



Via Electronic Submission

September 21, 2016

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel Switzerland

Re: Consultative Document, Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities

Dear Sir or Madam:

Pacific Investment Management Company LLC (“PIMCO”) appreciates the opportunity provided by the Financial Stability Board (“FSB”) to comment on the Consultative Document on Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities (“Consultation”).

PIMCO is registered as an investment adviser with the U.S. Securities and Exchange Commission (“SEC”) and as a commodity trading advisor and a commodity pool operator with the U.S. Commodity Futures Trading Commission (“CFTC”). As of June 30, 2016, PIMCO managed approximately \$1.51 trillion in assets on behalf of millions of individuals and thousands of institutions globally, including university endowments, unions, corporate defined contribution and defined benefit plans, and pension plans for teachers, firefighters and other government employees. PIMCO manages both separately managed accounts in accordance with specific investment guidelines and objectives specified by its clients, and public and private funds that are offered to individual and institutional investors. In the case of all these management services, PIMCO is engaged in the long-term management of its clients’ assets as a fiduciary.

PIMCO is not engaged in activities outside of traditional investment management services, such as those related to securities lending (or indemnification thereof), pricing, technology, risk management, or custodial functions. Additionally, PIMCO does not engage in proprietary trading for its own account nor does it hold client funds on its balance sheet or provide balance sheet lending. As a fiduciary to clients who are primarily saving for retirement, PIMCO’s principal goal is to make sound, long-term investments that will meet its clients’ objectives and provide them with returns that are consistent with their risk preferences over their desired time horizons. It is with this goal in mind that we are providing comments on the Consultation.

Overview

PIMCO welcomes the FSB's issuance of the Consultation and the progress that has been made in evaluating potential systemic vulnerabilities that may arise from asset management activities. We further appreciate the FSB's consideration of the extensive feedback provided by the asset management industry on prior Consultations. We are encouraged that the FSB has shifted its focus from entity-based regulation to a more objective, activities-based approach.¹ We continue to believe, however, that the FSB – and the Consultation specifically – overstate the potential systemic vulnerabilities related to the asset management industry. In particular, the Consultation (i) lacks empirical evidence that open-end mutual funds or asset managers are a transmission channel of systemic risk and (ii) fails to adequately take into account the measures pursued by global regulators to address the types of risks raised by the Consultation. Although we continue to disagree with the fundamental assumption that the asset management activities described in the Consultation are a source of systemic risk, we appreciate the FSB's consideration of our thoughts on the architecture of potential future regulation.

Our comments regarding the Consultation are organized into the following five sections:

- I. The overstatement of risks posed by investment funds
- II. Global coordination of regulation
- III. Liquidity-related issues
- IV. Leverage within funds
- V. Operational risk mitigation in transferring investment mandates

I. The structural vulnerabilities potentially caused by investment funds are overstated

The Consultation seeks to identify structural vulnerabilities associated with asset management activities. While we support the FSB's intended goal of seeking to ensure that the financial system is not subject to undue stress during a market crisis, we continue to believe that the asset management structural vulnerabilities identified by the FSB are overstated, particularly those activities asserted to be of concern for open-ended, commingled investment funds, such as U.S. mutual funds.² Indeed, there is ample historical evidence that the asset management activities discussed in the Consultation are neither a source nor a transmission channel of systemic risk during periods of market stress.

As a general matter, PIMCO, as a large, active market participant, has a vested interest in transacting in a stable, robust and deep financial market system in order to satisfy its fiduciary obligations to its clients. We are interested in seeing market fragilities addressed and systemic

¹ See FSB, IOSCO, Consultative Document, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, 30 (Jan. 8, 2014) [hereinafter First Consultation]; FSB, IOSCO, Consultative Document (2nd), Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, 8 (Mar. 4, 2015).

² For purposes of this letter, we will refer to these funds as "investment funds" or "U.S. mutual funds" regulated under the Investment Company Act of 1940, codified at 15 U.S.C. § 80a-1 *et seq.* [hereinafter the 1940 Act]. All statutory references to the 1940 Act are to 15 U.S.C. § 80a, and unless otherwise stated, all references to rules under the 1940 Act are to Title 17, Part 270 of the U.S. Code of Federal Regulations.

risk reduced through different avenues, including appropriate and effective regulation where appropriate. However, we believe the Consultation has overstated the vulnerabilities posed by investment funds. While the Consultation correctly acknowledges that “there is little historical evidence of systemic risks arising from investment funds,”³ it continues to assert that these systemic risks exist without providing any empirical evidence or robust analysis to support its claims.

The Consultation outlines a purely hypothetical scenario where:

if market prices were to drop sharply and liquidity were to deteriorate, investors in less liquid asset classes through open-ended funds **could** experience greater and more sudden losses than expected, which **could** result in a significant number of fund investors attempting to exit these asset classes at the same time. The action of these fund investors **could** amplify downward repricing of assets and increase the severity of liquidity strains in the affected asset classes. It **could** also increase the potential for contagion across asset classes.⁴

The Consultation fails to cite an example of a “run” on a floating net asset value (“NAV”) mutual fund that caused spillover effects on the broader financial system and does not adequately explain how the self-reinforcing feedback loops and “contagion” effects could take place given the unlevered nature of open-end funds as well as the liquidity management tools already available to fund managers. This is simply conjecture that ignores empirical evidence and instead relies on academic theory, similar to the academic theory included in the widely-discredited Office of Financial Research’s “Report on Asset Management and Financial Stability.”

