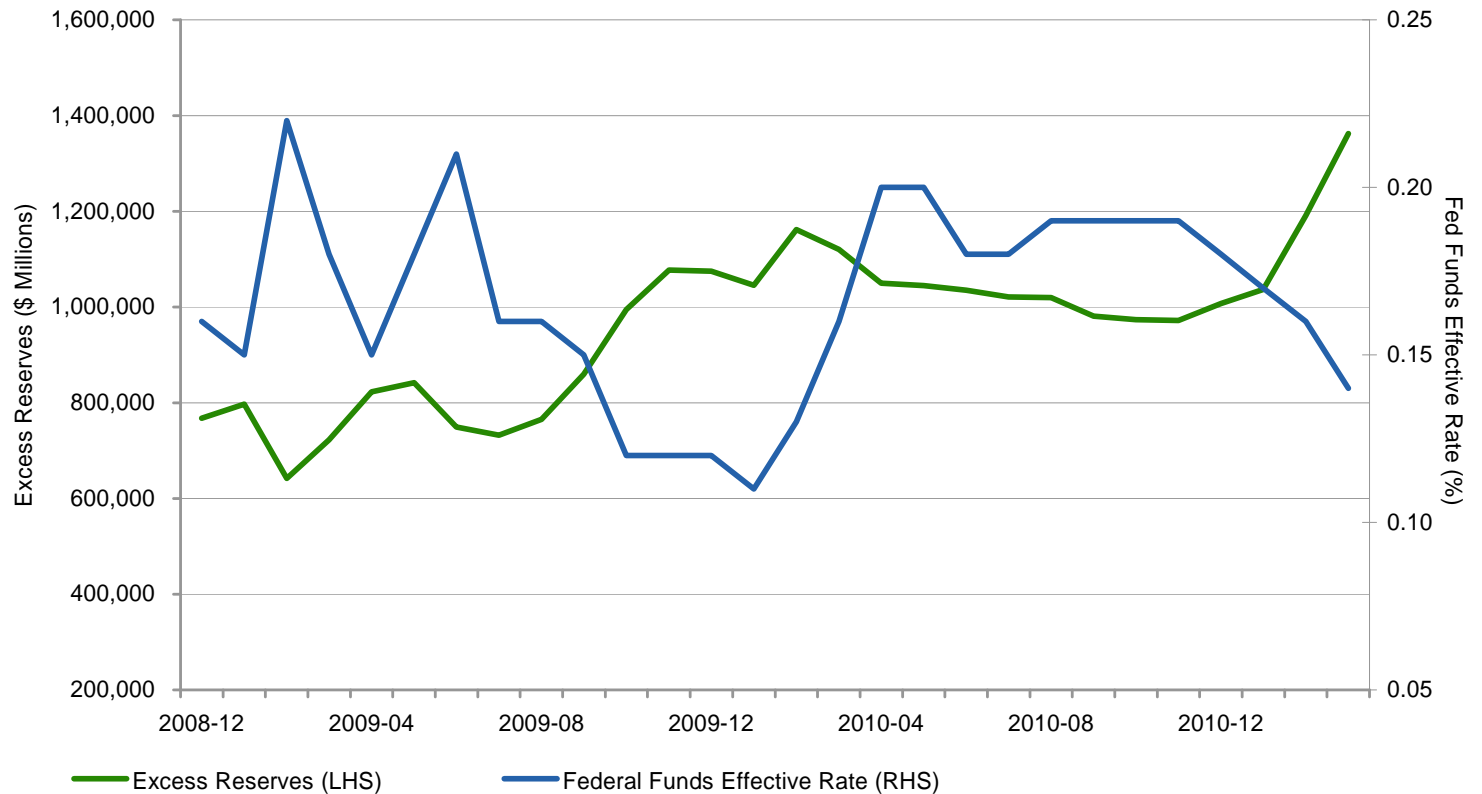
The Regulators' Response to Crisis: Dodd–Frank Wall Street Reform and Consumer Protection Act

- Background - Dodd – Frank and the Change in the FDIC Base Assessment Methodology.
- The Impact of the New FDIC Base Assessment Regime.
- Background - Dodd – Frank and the Repeal of Regulation Q.
- The Impact of the Repeal of Regulation Q.

