Understanding Liquidity in Money Market Mutual Funds

Liquidity is defined by SEC regulations

For a money market mutual fund, "liquidity" refers to the extent to which the fund's holdings can be quickly converted to cash. Liquidity is a particularly important attribute of a money market mutual fund, as it measures the fund's ability to meet near-term shareholder redemptions.

The SEC defines "liquid assets" in Rule 2a-7.[1] This rule defines the categories of daily liquid assets and weekly liquid assets by identifying specific types of fund holdings that can be readily converted to cash within one or five business days, respectively. The particular instruments and claims that qualify as either daily or weekly liquid assets are listed in Exhibit 1, below.

EXHIBIT 1: TYPES OF FUND HOLDINGS THAT SATISFY SEC DEFINITIONS OF DAILY AND WEEKLY LIQUID ASSETS

DAILY LIQUID ASSETS	WEEKLY LIQUID ASSETS
Cash[2]	Daily liquid assets (see column at left)
Direct obligations of the U.S. government[3]	Government agency discount notes with remaining maturities of 60 days or less
Securities that will mature or are subject to a demand feature[4] that is exercisable and payable within one business day	Securities that will mature or are subject to a demand feature that is exercisable and payable within five business days
Receivables scheduled to be paid within one business day	Receivables scheduled to be paid within five business days

Money market mutual fund liquidity must exceed a prescribed level

Rule 2a-7 requires that each money market mutual fund hold sufficient liquidity to meet reasonably foreseeable shareholder redemptions, as well as any other commitments it has made to shareholders.

In fact, the SEC also imposes the complementary requirement that money market mutual funds adopt "know your customer" policies and procedures to assure that funds undertake appropriate efforts to identify risk characteristics of their shareholders and to plan their holdings of liquid assets accordingly.[5]

In addition to these general requirements, the SEC rules impose specific minimum requirements on the amounts of daily and weekly liquid assets a money market mutual fund must hold, as well as specific remedies for restoring liquidity in cases where these minimum levels are breached. In particular, whenever a fund's daily liquid assets account for less than 10 percent of its total assets, the fund is prohibited from acquiring any new asset other than a daily liquid asset.[6] Similarly, if a fund's weekly liquid assets make up less than 30 percent of its total assets, the fund cannot acquire any new asset other

Key Takeaways

- Securities and Exchange Commission (SEC) regulations define liquidity and prescribe a minimum amount of liquidity that each money market mutual fund must hold.
- SEC rules permit the imposition of liquidity fees and redemption gates on certain money market mutual funds if a fund's weekly liquid assets were to fall below 30%.
- At Fidelity Investments, we carefully monitor the factors affecting redemptions in our money market mutual funds, and apply a consistent, rigorous approach to determine the appropriate levels of liquidity across all our funds.
- We understand that readily available liquidity is a primary goal of our money market mutual fund shareholders, and therefore we make liquidity management a critical priority in our investment process.

than a weekly liquid asset. These conditional restrictions on fund management are designed to help rebuild a fund's daily and weekly liquidity levels whenever these levels become too low. Rule 2a-7 also has a separate limitation that a money market mutual fund shall not invest more than 5% of its total assets in illiquid securities. The SEC defines an illiquid security as one that cannot be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund.

SEC rules impose liquidity fees and/or redemption gates on certain funds based on weekly liquid assets level

The SEC's rules permit some money market mutual funds to limit redemptions under certain conditions. Specifically, if a fund's weekly liquid assets were to fall below 30%, the board of directors of a prime (general purpose) fund or a municipal fund may either charge a liquidity fee of up to 2% on shareholder redemptions or impose a halt on all shareholder redemptions (known as a "gate") for no longer than 10 days. Additionally, if weekly liquid assets were to fall below 10%, a prime or municipal fund must impose a liquidity fee of 1%, unless the fund's board determines that such a fee is not in the fund's best interests. These liquidity fee and redemption gate requirements apply to both retail and institutional funds. Government and U.S. Treasury money market mutual funds will not be subject to liquidity fees or redemption gates.[7]

Liquidity fees: guidelines

- The board of directors may impose a fee of up to 2% on shareholder redemptions if a fund's weekly liquid assets were to fall below 30%.
- If weekly liquid assets were to fall below 10%, the board is required to impose a 1% liquidity fee, unless the board determines that a fee is not in the best interests of the fund.
- The fee would be lifted when weekly liquid assets return to 30% or when the fund's board determines that a liquidity fee is no longer in the best interests of the fund.
- All fees would be payable to the fund.
- The board will have the authority to impose a lower fee or perhaps no fee at all if, in its opinion, that is in the best interests of the fund.