There is no evidence that mass redemptions in U.S. open-end mutual funds have had the destabilizing effects that the Consultation imagines, a point that the Consultation concedes: “evidence suggests that most open-ended funds have been generally resilient. They have not created financial stability concerns in recent periods of stress and heightened volatility. . . .”⁵ Indeed, even during the highly volatile period of the 2008 financial crisis, redemptions from U.S. mutual funds were relatively limited with no broader systemic impact. Even by the FSB’s own admission, “no mutual fund liquidations led to a systemic market impact throughout the [2000 to 2012] observation period.”⁶

Similarly, the high profile suspension of redemptions in the U.S. high yield bond fund, Third Avenue Focused Credit Fund (“FCF”) in December 2015 failed to create the cycle of redemptions, forced sales, liquidity strains and “contagion across asset classes” that the

³ See FSB, Consultative Document, Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, 8 (June 22, 2016) [hereinafter Consultation].

⁴ Consultation, *supra* note 3, at 1 (emphasis added).

⁵ Consultation, *supra* note 3, at 1.

⁶ First Consultation, *supra* note 1, at 30, n.38.

Consultation (and previous consultations) have envisioned.⁷ In reality, even though the high yield market was under stress on worries of declining oil and emerging market weakness and seeing heavier-than-usual redemptions when FCF announced the suspension of redemptions in the FCF, redemptions from high yield funds market-wide were relatively small and orderly during the corresponding time period: net outflows were \$4.6 billion (or 1.3% of high yield fund assets) during the week of December 9th and \$5.8 billion or 1.7% of high yield fund assets the week of December 16th.⁸ After this initial redemption activity, net outflows started to moderate as nearly a quarter of high yield funds actually began to see inflows as large investors, presumably sensing a technically-driven dislocation, stepped-in to take advantage of the higher yielding funds.⁹

We submit that these examples underscore the stability and resiliency of U.S. open-end mutual funds that safeguard them from being a source of financial instability. In fact, there are many attributes of U.S. mutual funds that help insulate them from market shocks, which include:

- **The characteristics of open-ended U.S. mutual fund investors:** Investors in U.S. mutual funds tend to have longer-term investment horizons and are therefore less likely to seek redemptions in times of market stress or exogenous shocks. In 2015, according to the Investment Company Institute (“ICI”), an estimated 53.6 million households – or 43% of all U.S. households – owned mutual funds.¹⁰ Of these, 91% indicated that saving for retirement was one of their primary financial goals, 72% said saving for retirement was *the* primary financial goal, and 95% had exposure to mutual funds inside workplace retirement plans, individual retirement accounts and other tax-deferred accounts.¹¹ These investors have long-term horizons by definition and tend to purchase shares in mutual funds via retirement accounts through such mechanisms as automatic payroll deductions, which typically continue even during stress periods.¹² Additionally, these investors also may engage in dollar-cost averaging and portfolio rebalancing, which in fact can have a counter-cyclical stabilizing effect.¹³

⁷ See Consultation, *supra* note 3, at 10.

⁸ See Paul Schott Stevens, President & CEO, ICI, Response to the FSOC Update on Review of Asset Management Products and Activities to the Financial Stability Oversight Council, app. B-6, B-7 (July 18, 2016), https://www.ici.org/pdf/16_ici_fsoc_ltr.pdf.

⁹ See *id.* at app. B-8, B-10.

¹⁰ See Investment Company Institute, *2016 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry*, 112 (56th ed. 2016).

¹¹ See *id.* at 120, 121.

¹² See *id.* at 33.

¹³ See Paul Schott Stevens, President & CEO, Investment Company Institute, Response to the FSOC’s Notice Seeking Comment on Asset Management Products and Activities (FSOC-2014-0001), 20 (Mar. 25, 2015), https://www.ici.org/pdf/15_ici_fsoc_ltr.pdf.