Federal Funds Effective Rate vs. Excess Reserves

Federal Funds Effective Rate vs. Excess Reserves

1/1/2007- 3/31/2011



Sources: U.S Federal Reserve

The Regulators' Response to Crisis: Presidents Working Group on Financial Markets – Money Market Fund Reform Options

- PWG – A Brief History
- Money Market Fund Reform Options – Potential Impact

President’s Working Group (“PWG”) ⁽¹⁾ Proposed Enhanced Money Fund Reform

- On October 21, 2010, PWG proposed further Money Market Funds’ (MMF) reforms, which:
 - Seek to complement the recently adopted SEC 2a-7 reforms to limit MMFs’ susceptibility to runs
 - Reduce systemic risks posed by a run on a money fund
 - Further enhance investor protection
 - Maintain MMFs’ attractiveness relative to less regulated investment options
 - Internalize the costs of liquidity or risks associated with operation, by aligning incentives
 - Seeks to address further elements of MMFs which make them vulnerable to runs, including:
 - Stable / rounded NAV
 - Discretionary sponsor support
 - Highly risk-averse investor-base
- The proposal was open for public comment through January 10, 2011
- Implementation is expected to include both regulatory and legislative action

Reform Option	Issue	Process	Considerations
Eliminate stable NAV and move floating NAV for MMFs (SEC)	<ul style="list-style-type: none"> • Concepts of stable NAV and history of sponsor support have lead to perception that MMFs are risk-free. Inability to maintain stable NAV increases susceptibility to runs 	<ul style="list-style-type: none"> • Floating NAV reporting would make gains and losses more transparent, thereby reflecting the inherent risks to investors 	<ul style="list-style-type: none"> • Does not completely eliminate risk of a run • Could reduce the attractiveness of MMFs, thereby limiting credit they provide to the broader economy • May shift MMFs flows into less regulated vehicles potentially increasing systemic risk • Implementation would be critical as the transition process may generate destabilizing effects
Private emergency liquidity facilities for MMFs	<ul style="list-style-type: none"> • Inability to quickly access alternate sources of liquidity in times of distress exacerbates the effects of a run on the fund 	<ul style="list-style-type: none"> • Facility capitalized and financed by the MMF industry 	<ul style="list-style-type: none"> • Issues surrounding mandatory vs. voluntary participation include appropriate governance, alignment of incentives, and generating capacity elements to ensure efficacy during times of distress • Raising sufficient capital might be burdensome the industry and of the facility may require other sources of liquidity • Mandatory participation would necessitate regulatory oversight and monitoring
Mandatory redemptions in kind for large redemptions by institutional investors (SEC)	<ul style="list-style-type: none"> • Large redemptions impose greater liquidity strains and higher costs on MMFs and their shareholders during a crisis (primarily from the most liquid assets being sold first to raise cash) 	<ul style="list-style-type: none"> • MMFs would distribute securities in proportion to the investor’s claim and any realized loss associated with the sale of those securities would be limited to the investor 	<ul style="list-style-type: none"> • Indirect consequences of observed market prices from a sale may affect the MMF • Operational issues, such as transferability, criteria for distribution, and allocation of securities would need to be worked out
Public and / or private insurance for MMFs	<ul style="list-style-type: none"> • Lack of formal capital and liquidity mechanisms and expectation of sponsor support contribute to runs 	<ul style="list-style-type: none"> • MMFs would pay premium to cover potential losses 	<ul style="list-style-type: none"> • Pricing challenges may be hard to overcome and limit private participation • Determining mandatory vs. voluntary participation • Balancing competing products and creating appropriate participation incentives are key • Mandatory participation would necessitate greater regulatory oversight and monitoring
Regulating stable NAV MMFs as special purpose banks (“SPBs”) (legislation)	<ul style="list-style-type: none"> • Expectation of the sector to function like a bank without the explicit benefits creates issues during crisis 	<ul style="list-style-type: none"> • Unclear 	<ul style="list-style-type: none"> • Requirements to reorganize as SPBs may be too onerous for the sector • May trigger limitations on availability of short-term credit and / or put pressure on returns relative to bank deposits resulting in shifts to unregulated entities

Source: The U.S. National Archives and Records Administration, U.S. Department of the Treasury

1. The Working Group on Financial Markets or the President’s Working Group, chaired by the Secretary of the Treasury, includes the Chairs of the FRB, SEC and the Commodity Futures Trading Commission.