Liquidity fees: reasoning, disclosure requirements

- The SEC's intent in imposing a fee is to transfer the costs of liquidating fund securities from the shareholders who remain in the fund to those who leave the fund during periods when liquidity is scarce.
- In April 2016, each money market mutual fund began disclosing daily on its website the daily and weekly liquid assets as a percentage of the fund's total assets as well as net shareholder flows from the previous business day.
- The imposition or removal of a liquidity fee, as well as a discussion of the board's analysis in determining whether or not to impose a fee, must be disclosed promptly and publicly by a money market mutual fund.

Redemption gates

- In addition to imposing a liquidity fee, the SEC rules permit the fund's board to impose a temporary suspension of all redemptions if weekly liquid assets were to fall below 30%.
- The gate would be lifted when weekly liquid assets return to 30% or when the fund's board determines a gate is no longer in the best interests of the fund.
- The gate could be in place for 10 consecutive days or 10 days in total over the course of a 90-day period.
- A money market mutual fund must disclose promptly and publicly whether a redemption gate has been imposed or removed, as well as a discussion of the board's analysis in determining whether or not to impose or remove a gate.

Shareholder composition can strongly influence money market mutual fund liquidity levels

In addition to the specific liquidity requirements of Rule 2a-7, a prudent money market mutual fund manager should determine whether the required minimum levels of liquidity are sufficient to satisfy shareholder redemptions that could occur in the near term and, if necessary, the amount of additional liquidity that is appropriate.

Some future redemption activity can be accurately predicted based on regular discussions with customers about their goals and liquidity needs. However, much future redemption activity is uncertain, and fund managers must deal with this uncertainty by determining a reasonable upper boundary on potential near-term redemption volume—a limit that includes a significant margin of safety beyond the expected volume so that any unexpected redemptions will likely be satisfied. At Fidelity, we determine the appropriate margin of safety for each money market mutual fund by conducting a quantitative analysis of such factors as historical shareholder redemption patterns, shareholder composition and concentration, and overall financial market conditions.

Proper liquidity management is among Fidelity's highest money market mutual fund priorities

Our experience in managing money market mutual funds has taught us that readily available liquidity is a primary goal of our shareholders. We therefore consider the management of liquidity a critical priority in our investment process, and we dedicate a significant proportion of our time and resources to ensure that we understand, monitor, and mitigate liquidity risks appropriately within our funds.

You could lose money by investing in a money market fund. An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Before investing, always read a money market fund's prospectus for policies specific to that fund.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

These materials are provided for informational purposes only and should not be construed as a recommendation of any security, sector, or investment strategy. Please consult your tax or financial advisor for additional information concerning your specific situation.

Past performance is no guarantee of future results.

Endnotes

1. Rule 2a-7, promulgated under the Investment Company Act of 1940, regulates how all U.S. money market mutual funds are managed.

2. In the money market mutual fund industry, "cash" is broadly understood to take the form of demand deposits at banks.

3. Direct obligations consist primarily of U.S. Treasury bills, notes, and bonds.

4. A demand feature is an embedded attribute of a security that entitles the holder to redeem the security at a price that approximates its amortized cost plus any accrued interest at the time of exercise.

5. The adoption of "know your customer" policies and procedures is required by Rule 38a-1 under the Investment Company Act of 1940.

6. Municipal money market mutual funds are currently exempt from the requirement of holding a minimum amount of daily liquidity.

7. The final rules are clear that liquidity fees and/or redemption gates do not apply to U.S. Treasury or government money market mutual funds.

The SEC is allowing U.S. Treasury or government money market mutual funds to add liquidity fees and/or redemption gates to a fund, but only after shareholders receive 60 days' written advance notice.

Before investing, consider the funds' investment objectives, risks, charges, and expenses. Contact Fidelity for a prospectus or, if available, a summary prospectus containing this information. Read it carefully.

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