- The unlevered nature of U.S. mutual funds:** U.S. mutual funds are subject to strict requirements regarding the use of leverage, thereby minimizing potential stress to their counterparties and to the system more broadly, even during periods of heavy redemptions. Indeed, U.S. law requires that mutual funds have at least 300% asset coverage for all borrowings of the fund.¹⁴ Additionally, in the United States, mutual funds must segregate or earmark assets equal to 100% of any obligation to a counterparty created through the use of derivatives, or enter into offsetting derivative positions.¹⁵ The practical implication of this is that most U.S. mutual funds engage in a minimal amount of leverage.¹⁶ Thus, while investors may lose invested capital, those losses have limited spill-over effects to the rest of the financial system. Indeed, these mitigating factors serve as controls to prevent a market participant from having a systemic impact on the financial system.¹⁷ In this sense, the worst case scenario for a fund is for its value to go to zero and for investors to lose invested capital – not a desirable outcome, but also not a systemic event. Indeed, as described in the First Consultation “fund investors absorb the negative effects that might be caused by the distress or even the default of a fund, thereby mitigating the eventual contagion effects in the broader financial system.”¹⁸
- Liquidity tools that are available to fund managers:** The Consultation’s assertions about “runs,” forced asset sales, and contagion effects also fail to recognize how asset managers actually manage liquidity and redemption risk, and in doing so, efficiently process risk and liquidity for the market as a whole. Indeed, even the Consultation concedes that “[a] wide range of policy measures and tools currently exists to reduce the liquidity risks associated with open-ended funds. . . . [and] their use may also help mitigate financial stability risks in certain circumstances.”¹⁹ In our experience, liquidity management is a dynamic, iterative process that we perform daily and is an interaction between our risk management and portfolio management teams. Every day, cash (and cash-like) buffers are reinforced based on several considerations, including the strategy of the fund, the liquidity of the underlying assets, the past historical redemption activity of the fund, the macroeconomic landscape, and the way in which the strategy may react to different shocks (e.g., a significant interest rate shock). Portfolio managers frequently deploy other techniques to manage liquidity as a fundamental part of portfolio construction, including buying short-term securities (which are self-liquidating), increasing liquidity buffers with cash inflows, and choosing the most liquid instrument to gain a specific exposure (e.g., a Treasury bond vs. an interest rate swap).

¹⁴ The 1940 Act, 15 U.S.C. § 80a-18(f)(1) and (h).

¹⁵ See Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666, 44 Fed. Reg. 25,128, 25,131-32 (Apr. 27, 1979).

¹⁶ See Dan Waters, Managing Director, ICI Global, Preliminary Observations: FSB Proposed NBNI G-SIFI Methodology for Investment Funds, 18 (Mar. 2014).

¹⁷ Cf. James Bullard, Christopher J. Neely, and David C. Wheelock, *Systemic Risk and the Financial Crisis: A Primer*, Federal Reserve Bank of St. Louis Review, 403, 409-10 (Part 1) (Sept./Oct. 2009) (citing financial market exchanges as example of systemic risk mitigation).

¹⁸ First Consultation, *supra* note 1, at 29.

¹⁹ Consultation, *supra* note 3, at 11.

These liquidity management practices are employed on an ongoing basis both to meet the daily redemptions of the funds we advise as well as when we are raising liquidity in order to make large asset allocation shifts (e.g., selling out of Treasury bonds and buying corporate bonds). These robust – and we believe universal – best practices around liquidity management for investment fund managers are simply reinforced by the SEC’s regulations and guidance on these issues.²⁰ Further, mutual funds policies, including those related to liquidity, are overseen by the funds’ board of directors, which provides an additional layer of oversight of these practices.

- **Fund investment risk does not equate to systemic risk:** We believe assumptions about the systemic riskiness of investment funds conflate investment risk with systemic risk. Investment risk – which describes the risk that investors can lose (or make) money because of declining (or rising) prices – is well-understood and well-documented. Indeed, as pointed out in the First Consultation: “[I]nvestment management is characterised by the fact that fund investors are knowingly exposed to the potential gains and losses of a fund’s invested portfolio. . . . [F]und investors decide, based on full-disclosure, to take on investment risks.”²¹ Indeed, asset managers and the funds they advise do not – and are not meant to – function as banks, in which depositors expect a complete return of their capital; instead, investors retain asset managers and their funds to pursue their investment goals and preferences through the management of investment risk. While price declines may occur – and in doing so may exhibit investment risk, they do not, particularly in vehicles such as mutual funds, pose systemic risk.

Many of the Consultation’s recommendations derive from an erroneous assumption that the activities of investment funds pose systemic vulnerabilities; given the lack of empirical evidence or analysis provided, this assumption has not been adequately established and should not be used as a basis to implement policy changes.

II. The FSB should avoid establishing conflicting regulatory regimes

We believe that the high level of focus that the SEC is presently devoting to evaluating potential risks associated with asset management activities provides a strong basis for the FSB to monitor the SEC’s efforts before it draws any conclusions regarding potential systemic risk that may be created or transmitted by the asset management industry. In particular, we note that the SEC has continued to focus on potential enhancements under the 1940 Act and the Investment Advisers Act of 1940²² and is currently pursuing a comprehensive program to enhance its

²⁰ See generally U.S. Securities and Exchange Commission, Div. of Inv. Mgmt., No. 2014-01, IM Guidance Update, Risk Management in Changing Fixed Income Market Conditions, (Jan. 2014), <http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf>.

²¹ First Consultation, *supra* note 1, at 29.

²² 15 U.S.C. § 80b-1, *et seq.*

regulation of mutual funds and asset managers.²³ The agenda the staff is pursuing involves (i) rules to enhance data reporting for funds and advisers, including disclosure of fund investments in derivatives and the liquidity and valuation of their holdings; (ii) rules to enhance liquidity risk management programs and stress testing programs for mutual funds and exchange-traded funds, (iii) evaluating open-end mutual fund use of derivatives, and (iv) rules to enhance or otherwise create business continuity and transition plans to prepare for a major disruption in a fund's or adviser's business. This agenda highlights the SEC's focus on overall portfolio composition risk and operational risk and the overall initiatives to seek to address these risks.²⁴

As the Consultation specifically highlights the increase in size in the asset management sector and certain asset management firms in particular, most of which are U.S. based,²⁵ the FSB should carefully consider the standards that are currently imposed in the U.S. and those that are in the proposal stage (along with those of any other global regulators) to ensure that these regulatory efforts are not duplicative or conflicting. Once the SEC and its staff have completed their review and issued final rules under the agenda outlined above, the FSB would have the benefit of evaluating the efficacy of any additional risk mitigation recommendations or regulations that may be warranted for the asset management industry. In the interim, we believe it is premature for additional standards to be established without close coordination with the SEC, at a minimum.

