P I M C O

Via Electronic Submission

April 7, 2014

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

Re: Consultative Document, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions

Dear Sir or Madam:

Pacific Investment Management Company LLC ("PIMCO") appreciates the opportunity provided by the Financial Stability Board ("FSB") and International Organization of Securities Commissions ("IOSCO") to comment on the Consultative Document on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions[1] ("NBNI G-SIFIs") ("Consultation").

PIMCO is registered as an investment adviser with the U.S. Securities and Exchange Commission ("SEC") and as a commodity trading adviser and commodity pool operator with the U.S. Commodity Futures Trading Commission ("CFTC"). As of December 31, 2013, PIMCO managed approximately $1.9 trillion on behalf of millions of individuals and thousands of institutions in the United States and globally, including state retirement plans, unions, university endowments, corporate defined contribution plans, sovereign wealth funds, and pension plans for teachers, firefighters, and other government employees. PIMCO manages separate client accounts, in accordance with specific investment guidelines and objectives specified by the client, and funds that are offered to institutional and individual investors. In the case of all of these management services, we are engaged in long-term investment management of our clients' assets as a fiduciary. We do not engage in proprietary trading for our own account nor do we hold client funds or provide balance sheet lending to our clients. Our principal goal is to make sound, long-term investments that will meet our clients' objectives and provide them with stable returns that are consistent with their risk preferences over their desired time horizons.

[1] For purposes of this letter, we refer only to investment funds unless otherwise stated.

Executive Summary

PIMCO believes the Consultation does not accurately reflect the risks associated with investment funds or the asset management industry as a whole, nor does it provide a fair basis upon which the public can meaningfully provide comment.[2] Specifically, PIMCO respectfully requests that the Consultation be withdrawn for the following reasons:

1. The proposed methodology for designation of NBNI G-SIFIs arbitrarily results in only U.S. registered funds, which are subject to some of the most stringent regulation worldwide, being eligible for designation;

2. The Consultation's use of investment fund size as an initial threshold for NBNI G-SIFI consideration is not supported by any evidence that large funds present greater risks to the financial system (unlike other indicators such as leverage);

3. The Consultation presents an inaccurate picture of how the U.S. registered fund industry operates and does not provide a basis for the view that investment funds create and transmit financial risk;

4. There is no analysis of the comprehensive regulatory structure under which U.S. registered funds operate, and no discussion of whether or how U.S. registered funds have contributed to global financial instability in the past;

5. There is inadequate consideration given to alternative forms of regulation, such as activities-based regulation, which is more likely to directly address any specific risks that may be viewed as causing systemic risk; and

6. The unstated presumption that investment funds should be NBNI G-SIFIs is (i) not supported by empirical evidence, (ii) not required or suggested by the G20's governing documents, and (iii) not analytically correct.

The following is our analysis of the Consultation, followed by answers to the specific questions posed by it in a separate Appendix.

[2] The Consultation refers to investment funds but does not define the term. For purposes of this Letter, "investment funds" means collective investment vehicles that are advised by asset managers. In addition, open-end funds that are registered with the SEC as investment companies under the Investment Company Act of 1940, as amended (the "1940 Act") and that operate with a floating net asset value ("NAV") are referred to as "U.S. registered funds," but do not include money market mutual funds, which seek to maintain a stable NAV.

Comment

1. <u>The Consultation Is Fundamentally Flawed And Should Be Withdrawn</u>

The goal of the G-SIFI designation process is designed to make sure that no financial firm is "too big to fail" and to protect taxpayers from having to bear the costs of the resolution of such a firm.[3] While we appreciate the objective of the FSB and IOSCO, we do not believe the Consultation accurately characterizes the risk profile of investment funds or makes a case for why designation is appropriate for the following reasons:

(a) The focus on size as a materiality threshold is misplaced

The Consultation states: "[i]n *theory*, the larger the size of a fund, the greater its potential impact on counterparties . . . and markets . . . ."[4] The Consultation has proposed a size threshold of $100 billion. However, it cites no empirical data or academic study indicating that the size of an investment fund has any impact on the financial system should a fund close, liquidate, merge or otherwise lose its entire value. In addition, the Consultation does not provide any other economic basis upon which the $100 billion threshold may be evaluated on its own merits.[5] It is also lacking any empirical evidence that supports the thesis that larger funds are systemically riskier than smaller funds. Therefore, the Consultation's $100 billion size threshold for investment funds seems arbitrary on its face.

Size does not accurately capture the risk profile of a fund and, therefore, should not be a dispositive factor in assessing how to protect against systemic risk. Ironically, the Consultation has proposed a size threshold that captures *only* U.S. registered funds.[6] Therefore, the current assessment methodologies would apply to only the world's most stable, most heavily-regulated and least leveraged investment funds for possible designation as NBNI G-SIFIs, while ignoring smaller investment funds that may be engaged in activities that contribute considerably more risk to the global financial system. Because of this odd result, the size materiality threshold should be withdrawn or, at the very least, more thoroughly examined and refined so as to produce a set of investment funds that are likely to present real global financial risks.