President’s Working Group (“PWG”) ⁽¹⁾ Proposed Enhanced Money Fund Reform (cont’d)

Reform Option	Issue	Process	Considerations
<p>A two – tier system of MMFs with floating and stable NAV offerings:</p> <ul style="list-style-type: none"> Enhanced protection for stable NAV funds (SEC) <p>Or</p> <ul style="list-style-type: none"> Stable NAV MMFs reserved for retail investors 	<ul style="list-style-type: none"> MMF investors have varying risk-tolerance and larger shareholders have a greater need for a stable NAV product make(s) the MMF and vulnerabilities to runs and contribute to contagion effects for the sector in times of crisis 	<ul style="list-style-type: none"> Creating two offerings between which investors can choose with the stable NAV having more stringent mechanisms to minimize liquidity issues / runs Same as above with the choice between the two offerings made available to retail, but limiting institutional investors to floating NAV 	<ul style="list-style-type: none"> Investor education about the differences between the options would be key to mitigate market-disrupting flows The challenges of any incremental requirement(s) for stable NAV funds relative to floating NAV offering would have to be considered (i.e., a requirement to have access to emergency liquidity) Defining qualifying criteria for each investor class would be key Institutional investors with a need for a stable NAV product might create incentives for offerings outside the scope of regulation
<p>Regulating stable NAV MMFs as special purpose banks (“SPBs”) (legislation)</p>	<ul style="list-style-type: none"> Expectation of the sector to function like a bank without the explicit benefits creates issues during crisis 	<ul style="list-style-type: none"> Unclear 	<ul style="list-style-type: none"> Requirements to reorganize as SPBs may be too onerous for the sector May trigger limitations on availability of short-term credit and/or put pressure on returns relative to bank deposits resulting in shifts to unregulated entities
<p>Enhanced constraints on unregulated MMF substitutes legislation)</p>	<ul style="list-style-type: none"> Additional reforms likely to create pressure on MMFs yields create incentives for shareholders to look for alternative offerings that do not comply with SEC rules 	<ul style="list-style-type: none"> Potential approach would be prohibiting unregistered investment vehicles from offering stable NAV funds 	<ul style="list-style-type: none"> May require policy reforms outside the MMF industry to reduce any potential arbitrage Possible review of certain exemptions for registration under the Investment Company Act would be required

Source: The U.S. National Archives and Records Administration, U.S. Department of the Treasury

1. The Working Group on Financial Markets or the President’s Working Group, chaired by the Secretary of the Treasury, includes the Chairs of the FRB, SEC and the Commodity Futures Trading Commission.