III. Issues related to liquidity management

We disagree with the Consultation's assertions that the potential for liquidity mismatch in open-end mutual funds creates a structural vulnerability.²⁶ The Consultation does not cite any examples of this phenomenon but rather describes a number of hypothetical scenarios that would all have to materialize in order for there to be a potential negative systemic impact. For example, the Consultation says that "during prolonged periods in which highly accommodative monetary policies affect assets valuations, investors may reach for yield" and "a shift in market expectations could produce repricing of assets, liquidity strains in certain markets and the potential for contagion across asset classes" all while again providing no support for these assertions. In fact, the Consultation acknowledges that "historical evidence suggests that non-money-market open-ended funds have not created global financial stability concerns in recent periods of stress and heightened volatility."²⁷ We do not believe the conjectures in the Consultation are sufficient to conclude that any of the potential risks noted are indicative of a structural vulnerability.

²³ See Mary Jo White, Chair, SEC, Enhancing Risk Monitoring and Regulatory Safeguards for the Asset-Management Industry, Speech to The New York Times DealBook Opportunities for Tomorrow Conference (Dec. 11, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VQr56X_n-70.

²⁴ *Id.*

²⁵ Consultation, *supra* note 3, at 7.

²⁶ Consultation, *supra* note 3, at 10.

²⁷ Consultation, *supra* note 3, at 10.

While we do not agree with many of the Consultation’s presumptions regarding purported risks of open-end mutual funds to the financial system, PIMCO is very supportive of principles that are designed to maintain efficient and orderly markets. In this regard, PIMCO believes that liquidity risk management is an essential component of the portfolio management process and that developing and implementing a program that monitors for liquidity-related risks is critical to a manager’s fiduciary duty to its funds and clients. Accordingly, we support the FSB’s recommendations to require asset managers to implement liquidity risk management programs and stress testing. Like many other investment managers, PIMCO has had extensive liquidity management processes in place for many years, which is instrumental to how we manage our client portfolios.

As we note above, we believe that any such recommendations or requirements should be subject to the requirements of the asset manager’s applicable regulator. With regard to liquidity risk management and stress testing, the U.S. is expected to finalize new requirements by the end of this year²⁸ and Europe has already adopted its own standards.²⁹ Nevertheless, since PIMCO already has robust risk management processes in place, we appreciate the opportunity to provide insight into our experiences with regard to liquidity risk management and stress testing.

A. Investment managers are capable of developing robust liquidity risk management programs using a principles-based approach and without the need for prescriptive requirements

We support the flexibility in the FSB’s recommendations that open-end mutual funds’ liquidity risk management programs should not be “one-size fits all.”³⁰ An asset manager needs flexibility to implement a liquidity risk management program that is tailored to its business. This type of flexibility will allow an investment manager to best develop its program with the goal of identifying any potential vulnerabilities.

²⁸ Proposed Rule 22e-4 under the 1940 Act.

²⁹ See generally International Capital Market Association and European Fund and Asset Management Association, *Managing Fund Liquidity Risk in Europe* (Apr. 2016) [hereinafter *European Liquidity Risk Management Report*], https://www.efama.org/Publications/EFAMA_AMIC_Report_Managing_Fund_Liquidity_Risk_Europe.pdf. The *European Liquidity Risk Management Report* explains that “the UCITS Directive . . . is a unique investment product legislation – justified by the retail nature of the UCITS pan-European passporting. It is characterised by the offer to investors of on-demand liquidity and built around a significant and prescriptive regulatory framework.” *Id.* at 10. The UCITS regime prescribes the types of instruments that a fund may hold, including liquidity considerations. Furthermore, the Alternative Investment Fund Managers Directive (“AIFMD”), which took effect on July 22, 2013, provides specifically for “a robust liquidity management framework.” *Id.* at 6. The AIFMD requires funds to employ “an appropriate liquidity management system, including procedures to monitor the liquidity risk of the [alternative investment fund] and to ensure that the liquidity profile of the investments of the [alternative investment fund] complies with its underlying obligations.” Directive 2011/61, of the European Parliament and the Council of the European Union of 8 June 2011 on Alternative Investment Fund Managers, 2011 O.J. (L 174), 25, available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011L0061&qid=1474228815581&from=EN>. Also, European fund legislation includes in-depth stress testing of AIFMs, which entails “account[ing] for valuation sensitivities under stressed conditions.” Commission Regulation 231/2013, Supplementing Directive 2011/61/EU, 2012 O.J. (L 83), 8, available at <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0231&qid=1474229758965&from=EN>.