Rather than size, factors such as engaging in excessive leverage or failing to collateralize counterparty risk, are much more likely to be indicators of activity that could cause "significant disruption to the global financial system and economic activity across jurisdictions."[7]

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3 *See* Cannes Summit Final Declaration ("Cannes Declaration"), 4 November 2011.

4 Consultation at 33 (emphasis added).

5 Indeed, the size threshold was used merely to manage the size of the assessment pool and to maintain "a certain degree of consistency across the entire NBNI financial space." Consultation at 5.

6 *See* Fitch Ratings, Fitch Wire, FSB's Nonbank SIFI Rules Will Have Narrow Impact, January 14, 2014.

7 Consultation at 2.

(b) Structural characteristics of U.S. registered funds prevent them from giving rise to systemic risk

U.S. registered funds *do not* raise and historically *have not* raised systemic risk concerns largely because of the structural characteristics unique to registered funds. They are vehicles through which individual investors access investment markets. In fact, the Consultation acknowledges the FSB's and IOSCO's understanding that investment funds are fundamentally *stabilizing* rather than destabilizing elements in the financial system. It points out that investment funds are "shock absorbers" because investment fund investors "absorb the negative effects that might be caused by the distress or even the default of a fund."[8] The Consultation further acknowledges that this "shock absorber" feature mitigates any eventual contagion effects in the broader financial system.[9] This is in stark contrast to banks, finance companies and securities dealers, which are operating entities that principally generate risk assets for their shareholders, creditors and counterparties on their balance sheets.

U.S. registered funds are not leveraged the same way that other financial entities are. During the financial crisis, "investment banks held a mere $4 of equity for every $100 of assets in their balance sheets," consequently, "a relatively modest decline (4 percent) in the value of an investment bank's assets would wipe out the bank's equity . . . ."[10] This means that an investment bank's balance sheet, such as Bear Stearns, could disappear in a matter of hours.[11] Banking organizations may operate with leverage ratios of approximately 15:1, or more.[12] In contrast, U.S. registered investment funds generally have a maximum allowed leverage ratio of 1.5 to 1. This means that a U.S. registered fund is unlikely ever to have losses magnified by leverage that could wipe out the investment fund and leave behind large counterparty losses.

Furthermore, most financial intermediaries "borrow short and lend long," which results in these intermediaries being "vulnerable to temporary disruptions of liquidity in financial markets."[13] Banks may use demand deposits to fund their lending activities, and securities firms use commercial paper or repos to finance their long-term illiquid investments.[14] However, as a pool of managed assets issuing securities at NAV, U.S. registered funds simply do not engage in this type of activity in any meaningful way.[15] Their regulatory structure and operations are based

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8 Consultation at 29.

9 *Id.*

10 *See* Bullard, Neely, Wheelock *Systemic Risk and the Financial Crisis: A Primer*, Federal Reserve Bank of St. Louis Review, September/October 2009 (5, Part 1) ("St. Louis FRB Paper"), pp. 408-9.

11 We also note that when Long-Term Capital Management failed it was levered 25 to 1, almost 25 times more than any U.S. registered fund or UCITS.

12 *See* A More Prominent Role For The Leverage Ratio In The Capital Framework, Remarks by FDIC Director Jeremiah O. Norton to the Florida Bankers Association, Orlando, Florida, February 6, 2013, at n. 1.

13 St. Louis FRB Paper at 408-9.

14 *Id*.

15 For instance, PIMCO's footprint in these short-term markets is negligible. PIMCO also does not act as a lending agent in securities lending programs. Like most U.S. registered funds, PIMCO funds' repo

on the fundamentally different principle – that investors in such funds fully understand that the NAV of a fund may increase or decrease at any time, and that there are no guarantees as to what the future value of their investment in a U.S. registered fund will be – a risk that is thoroughly disclosed to investors.

Moreover, investors in U.S. registered funds have a long-term investment horizon, which is supported by empirical data. Indeed, as of the end of 2013, "[n]inety-two percent of mutual fund-owning households indicated that saving for retirement was one of their household's financial goals, and 72 percent indicated that retirement saving was their primary financial goal."[16]

Finally, U.S. registered funds are not so interconnected that a fund's closing, liquidation or even hypothetical failure would cause a disruption in the market. The Consultation recognizes that the structure and investment orientation of shareholders of U.S. registered funds results in such funds not being a cause of financial system risk in the real world. The Consultation explains that the FSB and IOSCO reviewed industry data for U.S. mutual funds for the period 2000 through 2012 and concluded that:

> even when viewed in the aggregate, *no mutual fund liquidations led to a systemic market impact throughout the observation period*. Part of the explanation may be that many U.S. investors hold mutual fund shares for retirement purposes.[17] As such, these investors' investment horizon could be long-term, whereby they would prefer to remain invested rather than cash-out during a market downturn.[18]

As a result, from a market structure perspective, U.S. registered funds do not possess the risk profile of a systemically important institution.[19]

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activities are isolated almost exclusively to the overnight markets, where we use a diversity of counterparties, and are not part of the strategic term financing of financial institutions.

16 ICI Research Report, Profile of Mutual Fund Shareholders, at 8, 2013 (Feb. 2013), available at http://www.ici.org/pdf/rpt_14_profiles.pdf.

