With the formal announcement of updated regulations for money market funds received from the Securities & Exchange Commission, investors and fund manager are actively evaluating the impact of these changes. A key component of these regulations includes the implementation and use of floating net asset values (NAVs) for all institutional prime funds. Deutsche Asset & Wealth Management has first-hand experience managing a floating NAV prime institutional money market fund operating in accordance with the requirements of current Rule 2a-7, and we are pleased to share our perspectives on questions related to the anticipated changes.

**Early adopters** - *Would you be able to provide some additional information regarding the two year implementation period for the floating NAV, liquidity fees, and redemption gates? What are the expectations on when funds will actually be compliant and the new rules to go into effect? Could there be early adopters of the new rules prior to the two year deadline?*

The main provisions of the new regulations, including the requirement to implement a floating net asset value ("NAV") for all prime institutional money market funds and liquidity fees and redemption gates for non-government money market funds (government money market funds may opt into liquidity fees and gates with the approval of the money market fund’s board and appropriate disclosures), will take effect on October 14, 2014, with a compliance date two years after the effective date. The two-year compliance period will expire on October 14, 2016, after which all money market funds will need to be in compliance with these new requirements.

During the compliance period, we would expect that firms that offer money market funds would evaluate the operational elements necessary to implement these new regulations and would work with teams across their organization and with service providers to the money market funds to determine the steps necessary to achieve compliance within the two-year period. As operational and structural issues are addressed internally, we would expect that the money market funds may proceed to adopt policies and procedures to operate under the new rules, subject to any board approvals, public disclosures, and applicable shareholder votes. We would expect that money market funds will be implementing any changes necessary to comply with these new regulatory requirements in advance of the 2016 deadline.

**Float in practice** - *How are funds going to determine the floating NAV? Will it be a continuously floating price or will the price be set at a specific time each day for the current day or next trading day? Is there guidance on how this needs to operate or is it left up to the fund? Trying to understand how this will actually work in practice.*

We would expect that a floating NAV money market fund will calculate its NAV at least once each business day, typically not later than 4:00 p.m. Eastern time, that the fund is open for business. The price at which investors buy and sell shares is based on the NAV per share calculated after the order is received and accepted by the money market fund.
A floating NAV money market fund will determine its current NAV per share based upon the market value of the securities within the portfolio that have readily available market quotations, or at fair value, determined in good faith by the board of the money market fund, for other securities within the portfolio. We would expect that most institutional prime money market funds will value securities within their portfolio using information furnished by an independent pricing agent based upon board adopted valuation procedures. Since the share price needs to be determined in order to fairly value purchases and redemptions in a fund, the total portfolio needs to be priced before transactions are completed. While currently we do not believe it is operationally feasible for a floating NAV money market fund to calculate intra-day NAVs (e.g., at 1:00 p.m. ET and 4:00 p.m. ET), we understand that certain pricing vendors are developing processes that may allow intra-day pricing of money market instruments in the future. Current $1.00 NAV money market funds have been able to provide multiple intra-day redemptions through their use of amortized cost accounting.

**Reporting** – Given the increased accounting activity will MMFs be able to provide daily transaction summaries and lot level details at cost when investors buy into and out of funds? This is a question that came up from our accounting department who has concerns around the tracking of unrealized and realized g/l. Any clarification you can provide will be helpful.

Taxable investors in floating NAV money market funds, like taxable investors in other types of mutual funds, may experience gains and losses in the event of fluctuation in the fund’s NAV. Accordingly, it should be expected that shareholders in floating NAV money market funds would owe tax on any realized gains, would receive tax benefits from any realized losses, and would be required to determine those amounts.

The Treasury Department and the IRS have issued proposed regulations that would permit investors in floating NAV money market funds to elect to use a simplified aggregate method of accounting which would be formally applicable for taxable years ending after the publication of the final regulations in the Federal Register. At this time, we do not have a formal date for the adoption and effectiveness of these new proposals.

The simplified aggregate accounting method proposed would allow money market fund investors to compute net capital gain or loss for a year by netting their annual redemptions and purchases with their annual starting and ending balances. The simplified aggregate method would enable investors to determine their annual net taxable gains or losses using information that is currently provided on shareholder account statements and would eliminate any requirement to track individually each share purchase, each redemption, and the basis of each share redeemed. We expect that the simplified aggregate method will significantly reduce the burdens associated with tax consequences of the floating NAV requirement because funds will not have to build new tracking and reporting systems and shareholders will be able to calculate their tax liability using their existing shareholder account statements, rather than tracking the basis for each share.

**SEC guidance** – Are unrealized g/l supposed to flow through OCI or the I/S? This was another question from our accounting team. If there is an official SEC or GAAP guidance document floating around that would be helpful.
Although final guidance regarding accounting treatment for unrealized gains or losses on vNAV money market funds has not yet been confirmed, the SEC did directly comment on the balance sheet classification for such investments which should allow investors to assess the accounting treatment with their auditors. As stated in the Adopting Release, it is the Commission’s position that, under normal circumstances, an investment in a money market fund with a floating NAV under the final rules meets the definition of a cash equivalent:

"The adoption of a floating NAV alone for certain rule 2a-7 funds will not preclude shareholders from classifying their investments in money market funds as cash equivalents, under normal circumstances, because fluctuations in the amount of cash received upon redemption would likely be small and would be consistent with the concept of a ‘known’ amount that give rise to credit and liquidity issues for money market funds so that shareholders would need to reassess if their investments continue to meet the definition of a cash equivalent."

For reference, as described in FAS 95, cash equivalents are short-term, highly liquid investments that are both: 1) readily convertible to known amounts of cash, and 2) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Generally, only investments with original maturities of three months or less qualify under that definition. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold. It would be appropriate for investors to review these requirements with their accountants and auditors to confirm that their agreement to classify floating NAV money market funds as Cash Equivalents, with all associated accounting treatment, in your financial statements.