³⁰ Consultation, *supra* note 3, at 18.

For investor protection reasons, we support the FSB’s recommendation that “authorities should have requirements or guidance stating that funds’ assets and investment strategies should be consistent with the terms and conditions governing fund unit redemptions,”³¹ but we believe this should be accomplished with a principles-based approach, rather than by specific terms directed by rulemaking. We believe that investment managers should be provided significant flexibility to develop a program that is appropriate given each fund’s unique characteristics (e.g., the nature of its investment objectives and strategies, portfolio holdings, the means and frequency of trading those holdings, potential obligations, historical fund flows, and the composition of the investor base). We believe that any rule dictating precise elements in a liquidity risk management program may have the effect of decreasing overall market and fund liquidity. Instead, an investment manager should be provided significant flexibility to develop a fund liquidity risk management program that is reasonably designed to mitigate liquidity risk in client portfolios.

In the United States, open-end mutual fund liquidity is already regulated³² and will be subject to even greater regulation upon the finalization of the SEC’s liquidity management rulemaking.³³ While PIMCO disagrees with some of the more onerous and prescriptive requirements of the SEC’s proposal, we continue to be supportive of the overall requirement to adopt liquidity risk management programs and believe that the FSB should coordinate with other regulators so as not to impose duplicative and potentially conflicting regulation on market participants.³⁴

We note that liquidity risk management programs cannot entirely mitigate all liquidity risk. The success of such programs, as with fund investment performance, is in large part based on the investment manager’s skill and diligence. Moreover, liquidity risk management programs do not protect against questionable investment management decisions. As indicated by the above-noted example, in late 2015, FCF announced that it would not be able to timely and fully meet redemptions for one of its open-end funds and the fund manager applied to the SEC for the ability to suspend redemptions. Importantly, the event did not cause any significant systemic market effects. While this event further emphasizes the need for investment management firms to adopt robust liquidity risk management programs, it should not cause regulators to conclude that it is in the interests of investors or market stability to adopt overly prescriptive rules rather than allowing investment managers the flexibility to develop programs best suited to their funds

³¹ Consultation, *supra* note 3, at 16.

³² See Revisions of Guidelines to Form N-1A, Investment Company Act Release 18,612, 57 Fed. Reg. 9828, 9829 (Mar. 20, 1992) (precluding open end funds from investing more than 15% of net assets in “illiquid” assets).

³³ Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization, Investment Company Act Release 31,835, 80 Fed. Reg. 62,274 (proposed Oct. 15, 2015) (to be codified at 17 C.F.R. pts. 210, 270, 274).

³⁴ See generally Comment from Douglas M. Hodge, CEO, PIMCO, to Brent J. Fields, Secretary, U.S. SEC, on Request for Comment on Open-End Fund Liquidity Risk Management Programs, Swing Pricing; Reopening of Comment Period for Investment Company Reporting Modernization (Jan. 13, 2016) [hereinafter PIMCO Comment on Liquidity Risk Management and Swing Pricing], <https://www.sec.gov/comments/s7-16-15/s71615-48.pdf>.

and clients. Requiring investment managers to prudently and responsibly consider investor redemption and other fund liquidity needs by adopting robust liquidity risk management processes is an integral part of the portfolio management and risk management functions and central to an investment manager's fiduciary duty.

B. Requiring public disclosure of the classification of fund assets by liquidity status is harmful to the market

The Consultation recommends a review of existing investor disclosure requirements and the degree to which additional disclosures should be provided to investors. We do not support any recommendation that would impose more prescriptive and granular requirements to classify the liquidity profile of all open-end fund assets. We expressed this view in our comment letter to the SEC in response to its proposal on liquidity risk management.³⁵ In addition, as a practical matter, it is impossible to classify the precise liquidity of every asset (much less any given position size of an asset held by a fund), and we do not believe this information will assist potential investors, shareholders or regulators in understanding or monitoring the actual fund liquidity. Further, we believe overly-granular classification systems will provide shareholders and the market with a materially false sense of comfort. Investment managers already must continuously monitor portfolio liquidity; indeed, we believe this is a core competency of the investment manager's role and a fundamental part of the manager's fiduciary duty. Accordingly, we believe that regulators should refrain from being unnecessarily prescriptive in mandating *how* the investment manager evaluates liquidity.

There are many different ways to evaluate liquidity risks, and investment managers have many tools available to them in performing this analysis. In PIMCO's case, we have successfully managed fund portfolio liquidity since our firm's inception in 1971 and since 1987 in the case of our mutual fund business, which includes our experience through the financial crisis of 2007-2008 and during heavier than typical redemptions that were experienced in PIMCO's Total Return Fund after the sudden departure of PIMCO's cofounder and CIO³⁶ along with other periods of abnormally high volatility. PIMCO's portfolio and risk management team evaluates client portfolios holistically when considering our ability to generate liquidity in client and fund portfolios. Our portfolio risk management team assesses fund liquidity constantly based on the strategy of the fund, the liquidity of the underlying assets, the past historical redemption activity of the fund, the macroeconomic landscape, and the way in which the strategy may react to different shocks (e.g., a significant interest rate shock). Based on this analysis, PIMCO's Investment Committee, in partnership with the portfolio risk management team, establishes minimum liquidity targets for each of our funds. These levels are monitored by our portfolio risk management team, and any deviations from established targets are discussed with the relevant portfolio manager and required action is promptly implemented. Accordingly, while PIMCO's liquidity management process may not conform to more prescriptive regulator

³⁵ See PIMCO Comment on Liquidity Risk Management and Swing Pricing, *supra* note 34.