17 In this regard, the ICI Factbook indicates that in 2012, "72 percent of mutual-fund-owning households owned funds inside employer-sponsored retirement plans." ICI, *2013 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry* 94 (2013), available at http://www.icifactbook.org/pdf.2013 factbook.pdf (concerning total assets) ("ICI Factbook").

18 Consultation at 30, n. 38 (emphasis added).

19 We also note that UCITS have substantially the same risk profile as U.S. registered funds. Like U.S. registered funds, UCITS are limited in their ability to be levered. For example, a UCITS must ensure that its global exposure relating to derivative instruments does not exceed the total net asset value of its portfolio. (*See* Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009, on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) ("Directive 2009/65/EC, Article 51(3).) In addition, a UCITS is limited in its ability to borrow money. If permitted by the EU host member state, a UCITS may borrow money on a temporary basis provided that such borrowing represents no more than 10% of the assets of the fund. (See Directive 2009/65/EC, Article 83.)

(c) The Consultation does not consider mitigating factors that render the articulated systemic risk transmission channels less relevant to U.S. registered funds

The Consultation's grounds for considering U.S. registered funds as NBNI G-SIFIs is based on two specified systemic risk transmission channels: (i) exposures/counterparty channel risk, and (ii) asset liquidation/market channel risk.[20] The Consultation should, but does not justify why it believes U.S. registered funds would possess these transmission risks, and it neither acknowledges nor considers the fact that the SEC's regulatory regime for U.S. registered funds fully addresses these exposure channels. In fact, current U.S. regulation of U.S. registered funds is a comprehensive regulatory structure that has successfully endured through 70 years and multiple market cycles. This regulation also already contains many provisions that mitigate U.S. registered fund exposures/counterparty channel risk and asset liquidation/market channel risk, including the requirements to:

- keep their capital structure simple by prohibiting the issuance of senior securities by open-end funds and thereby avoiding priority claim problems in the case of liquidation.[21]

- maintain 300% asset coverage for any borrowings, and 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.[22]

- maintain strict limits on a fund's exposure to its counterparties through collateral control requirements.

- limit concentration in a single industry to 25% (unless otherwise disclosed in the fund's prospectus) of the fund's holdings, including limiting a fund's investment in any one financial firm to 5%.[23]

- under certain circumstances, to trade or enter into futures, options and swaps on exchanges and clear such transactions through designated clearing houses.[24]

As it relates to counterparty exposure, and as discussed above, because U.S. registered funds are limited in their ability to borrow and use leverage, any counterparty exposure to these funds is relatively small in terms of risk exposure. In addition to the requirements listed above,

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20 One of the other indicators for an entity to be designated as an NBNI G-SIFI is that the entity serves such a critical function that its failure would be so devastating to the financial system that taxpayers would be forced to bail out the entity. However, as the Consultation concedes, "the investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies (funds are highly substitutable)" and, that funds liquidate "on a regular basis with negligible or no market impact." Consultation at 30.

21 *See* 1940 Act § 18.

22 *See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979), 44 Fed. Reg. 25128 (Apr. 27, 1979).

23 *See* 1940 Act § 12(d)(1), (3).

24 *See* Commodity Exchange Act § 2(h)(1), (8).

U.S. registered funds do not create exposures/counterparty risk because the U.S. regulatory structure requires them to adequately manage their exposures to counterparties through strict rules regarding custody of fund assets, thereby limiting a U.S. registered fund's exposure to its counterparties.[25] In fact, U.S. registered funds generally may only post collateral (both domestically and abroad) with qualified third-party custodians.

Moreover, it is common practice for asset managers to have internal policies that seek to further mitigate counterparty exposure. PIMCO seeks to minimize its exposure/counterparty risk by only transacting with counterparties that meet certain minimum credit and other standards. Counterparties are evaluated regularly using both quantitative and qualitative risk assessment methodologies. In addition, PIMCO has adopted rigorous collateral management practices, which include: (i) monitoring counterparty exposures by account and transaction using proprietary technology and analytics; (ii) generating collateral calls daily from counterparties whenever the intermediary position exceeds $250,000; (iii) managing failed trades by employing a dedicated team that performs oversight and forensics should a trade fail; and (iv) establishing collateral standards under which counterparties are required to post only high quality collateral.

We also note that counterparties are subject to master agreements negotiated by PIMCO on behalf of its clients for certain types of derivative and forward-settling transactions. These master agreements (i) permit PIMCO to "call" collateral on in-the-money positions greater than $250,000 (or the local currency equivalent); (ii) allow for mutual termination based on certain credit events; and (iii) require the highest quality collateral. Counterparty risk is further mitigated by central clearing of derivatives under the rules adopted pursuant to Title VII of the Dodd-Frank Act.

