Understanding Liquidity in Money Market Mutual Funds

Liquidity is defined by SEC regulations

For a money market mutual fund ("money market 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 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 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 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 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 25 percent of its total assets, the fund is prohibited from acquiring any new asset other than a daily liquid asset (tax-exempt funds are exempt from this requirement). Similarly, if a fund's weekly liquid assets make up less than 50 percent of its total assets,

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.
- 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.
- SEC rules require non-government money market funds to impose a discretionary liquidity fee (not to exceed 2% of the value of the shares redeemed) if the fund's board (or its delegate) determines that a fee is in the fund's best interests. Government money market funds may opt in to the discretionary liquidity fee.

  SEC rules require institutional prime and institutional tax-exempt money market funds to impose a mandatory liquidity fee if the fund experiences net redemptions that exceed 5% of net assets on a single day.

Fidelity Investments currently offers Government (including U.S. Treasury), Retail Prime, and Retail Municipal/Tax-Exempt money market funds to the public.

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the fund cannot acquire any new asset other than a weekly liquid asset.[6] 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 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 under certain conditions

Under the SEC's rules, non-government money market funds are required to impose a discretionary liquidity fee (not to exceed 2% of the value of the shares redeemed) if the fund's board (or its delegate) determines that a fee is in the fund's best interests. Government money market funds may opt in to discretionary liquidity fees. The SEC's rules require institutional prime and institutional tax-exempt money market funds to impose a mandatory liquidity fee if a fund experiences net redemptions that exceed 5% of net assets on a single day (or such smaller amount of net redemptions as the board determines).[7]

Liquidity fees: Guidelines

- SEC rules do not require a particular approach to determining the level of a discretionary liquidity fee. Once imposed, a discretionary liquidity fee must be applied to all shares redeemed and must remain in effect until the board determines that a fee is not in the best interests of the fund.
- The size of the mandatory liquidity fee for an institutional prime or institutional tax-exempt fund must be based on a good faith estimate (supported by data) of the costs the fund would incur if it sold a pro rata amount of each security in its portfolio to satisfy the amount of net redemptions. The calculation must take into account: (i) transaction costs, and (ii) for holdings that are not daily or weekly liquid assets, market impacts. The amount of the fee is not limited. No liquidity fee is required if fund's liquidity costs are de minimis (i.e., less than 1 basis point). Once a fund crosses the 5% limit, it must apply the liquidity fee to all shares redeemed at a price computed on that day.
- All fees would be payable to the fund.

Liquidity fees: Reasoning, disclosure requirements

- The SEC's intent in requiring liquidity fees 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 fund began disclosing on its website, at the end of each day, 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 of a liquidity fee, as well as information about the liquidity fee, must be disclosed as part of a money market fund's monthly public reporting.

Shareholder composition can strongly influence money market fund liquidity levels

- In addition to the specific liquidity requirements of Rule 2a-7, a prudent money market 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 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 fund priorities

Our experience in managing money market 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 funds are managed. On July 12, 2023, the SEC adopted amendments to Rule 2a-7 ("new rules") to be implemented over 2023 and 2024.

2. In the money market 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. The new rules increase a money market fund's minimum daily liquidity requirement from 10% to 25% and minimum weekly liquidity requirement from 30% to 50%; the new requirements go into effect April 2, 2024. Effective June 11, 2024, money market funds are required to publicly report if daily or weekly liquid assets fall below 12.5% or 25%, respectively.

7. Under the new rules, only institutional prime and institutional tax-exempt money market funds are subject to the mandatory liquidity fee framework. Discretionary liquidity fees apply for all prime and tax-exempt money market funds and do not apply to U.S. Treasury or government money market funds unless they opt in (after advance notice to shareholders). The compliance date for the mandatory liquidity fee framework is October 2, 2024, and for the discretionary liquidity fee framework is April 2, 2024.

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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