³⁶ See Comment from Douglas M. Hodge, CEO, PIMCO to Secretariat, FSB on the Consultative Document (2nd), Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, 13-14 (May 29, 2015), <http://www.financialstabilityboard.org/wp-content/uploads/PIMCO.pdf>.

proposals on liquidity risk management, it demonstrates that an asset manager can conduct meaningful liquidity risk management without employing a one-size fits all approach.

C. There are significant operational challenges to implementing swing pricing in the United States

We support the Consultation’s recommendation that “authorities should consider, as appropriate, any operational difficulties to implementing various liquidity risk management tools,”³⁷ and would like to highlight the operational challenges to implementing one of the proposed tools – swing pricing – in the United States.

In our experience, swing pricing cannot be effectively implemented in the United States given current market conventions because fund flow information is not available at the time a fund strikes its NAV. Most funds in the United States are sold through intermediaries such as a broker-dealer, independent registered investment adviser, insurance company or retirement plan record-keeper (collectively, an “Intermediary”). Each Intermediary aggregates all of its respective client purchases and redemptions in a particular fund and provides the fund with the net subscription or redemption orders for each fund in which there is activity. These orders are transmitted through Fund/SERV, which is a part of the Depository Trust & Clearing Corporation (“DTCC”).³⁸ In 2015 alone there were reportedly 219 million mutual fund transactions, of which 119 million were Defined Contribution Clearance and Settlement transactions (“DCC&S Transactions”).³⁹ The DCC&S Transactions, which comprise approximately 54% of all mutual fund volume, however, are not provided to the funds until the morning after the fund’s NAV has already been calculated.

Swing pricing requires the net cash flows for a fund to be known or reasonably estimated, before determining whether to adjust the fund’s NAV on a particular day. However, as described above, this critical information is not available to a fund when it strikes its NAV. Because a U.S. fund cannot possibly know or even reasonably estimate flows given the lack of transparency in fund flow at the time a fund’s NAV is calculated, then swing pricing is not a viable liquidity risk management tool to implement in the United States.

Given that critical transaction information for U.S. funds is available only after the NAV has been calculated, a portfolio manager or fund administrator could reasonably believe that there is a net outflow on the day the NAV is calculated when after receiving the actual flow information from Intermediaries, there could have been a net inflow (or vice versa). In this example, if a fund utilized swing pricing and the swing threshold was met on the day the NAV is calculated while offsetting inflows were not reported until the next morning, the shareholders who redeemed that day would receive their redemption proceeds determined by a lower NAV.

³⁷ Consultation, *supra* note 3, at 18.

³⁸ DTCC and its subsidiaries provide centralized processing, clearing and settlement services for registered mutual funds.

³⁹ Depository Trust & Clearing Corporation, 2015 Annual Report, 41-42 (2016), available at <http://www.dtcc.com/annuals/2015/pdfs/dtcc-printed-report-2015.pdf>.

This could result in certain shareholders being unnecessarily penalized or extensive reprocessing of fund transactions necessary to correct the error. In our experience, net fund flows can vary significantly once we receive Intermediary information.

In addition, there would be a disconnect between the timing of receipt of the final fund flow information on T+1 and any transactions that are conducted in response to the net flows. Accordingly, there can be no actual correlation between the amount of the transaction costs incurred by a fund to generate liquidity as compared to the discount associated with the swing pricing NAV. Moreover, there may be instances where a portfolio manager does not need to put on trades to generate liquidity or may trade out of instruments that have run their investment course to fulfill the requested redemptions. It seems contrary to fundamental shareholder fairness to impose swing pricing in these instances.

Therefore, we believe it is impossible to calculate whether to swing the NAV of a fund on any given day with an appropriate level of certainty that the fund is acting on accurate information, and we caution regulators against unequivocally endorsing such an approach without examining its viability.

IV. Leverage within investment funds

PIMCO welcomes the FSB's goal of developing consistent fund leverage measures that would apply across jurisdictions and appreciates the FSB's acknowledgement that simple measures may have limitations in measuring actual risk.⁴⁰ Overly simplistic measures of leverage may actually mislead investors and regulators, obscuring the true sources of risk. We support the initiative to develop risk-based measures and believe this would be a far more accurate way to monitor leverage-related risks to the financial system, especially in funds that use derivatives.

Additionally, we are encouraged by the assertion that risk-based measures should take a nuanced view of synthetic leverage as well as netting and hedging. We would like to note our views supporting the Consultation's assertion, specifically that the measure of any derivatives should be risk-adjusted and currency derivatives should be viewed on a net basis when measuring leverage.