As it relates to the potential for asset liquidation risk, PIMCO submits that there is no support for the principle that "runs" are an observable risk among floating NAV U.S. registered funds. In fact, we are not aware of any instance in the more than 70 year history of the 1940 Act where a U.S. registered fund of any significance was unable to meet redemptions in accordance with applicable law.[26] Indeed, U.S. registered funds are protected against any first-mover advantages based on the nature and operations of U.S. registered funds' floating NAVs.[27]

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25 *See* 1940 Act § 17(f) and rules thereunder. In addition to the statutory and regulatory requirements, when U.S. registered funds post their assets as collateral for derivatives transactions, U.S. registered funds generally enter into tri-party collateral control agreements with the U.S. registered fund custodian and applicable counterparty, creating a security interest for the benefit of the counterparty. Only the U.S. registered fund's custodian, and not the counterparty, has custody of the collateral. This requirement protects the U.S. registered fund from the risk of default or insolvency of its counterparty and, accordingly, mitigates systemic risk.

26 We are aware of a limited number of relatively small U.S. registered funds that have failed to meet redemptions in compliance with the requirements of section 22(e) of the 1940 Act, but these failures generally were caused by mismanagement or improper actions by personnel of the investment adviser or other service providers. We are aware of no such cases involving a family of U.S. registered funds of relative significance in the industry, or any case that involved a spillover effect to the financial system at large.

27 The Consultation does not suggest that open-end floating NAV funds globally experienced "runs" during the financial crisis. Historical experience suggests that funds experience drastically increased redemptions for only two reasons: (i) when investors are concerned about the fund or adviser being engaged in

As acknowledged by the Consultation and supported by empirical data, investors in U.S. registered funds tend to have long-term investment horizons and are therefore less likely to seek redemptions in times of market stress. Data from the financial crisis supports this notion. Even during the highly volatile period of 2008, redemptions from U.S. registered funds were limited, demonstrating quite plainly the long-term investment horizons of investors in U.S. registered funds. Specifically, in September, October and November of 2008, the worst period of the financial crisis, U.S. registered funds experienced net redemptions of approximately $60 billion, $128 billion and $41 billion, respectively, on a net asset base of almost $5.8 trillion.[28] These funds returned to positive net purchases of approximately $25 billion in January 2009.[29] U.S. registered funds managed by PIMCO experienced similar results during the financial crisis. PIMCO's largest fund, the Total Return Fund, experienced net redemptions of $2.7 billion during the fourth quarter of 2008 which accounted for only 2.1% of the total value of the fund.

In addition, the 1940 Act and related interpretations limit the use of leverage by U.S. registered funds. U.S. registered funds are subject to strict limitations on their ability to utilize leverage (300% asset coverage) and are generally required to cover their outstanding liabilities with liquid assets. Moreover, U.S. registered open-end funds must maintain 85% of their assets in liquid securities under SEC guidance.[30] They are also subject to other prudential limitations required under the ICA, such as concentration limits (in certain circumstances) and, as noted above, prohibitions against owning, and being owned by, investment companies above certain limitations,[31] as well as 5% ownership limitations on financial companies.[32] These restrictions significantly mitigate the risks that are associated with leverage and liquidity for U.S. registered funds.

U.S. registered funds also have ways to meaningfully control drastic redemption activity by either (i) postponing payment of redemptions when the market is closed; (ii) suspending redemptions in the event of an emergency (with the SEC's approval); and (iii) generally reserving the right to redeem in kind. Additionally, mutual fund boards are free to terminate the investment adviser at any time and port the given fund's underlying securities, which are held at third-party custodians to a different investment adviser without the need to liquidate their securities or expose them to market risk.

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fraudulent activity; or (ii) when investors become concerned about the asset class as a whole. Assuming those predicates, an NBNI G-SIFI designation would not mitigate the risk of drastic redemptions when investors exit a particular asset class, as they would be pulling money out of any fund invested in the asset class, not just the larger funds (which, in fact, may be in a better position to withstand a run).

28 *See* ICI, *Long-Term Mutual Fund Flows Historical Data* (2013), http://www.ici.org/info/flows data 2013.xls (concerning redemption activity); ICI Factbook at 144.

29 ICI Factbook at 94.

30 *See* Investment Company Act Release No. 18612 (March 12, 1992).

31 *See* 1940 Act § 12(d)(1).

32 *See* 1940 Act Rule 12d3-1.

2. An Activities-Based Methodology That Considers Mitigating Factors Is More Appropriate for Investment Funds

We believe that the FSB and IOSCO should focus on activities-based regulation and targeted regulatory enhancements designed to address specific systemic risks to the financial system rather than applying broad based methodologies that are not otherwise correlated to actual risks.

The FSB and IOSCO should also undertake further study to determine which *activities*, not *entities*, may actually create systemic risk. This approach would result in a more objective and appropriate set of assessment methodologies, which is consistent with the Consultation's own statements:

> [A]nother possible approach to assessing systemic risk in the asset management sector could be to consider possible financial stability risks that could arise out of certain asset-management related activities. Under this approach, the methodologies would consider how particular activities or group of activities might pose systemic risks.[33]

The activities-based approach should also be coupled with the consideration of other mitigating factors. Such mitigating factors for U.S. registered funds should include at a minimum the strength and capability of management, effective risk controls, effective board oversight, diversification, liquidity options, disclosure and the relative ease of resolvability of an investment fund in the event it encounters financial distress.