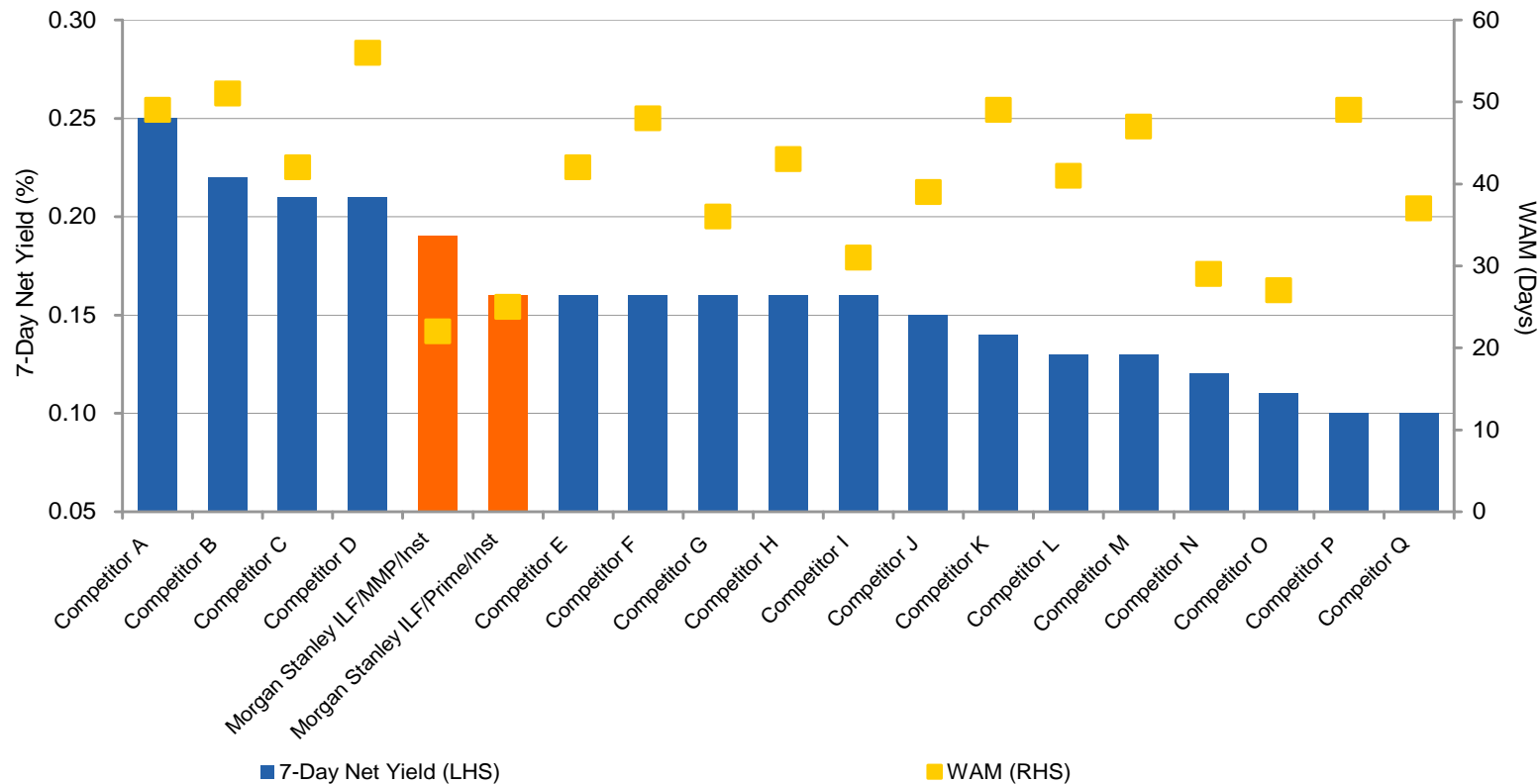
Looking Ahead and Challenges for Money Markets

- The changing regulatory landscape has created unintended challenges for various constituents in the global money markets.
- The supply/demand equilibrium is vulnerable to shifts as the regulatory changes create different incentives for investors and borrowers.
- Although the form is unknown, more regulatory changes are on the horizon. Risk premiums in the money markets will prevail without knowing for certain how the regulatory framework for various constituents will ultimately be defined.
- Continuing to be prudent in minimizing risk with a primary focus on preservation of capital and liquidity is key to money market funds in this current market

Prime and Money Market Portfolios Yield and Weighted Average Maturity (WAM) Comparison

Prime Institutional MMF Yield and WAM Comparison

As of 3/31/2011



Source: iMoneyNet

Performance data quoted represents past performance, which is no guarantee of future results, and current performance may be lower or higher than the figures shown. For the most recent month-end performance figures, please visit www.morganstanley.com/im or call 1-888-378-1630. Investment returns will fluctuate, and fund shares — when redeemed — may be worth more or less than their original cost. Yields/WAM shown are for the Institutional Class. Performance for other share classes will vary.

The information shown is provided solely for illustrative purposes only. Data is compiled from iMoneyNet and the 15 competitors referenced represents those the team deems to be their major competitors based on similar AUM levels.