A. The notional amount of derivatives should be risk-adjusted in leverage definitions imposed on funds

Leverage measures should adjust the notional amount of derivatives based upon the risk of the underlying reference asset. Notional amount is not a measure of the underlying risk of the derivatives contract, but rather merely the basis for determining the amounts payable under a derivatives contract. The risk of the derivatives contract is primarily dependent upon the risk of the underlying asset, and as a result, two different derivatives with the same notional amount can have very different risk profiles. For example, a Eurodollar future contract has minimal price volatility since it represents minimal interest rate risk due to its short maturity (e.g., 3 months), while a 30 year swap contract has much greater price volatility because it represents interest rate

⁴⁰ Consultation, *supra* note 3, at 25.

exposure for a longer time period. Under a simple leverage measure without notional adjustment, these two derivatives would have equal weighting if they had the same notional amount.

We believe that leverage measurements incorporating the notional amount of derivatives could discourage fund portfolio managers from mitigating risk in an efficient manner, particularly in fixed-income portfolios. For example, if a portfolio manager wishes to target a specific duration level in order to get a specific interest rate sensitivity in the portfolio, it may be very difficult to achieve by simply purchasing physical fixed income securities of various durations because the securities needed may not be available to achieve the duration target. On the other hand, the portfolio manager could achieve the specific duration target by entering into interest rate derivatives contracts, such as Eurodollar futures or interest rate swaps, to achieve the precise duration target without significantly increasing the riskiness of the fund. This strategy would result in significant use of derivatives if measured by notional amount, and as a result vastly and erroneously overstate the risk exposure of these instruments in the portfolio.

We recommend that leverage measures risk-adjust the notional amount based upon the relative risk of the underlying asset. This would have the effect of discouraging the use of derivatives that expose the fund to greater risk of loss, while not unduly discouraging the use of derivatives that do not have a significant impact on the fund's volatility. We recommend two possible methods to make this risk adjustment.

We believe that the most precise manner in which a risk adjustment could be made would be to adopt a duration-weighted adjustment based upon an appropriate reference security. Using this methodology, the notional amount of a particular derivative would be multiplied by the ratio of the derivative's duration to the duration of the reference security. This would effectively risk adjust all interest-rate sensitive securities, reflecting the reduced volatility of shorter duration securities relative to longer duration securities. We would suggest that the reference security should be a 30-year U.S. Treasury bond, which has volatility approximating the S&P 500. Asset classes that are not interest rate sensitive would be counted at their full notional amount. This approach is simple and easy to administer.

Another possible approach being proposed by industry groups, and which we would also support, is to adopt a standardized schedule of risk adjustments that would be applied to the notional value of derivatives held by the fund. The adoption of a schedule of risk adjustments based upon various underlying asset classes would appropriately weight riskier assets, while not unduly discouraging the use of derivatives that may have a high notional amount while adding little risk to the portfolio. We suggest the standardized schedule for initial margin requirements for non-cleared swaps and non-cleared security-based swaps adopted by the U.S. Prudential Regulators⁴¹ as the basis for developing multipliers for risk-adjusting the notional amount of various derivatives. This schedule includes derivatives with various underlying asset classes, including credit, interest rates, commodities, equities and foreign currencies. In order to develop the multipliers for the various asset classes, the asset classes with the highest percentage initial

⁴¹ The Prudential Regulators are comprised of the Office of the Comptroller of the Currency, U.S. Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency.

margin requirements (i.e. equities and commodities - 15%) would be included in the measurement at their full notional amount. All other derivatives would be adjusted, based upon the underlying asset and its initial margin requirement relative to equities and commodities, to derive a multiplier that would be applied to the notional amount of the derivative. For example, an interest rate derivative with a 0-2 year duration (which has a 1% initial margin requirement), would be adjusted so that only 6.7% (1 % divided by 15%) of its notional amount would be included in the portfolio leverage calculation.

Although we support the use of a risk-adjustment schedule over no risk-adjustment at all, we believe that the duration-adjustment is a better method because it adjusts risk on a continuum rather than bucketing instruments with different risk characteristics together. For example, using the U.S. Prudential Regulators' initial margin schedule for uncleared swaps as the basis for a risk adjusted notional amount schedule would result in the same notional amount adjustment for all interest rate swaps with a term of 5 years or more. Using a duration-weighted adjustment would account for the particular interest rate risk of each term, and would adjust notional amount accordingly. Additionally, using a duration adjustment eliminates the requirement to maintain a risk-adjustment schedule.⁴²

B. Foreign currency derivatives should only be included in a leverage measurement to the extent that they result in “excess currency” exposure

“Excess currency” refers to currency derivatives that exceed the notional amount necessary to reduce currency exposure from a non-base-currency-denominated security held by the fund. As an example, in a U.S. fund that invests in non-U.S. dollar-denominated securities, the fund is exposed to currency risk on these securities. This risk may be substantial in the case of a fund that invests primarily in these types of securities (e.g., a foreign bond fund), but may be mitigated by entering into short positions in the non-U.S. dollar currency using forward contracts or other currency derivatives. However, if the fund enters into a substantial amount of these derivatives, its use of derivatives for other purposes (such as achieving duration targets) would be discouraged under a simplistic leverage measure that incorporates the full notional value of all currency derivatives. Therefore, we urge the FSB to include only short currency positions in excess of the amount of non-U.S. dollar currency exposure in leverage measurements, applied on a currency-by-currency basis. This would effectively exclude currency derivatives that reduce risk, while including currency derivatives that add risk to the portfolio.