In addition to implementing an activities-based approach that utilizes mitigating factors, the FSB and IOSCO should further evaluate each country's national regulatory structure for investment funds and study whether the current regulation in that jurisdiction adequately addresses potential systemic risks in the investment fund sector. If a country's national regulatory system is lacking in a certain area identified by the study, then the FSB and IOSCO should recommend enhancements to address such activities. This approach is far more appropriate than designating individual funds and depriving investors of the benefits larger funds provide in terms of cost and access to markets.

The FSB and IOSCO have acknowledged that between 2000 and 2012, the regulatory scheme for U.S. registered funds has operated in such a manner that even in the worst periods of financial crisis, U.S. registered fund liquidations in the aggregate did not lead to a systemic market impact. Nevertheless, the Consultation's analysis of the U.S. registered fund regulatory structure is incomplete in that the Consultation does not address recent developments in the U.S. or Europe that have even further mitigated the risk of leverage obtained through the use of derivatives and swaps, including central clearing and margining requirements.[34] For example, Title VII of the Dodd-Frank Act mandates registration requirements and regulation of swap dealers and major swap participants, which are those swap users that, by virtue of high levels of swaps or security-based swap activities, "create substantial counterparty exposure that could

[33] Consultation at 32.

have serious adverse effects on the financial stability of the U.S. banking system or financial markets."[35] These derivatives market reforms are comprehensive and are specifically designed to reduce systemic risk and create transparency in the market. For the Consultation not to take note of this extensive financial reform, which was enacted specifically to address financial systemic risk, is a significant omission.

Other mitigating factors should also include board of directors' oversight of U.S. registered funds. U.S. registered funds are required to have a majority of independent board members that oversee the operations of the fund and provide an additional layer of oversight to ensure that the fund's investment objective and risk parameters are adhered to. Additionally, the board of directors of a U.S. registered fund is required to evaluate the adviser yearly. It is essential for the FSB and IOSCO to consider regulatory risk limiting factors of an investment funds home regulatory regime.[36]

3. The Costs of Designation Would Far Outweigh Any Benefits

There is no productive value to an NBNI G-SIFI designation if it does not lead to a reduction of actual systemic risks. Making such designations where there is no true systemic risk serves only to increase costs for investors and subject investment funds and their managers to new burdensome regulations and accompanying costs.

The Consultation does not identify any specific systemic risks that will actually be reduced by designating investment funds. It does not describe the regulatory requirements that would be imposed on a designated investment fund to achieve those risk reductions.[37] This is a critical defect because the only forms of systemic risk reduction employed to date have been bank centric, prudential regulations that are generally not feasible for investment funds. The Consultation does not address, among other things, how prudential regulation that is designed for the safety and soundness of the financial system can co-exist with an asset manager's fiduciary duty to act in the best interests of its clients.[38] Moreover, this type of regulation conflicts with the U.S. regulatory structure that oversees the only investment funds that would be caught by the Consultation's assessment methodology.

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[35] 7 U.S.C. § 1a(33); Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596, 30661 (May 23, 2012). We note that neither PIMCO nor any of the U.S. registered funds that we advise are MSPs.

[36] As recognized in the Consultation, the U.S. regulatory structure has been extraordinarily successful from a financial stability perspective. The Consultation's conclusion that "even when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact throughout the observation period" certainly bears repeating in any consideration of the efficacy and adequacy of the regulation of the U.S. registered funds sector.

[37] The Consultation indicates that the FSB will begin to work to develop policy measures for NBNI G-SIFIs only *after* the methodology for investment funds to qualify as NBNI G-SIFIs (the "Fund Methodology") has been finalized. Consultation at 2, n.6.

[38] Furthermore, prudential regulation to date has mainly focused on capital requirements designed to prevent financial institutions from becoming insolvent thereby mitigating counterparty risk. It is hard to see how capital standards on U.S. registered funds would ameliorate the purported counterparty and transmission risks that the Consultation presumes to exist.

It is not possible to comment meaningfully and provide constructive assistance to the FSB and IOSCO until at least three critical pieces of information are evaluated and disclosed for public scrutiny: (i) the nature of enhanced regulatory supervision that will be imposed; (ii) how the assessment methodologies and attendant regulation will reduce the perceived risks created by the designated investment fund; and (iii) how the question of resolvability in the event of a fund's financial distress impacts the process.

4. Asset-Managers Do Not Pose a Systemic Risk

Unlike banks and other types of financial firms, asset managers do not hold client assets on their own balance sheets, and therefore investment funds do not depend on the solvency of their asset managers. Investment products offered by banks and other finance companies often rely on the institution's financial health and its ability to back obligations incurred by those investment products. This approach differs from asset managers, which do not guarantee (expressly or implicitly) the performance of the funds they manage. Indeed, PIMCO has never supported any of its funds in any capacity during its 40 year plus history. Instead, the risk of loss falls exclusively on the fund and its shareholders. This arrangement underscores an important distinction that the Consultation fails to adequately acknowledge: an asset manager functions as an agent for its clients, while banks act as principal.

In addition, asset managers are separate and distinct legal entities from their investment fund clients. All gains and losses of the investment fund are thus borne only by the investment fund. Furthermore, client assets are held by custodians of their own choosing in segregated accounts. Neither the asset manager, nor its other clients, nor the creditors of either has a claim on such assets. Moreover, because each investment fund client is a separate legal entity from the other, losses borne by one fund will not affect any of the asset manager's other clients.