**Historical NAV movement** – Are there any historical studies or data that show NAV price movements? The question has come up regarding what the expectations are for day to day movements.

Below is the historical price movement of the Deutsche Variable NAV Money Market Fund (ticker VNVXX), which is a AAA-rated prime money market fund managed in accordance with Rule 2a-7. This fund provides a live track record for the historical price volatility in a floating NAV money market fund.

Source: Bloomberg as of 8/26/14. Past performance is historical and does not guarantee future results.
As you can see, the NAV of this fund has moved very infrequently and in only 1bps increments. With an NAV history going back over three years, this timeframe includes periods of significant market turmoil, including the US downgrade, the European financial crisis, and the US government shutdown, among many other geopolitical and credit events.

Prime institutional money market funds will still need to comply with the credit quality, diversification, and, importantly, liquidity requirements set forth under the new rule 2a-7 guidelines.

**Hypothetical** – In a scenario where a fund drops to 0.995, typically how long would it take for the fund price to return to ~1.00 given the turnover and roll down in the fund portfolio? This probably a difficult question to answer but in general we are wanting to understand how a floating NAV would act, how volatile it would be, and given the short term nature of the investment how the price will continue to adjust back to 1.00 as securities roll off.

To consider this hypothetical, let’s first look at the investment strategy that would likely be deployed by a floating NAV money fund. We’ll examine the strategy in terms of managing through credit risk, liquidity and redemption risks, and market rate shocks.

**Credit risk scenario** – For money market fund holdings that are experiencing a credit quality event, the decisions of a portfolio manager, whether to sell securities that are under stress, may vary depending on if they are held in a stable-NAV versus a floating-NAV fund. In a stable-NAV strategy, unrealized losses are not reflected in the shadow NAV. However, the sale of a security for a loss will result in that loss being left within the fund and reflected in the shadow NAV that is used for dollar-rounding. Given the material impact that realized losses can have on the fund, portfolio managers may seek to balance the risk to holding a security that is declining in credit quality against the desire to maintain value in the underlying shadow NAV.

In a floating NAV fund, the price of deteriorating credits is already reflected in the NAV. Therefore, when losses are realized, there is no further impact to the NAV directly as a result of the sale transaction. Accordingly, portfolio managers have the choice to sell a security that is deteriorating in credit quality without concern of it impacting the fund or shareholders. As a result, the portfolio managers of a floating NAV fund may find it possible to be more nibble and proactive with managing credit risk in the fund.

**Liquidity and redemption risk scenario** – Similar to the options available for managing credit risk in a money market fund portfolio, manager also have different options available to them for addressing the liquidity needs of floating NAV funds compared with stable NAV funds. In a traditional stable NAV strategy, it is most common to meet daily redemption activity by using cash available in the short-term liquidity buckets, which are not regulated to be at least 10% overnight and 30% within a week. These short-maturing holdings are designed provide the liquidity to meet the needs of shareholder activity without requiring portfolio managers to sell securities, potentially for a gain or loss. In the event that additional cash is needed to meet redemptions, above that which is maintained in the liquidity buffers, the next likely decision made by portfolio management would be to sell securities that are priced at or above cost, so they would not need to be sold for a loss.

Just as described in the credit risk scenario above, selling for a loss embeds the financial impact in the fund and adversely affects the shadow NAV. Importantly, however, when these losses
coupled with large redemptions, the impact of those losses on the NAV gets magnified as they are distributed over a smaller shareholder base. A further impact is that the fund’s investment style has been impacted by needing to use both near-term liquidity as well as high quality securities to meet the redemption needs. The result is that the remaining portfolio is less liquid and is of lower overall quality than the original portfolio, regardless of changes in the credit market conditions.

With floating NAV fund, since the market value of securities is priced into the NAV, portfolio managers can selectively sell any securities in the portfolio to meet daily redemptions, without needing to cannibalize the mandatory liquidity buffers or other high quality holdings. This benefit results in a more resilient portfolio strategy with more consistent investment style, independent of client redemption activity. With a floating NAV strategy, redemptions alone don’t predicate a change to the fund’s NAV.

**Market rate shock scenario** – In order to consider how long a floating NAV portfolio hypothetically might take to recover value in times of market stress, we looked at the following factors. First, remember that a minimum of 10% must mature overnight plus an additional 20% within seven days. Combined with a maximum weighted average maturity of 60 days, the maximum average maturity of the remainder of the portfolio is 90 days. As a hypothetical, we modeled the recovery profile of a portfolio with characteristics including a 51-day weighted average maturity, coupon of 29bps, yield of 21bps, and average price of $100.011 to represent the underlying NAV of the portfolio holdings.

We tested a single-day parallel shock to the portfolio of 100bps. Under this extreme scenario, the portfolio would hypothetically experience an immediate price movement of 13.9bps, moving from a price of $100.011 to $99.9718. Based on the assumed characteristics, the portfolio would have a Theta (expressed as price) of $0.00255, representing the expected rate of price recovery per day. Accordingly, if no other circumstances changed, the portfolio would take 55 days to recover to its original NAV. Please recognize, however, this is a simple hypothetical that does not assume any market corrections or security price changes during the recovery time. Neither does it assume any reinvestment of the short maturities into new investments at the then higher market price values. Both of these conditions would naturally reduce the expected recovery time of the portfolio NAV.

**Important information**

The sources, opinions and forecasts expressed herein are those of Deutsche Asset & Wealth Management as of September 2014, and any forward-looking statements may not actually come to pass. Future results may be materially different than those expressed in our forward-looking statements. This information is subject to change at any time based on market and other conditions and should not be construed as investment advice.

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