V. Transition and operational risk

We disagree with the Consultation's suggestion that “[t]ransferring investment mandates (or client accounts) between asset managers . . . could potentially become a financial stability concern if they were to materialise during stressed market conditions.”⁴³ The Consultation in particular highlights difficulties that may be associated with the transfer of derivatives contracts

⁴² See Comment from Douglas M. Hodge, CEO, PIMCO, to Brent J. Fields, Secretary, U.S. SEC, on the Use of Derivatives by Registered Investment Companies and Business Development Companies, 5-7 (Mar. 28, 2016), <https://www.sec.gov/comments/s7-24-15/s72415-168.pdf>.

⁴³ Consultation, *supra* note 3, at 28.

and legal and regulatory difficulties that may be associated with transferring client accounts. While the Consultation notes numerous factors that mitigate these risks, it summarily concludes that systemic implications are more likely to develop at large and/or complex asset managers in “stressed market conditions”⁴⁴ and notes that the impacts could be considerable. Once again, the Consultation does not provide any empirical evidence supporting this conclusion.

Investment management clients routinely decide to change asset managers for many different reasons. Therefore, there are controls and processes around these types of transfers and any operational risks associated with such transfers are well understood and controlled. A change in the asset manager for a client typically involves coordination among the current asset manager, the new asset manager, and the custodian. Mitigating much of the risk in this process is the fact that typically the client’s assets are held in the custody of a particular custodian. Whether or not the assets are sold as part of the transition process (some clients simply choose to terminate their relationship with the asset manager and give authority over the assets to the new asset manager), they remain in the custody of the same custodian when the new asset manager begins its functions. Derivatives positions that were put on by the terminated manager typically are taken off by the terminated manager, though they may be transitioned in-kind under certain circumstances. This is typically handled during the termination process.

In our experience, the transition process for a client, under typical circumstances, can take anywhere between seven days and up to several months depending on the type of transition it is (specifically, whether assets are to be transferred in-kind), the nature of the asset class, and whether there is existing infrastructural connectivity with the client’s existing custodian (which is typically the case). It is possible that in an instance where a client is dissatisfied with an asset manager or during a time of market crisis, a client may provide little or no notice of termination and a transition can occur much more rapidly. In these cases, the client can simply terminate the asset manager’s authority to manage the assets in the custody account and transfer that authority to another manager, including to a transition manager, or manage the assets themselves. Under these circumstances, the client typically would not be incentivized to direct the current manager to liquidate a large portfolio in a short period of time and most assets would usually remain in the account until the new manager determines whether and when to liquidate them. In our experience, however, large, sophisticated clients typically provide a significant amount of lead time to an asset manager in advance of terminating the manager’s authority, particularly if it involves liquidating the portfolio.

The Consultation expresses specific concerns regarding derivatives in the context of a client transferring its account away from an asset manager. As a general matter, unless agreed under the terms of the governing master agreement between the parties, the failure of an asset manager or an affiliate will not provide the counterparty to a fund or separate account managed by the asset manager the option to accelerate, terminate or net derivative or other types of contracts of affiliates or investment vehicles that have entered into insolvency. It is however standard market practice for a counterparty to try to negotiate terms under the governing master agreement between the parties whereby it would be a termination event if an asset manager becomes insolvent, loses its relevant registration, or is no longer adviser to the fund/client

⁴⁴ Consultation, *supra* note 3, at 30-31.

account. It is also typical for such terms to include provisos where the termination event will not be triggered if another manager that is reasonably satisfactory to the counterparty is appointed as the new manager for the fund/client account and the derivative transactions also remain under a governing master agreement between the counterparty and the fund/SMA or are transitioned to a new master agreement entered into by the new manager on behalf of the fund/SMA. To the extent that an affiliate of the adviser is also a second-tier affiliate of the fund, that could potentially also constitute a termination event or event of default; however, it is generally standard market practice for a fund not to be deemed to have affiliates for purposes of derivatives and similar contracts.

To address the concerns articulated in the Consultation, the recommendations would require robust risk management, business continuity and transition plans for large and complex asset managers. It is important to note that in the United States, asset managers are already subject to stringent business continuity requirements by the SEC. Further, the SEC recently issued a proposal around business continuity planning and transition planning, which would require asset managers to enhance their business continuity plans and also adopt transition plans in the event that the asset manager were to no longer exist.⁴⁵ This is yet another area where we believe there should be deference to the national regulator and the rules that would apply to an asset manager that overlap with the recommendations of the Consultation or where the FSB should otherwise coordinate with the SEC in order to prevent redundant or duplicative regulation.

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On behalf of our clients, we thank the FSB for allowing us to comment on the Consultation, and appreciate in advance the FSB's diligent consideration of the above comments. Please do not hesitate to contact us if we can provide any assistance in the further evaluation of these very important issues.

Sincerely,



Douglas M. Hodge
Chief Executive Officer

⁴⁵ Adviser Business Continuity and Transition Plans, Investment Adviser Release 4,439, 81 Fed Reg. 43,530 (proposed July 5, 2016).