Typically, when PIMCO (and, we believe, other asset managers) arranges derivatives transactions on behalf of its clients, such transactions are non-recourse obligations. Accordingly, the lender cannot look to any other client assets (or the assets of the manager for that matter) for payment. Nor can the asset manager use the assets of one fund, which are separately custodied, to satisfy the obligations of another fund it manages.

Leverage limits set by clients often impose even stricter restrictions on asset managers than those that apply to registered investment funds. As noted above, in addition to U.S. registered funds, PIMCO also manages the assets of a diverse set of institutional investors. These investors are typically long-term investors that are often themselves fiduciaries which must adhere to strict policies established by an oversight board or similar body that ordinarily must approve any modification of investment strategy. Such clients may be subject to regulatory requirements (such as ERISA and state or local laws), or the investment guidelines established by their boards, or both, and tend to pursue relatively conservative investment strategies. The highly restrictive investment policies of such investors must be taken into account to adequately assess the potential for investment funds or asset managers to impose systemic risk – particularly when employing assets under management as an indicator of risk.

The asset manager industry is large and diverse and clients can easily move their assets from one asset manager to another. In this regard, asset managers are highly substitutable.

While the Consultation seeks to identify potential systemic risks that could occur during a hypothetical market crisis, the Consultation conspicuously fails to evaluate the experience of the most recent financial crisis.[39] To the extent that any U.S. registered fund asset manager failed during that period, we are not aware of any collateral or systemic issue that resulted from the failure of the asset manager.

5. <u>No Directive Or Analytical Basis Supports The FSB's Consideration Of Investment Funds For Designation</u>

The Consultation effectively presumes, without study or public input, that investment funds should be a category of financial entities to be considered for an NBNI G-SIFI designation. The G20 Leaders' Declarations in 2011 and 2013, however, did not identify investment funds as a specific category of NBNI G-SIFIs.[40] In contrast, the G20 Leaders specifically referred to banks that should be addressed from a global supervision perspective.[41] While the G20 required the FSB, in consultation with IOSCO, to develop methodologies for identifying potential NBNI G-SIFIs without regard to their form, nowhere do they indicate that investment funds (or investment managers) possess the types of risk characteristics that would warrant NBNI G-SIFI designation.

We cannot conclude from the record available that the Consultation follows the G20's implicit mandate to conduct a rigorous, analytical study to identify potential NBNI G-SIFIs. If it did, that analysis should be shared with the public.[42]

We respectfully request that the FSB and IOSCO either disclose the foundational analyses that they conducted, and/or initiate a comprehensive review and evaluation of the structure, characteristics and regulatory environment in which investment funds operate, and then seek public comment on these matters before proceeding to the next steps.[43]

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39 For example, there was no consideration that large independent asset managers did not receive any assistance from the Troubled Asset Relief Program ("TARP"), the U.S. Treasury, or the U.S. Federal Reserve during the financial crisis.

40 *See* Cannes Declaration at paragraph 29 and Saint Petersburg Summit G20 Leaders' Declaration, September 2013, paragraph 70 regarding the development of methodology to identify NBNI G-SIFIs.

41 *See* Cannes Declaration at paragraphs 28 and 29.

42 PIMCO is unable to comment on the merits of a process, if any, that has not been disclosed. Investment funds, as pools of investor assets, are fundamentally different from, and pose dramatically different risks than do entities such as banks, finance companies and securities dealers. But there is no record to evaluate how those differences were weighed for the purposes of the Consultation.

43 Since the Fund Methodology appears to be aimed exclusively at U.S. registered funds, we believe that the report that results from this process – (the "U.S. Registered Funds Report") – should address the actions of the U.S. Congress and the SEC to ensure appropriate disclosures to investors and to mitigate U.S. registered fund-related threats to financial stability. Ultimately the U.S. Registered Funds Report should present a balanced, well-reasoned explanation of why or why not U.S. registered funds may be designated as NBNI G-SIFIs.

6. **The FSB And IOSCO Must Identify Their Principles And Goals Before Eliciting Further Comment**

To elicit fair and meaningful comments, the FSB and IOSCO should identify the problems for which they are trying to solve and the externalities they are trying to address.[44] Public policy and costly, burdensome regulation should not be based on a vague set of untested assumptions about the investment fund industry. To avoid such arbitrariness in the regulatory process, all of the terms and goals should be clearly defined and exposed to public comment and additional data that demonstrates the actual causes of systemic threats should be collected before proceeding.

Finally, whatever methodologies are relied upon should accommodate improvements in financial markets which must necessarily change the amount and types of risk that are of concern. For example, as large banks and broker dealers become more closely regulated from a systemic point of view in the U.S. and around the globe, risks in the market presumably will change and hopefully lessen. Similarly, as new rules become effective to better regulate derivatives and other synthetic instruments, the market should become more transparent, and risks more measurable and controlled. We believe that an analysis of investment funds prior to the market improvements that these initial regulatory steps will have would differ substantially from one conducted after they have been in effect.

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44 For instance, what does it mean for a fund or an adviser to "fail?" Additionally, the words "financial distress," "disorderly failure" and "significant disruption" need to be defined in the context of investment funds and actual market scenarios in order to evaluate whether such funds actually present the attendant risks.

Please feel free to contact us if we can provide any assistance to you in the further evaluation of these very important issues.

Sincerely,

Douglas M. Hodge

Douglas M. Hodge
Chief Executive Officer

APPENDIX

PIMCO's Response to Certain Consultation Questions

Responses to Questions in Section 6 of the Consultation

Q6-1. In your view, does the proposed definition of investment funds provide a practical basis for applying the specific methodology (i.e. indicators) to assess the systemic importance of NBNI financial entities that fall under the definition?

No. As explained in our Letter, the proposed definition is far too inclusive as it includes investment vehicles with vastly different investment approaches. Different types of investment funds raise completely different issues and the Consultation's analysis should be broken into separate categories to more appropriately focus on the activities of particular investment funds. For example, some investment funds may be large in size but their activities may pose different or fewer risks, than smaller, more leveraged funds. In addition, without precise definitions of systemic importance, there is an insufficient basis to assess how any methodology should be applied.

Q6-2. Does the above description of systemic importance of asset management entities adequately capture potential systemic risks associated with their financial distress or disorderly failure at the global level?

No. We do not believe the Consultation adequately identifies the range of systemic risks associated with the kind of financial distress that is sought to be avoided, or accurately captures the systemic risks associated with an asset management entity's (*i.e.*, an investment fund) distress or disorderly failure. Its analysis is skewed toward assumptions that are likely to lead to the identification of any company reviewed as a G-SIFI. The Consultation focuses heavily on the threat of runs on a particular fund or funds that would potentially trigger a fire sale by such fund or funds. This risk is largely hypothetical and the Consultation fails to cite any historical basis or empirical data for concluding that this a true risk. The concept of a "run" on a fund usually relates to a money-market fund with a stable NAV caused by a first mover advantage as people aim to get 100 cents on the dollar when redeeming their shares. The use of a floating NAV, restricted use of leverage and the long-term investment horizon of typical investors in U.S. registered funds substantially limits the potential for a run on such funds.

The Consultation also does not take into account that this type of risk would most likely occur in funds holding illiquid securities that were forced to honor redemption requests without being able to liquidate the fund's assets. Further, the Consultation does not take into account that: (i) U.S. registered funds are limited to holding no more than 15% of their assets in illiquid securities at any one time; (ii) closed-end funds would not need to engage in fire sales because they do not offer redeemable shares; and (iii) most hedge funds have limitations on redemptions by shareholders. Further, as described in our Letter, U.S. registered funds also have ways to meaningfully control runs by either (i) postponing payment of redemptions when the market is closed; (ii) suspending redemptions in the event of an emergency (with the SEC's approval); and (iii) generally reserving the right to redeem in kind.

Importantly, the Consultation does not consider how theoretical fire sales of portfolio securities or runs on an investment fund correlate to size, complexity or interconnectedness of an affected investment fund. In most cases, a larger investment fund would be able to absorb increased redemptions and associated sales of its portfolio securities better than a smaller investment fund. The Consultation, however, does not address to what scale a run on an investment fund and attendant sales of portfolio securities would need to be in order to cause that investment fund to fail. Finally, the Consultation does not address how big an investment fund would need to be to have a significant impact on the financial system should it lose value.

Some empirical data supporting the existence of systemic risks caused by investment funds would need to be added for any description to be accurate. We do agree, however, with the Consultation's characterization that "funds contain a 'specific shock absorber' feature that differentiates funds from banks."[45] And we also agree with the Consultation's only empirical data on this subject which leads to the conclusion that "funds close . . . on a regular basis with negligible or no market impact."[46]

Q6-3. Which of the following four levels of focus is appropriate for assessing the systemic importance of asset management entities: (i) individual investment funds; (ii) family of funds; (iii) asset managers on a stand-alone entity basis; and (iv) asset managers and their funds collectively? Please also explain the reasons why you think the chosen level of focus is more appropriate than others.

It is impossible to answer the question given the lack of definition of each of the terms. We cannot express our concern enough that the Consultation presumes systemic risk exists with respect to investment funds. This question demonstrates this presumption. Further the question is misguided in that it does not look at activities of the aforementioned entities that would actually create risk, but rather it presumes that entities versus activities create risk.

Q6-4. Should the methodology be designed to focus on whether particular activities or groups of activities pose systemic risks? If so, please explain the reason why and how such a methodology should be designed.

PIMCO strongly believes any methodology should focus on the activities of investment funds rather than the size of funds. Focusing on the size of an investment fund is based on hypothetical risks. Enhanced regulation focusing solely on size will create an artificial disadvantage for larger investment funds and any associated costs of additional regulation would invariably be borne by the investors of those funds. As a result, investors in these funds may be reluctant to invest in larger funds as any looming G-SIFI designations would create uncertainty regarding a particular investment fund's costs.

45 Consultation at 29.

46 *Id.* at 30.

Q6-5. Are the proposed indicators appropriate for assessing the relevant impact factors? If not, please provide alternative indicators and the reasons why such measures are more appropriate.

We do not believe the proposed indicators are appropriate for assessing the relevant impact factors. We will address each indicator individually:

Indicator 1-1 – Size

The Consultation provides no support for the presumption that larger investment funds or asset managers pose higher risks and, as the Consultation admits, bases this indicator on an unproven "theory." As such, we cannot support an indicator that is not based on actual data and appears to single-out only U.S. registered funds. However, should the FSB and IOSCO be able to provide some sort of indicia that the size of an investment fund contributes to the systemic risk should the fund lose value, then regulators must also assess any factors that mitigate risk, such as the existence of adequate national regulation, the investment fund's diversification, risk management, and other factors as described in our Letter.

Neither of the proposed size indicators appropriately addresses the potential systemic risk of a fund. As indicated by the St. Louis FRB Paper, counterparty risk created by leverage is the main source of systemic risk. Accordingly, this should be a principal consideration when evaluating the amount of systemic risk an investment fund may contribute to the financial markets.

In addition, size and liquidity of the market in which an investment fund operates is also a key indicator of any risks actually posed by the fund. For example, in the U.S., even large investment funds tend to have limited influence, and there has been significant turnover among top companies based on size. According to a recent ICI report, "of the largest 25 fund complexes in 1995, only 15 remained in this top group in 2012." [47] The report also notes that "the [Fund] industry had a Herfindahl-Hirschman Index number[48] of 465 as of December 2012," where any number under 1,000 indicates a lack of concentration in an industry.[49] This indicates that an investment fund designated because of its size will more than likely have an irrelevant G-SIFI designation in the near future as there is a good chance that it will no longer have the same market share it had when it was designated.

Indicator 2-1 – Leverage Ratio

We believe leverage is a critical indicator. U.S. registered open-end funds are severely limited in the amount of leverage they can use because of the asset coverage requirements established by the SEC, which requires that a fund earmark liquid assets or enter into offsetting positions to cover 100% of the fund's obligations created by leverage. This is important for limiting interconnectedness because the coverage requirements are designed to ensure that a fund

[47] *See* ICI Factbook at 24-25.

[48] The Herfindahl-Hirschman Index is a commonly-accepted measure of market concentration.

[49] *See* ICI Factbook at 24-25.

will always have the liquid assets to make good on its commitments, even in an unstable or disorderly market.

Indicator 2-2 – Counterparty Exposure Ratio

We do not believe that the proposed total net counterparty exposure at the investment fund metric is appropriate. The more counterparties an investment fund has, the less exposure each counterparty will have to the investment fund, as the risk of default is spread out in the market to dissipated levels. Therefore, a total net number across counterparties is not a meaningful indicator. Investment funds manage counterparty exposure at the agreement level with each broker. Accordingly, counterparty exposure should be looked at on a per counterparty basis. Any counterparty that does not have a meaningful exposure should not be considered as a factor that contributes to systemic risk. Moreover, the Consultation should consider risk management and other practices that asset managers put into place to reduce overall counterparty risk.

Indicator 2-3 – Intra-financial System Liabilities (Credit Exposure)

Again, total net counterparty credit exposure should only be netted among the parties with meaningful exposure to the investment fund. The more counterparties, the less exposure each is subject to. Only counterparties with meaningful credit exposure to the investment fund should be considered in any metric.

Indicators 3-1 and 3-2 – Portfolio Turnover and Trading Volume

It is difficult to answer this question because “volume” and “asset class” are not defined. In any event, we do not see the correlation between portfolio turnover and trading volume to systemic risk in the case of an investment fund’s failure. Data suggesting the relevance of these indicators would need to be provided to show that a fund with a high turnover ratio and trading volume would cause a market disruption should it fail. Should the FSB and IOSCO find it necessary to keep this indicator, they should consider adopting the SEC’s definition of “turnover”, which excludes short-term securities, derivatives, and sale buy-backs.

Indicator 3-3 – Strategies or Asset Classes with Less than 10 Market Players Globally

This is an arbitrary indicator. There is no evidence that any funds meet this standard and there is no significance or reasoning in choosing “ten” as the threshold. There is also no evidence that an asset class with fewer than 10 participants is systemically important or would pose a risk to the financial system. Importantly, the Consultation does not appear to consider the harm this indicator could do by hampering of innovation. Investment managers could view new asset classes or investment strategies as a risk not worth undertaking under such a regime, thereby inhibiting creativity in introducing new investment options.

Indicator 4 – Complexity

Indicator 4-1 – More OTC derivatives increase counterparty risk.

This indicator does not take into consideration the sector-wide, activities-based enhancements, new regulatory developments. For example, both the U.S. and Europe require most standardized OTC derivatives to be cleared through a derivatives clearing organization ("DCO") or swap execution facility ("SEF"). DCOs and SEFs greatly reduce counterparty risk. Accordingly, any meaningful consideration of derivatives would need to consider the extensive market transformation that has been undertaken and continuing evolution of these practices and the risk mitigating effect that they contribute to the market.

Indicator 4-2 – A fund might re-hypothecate collateral it receives, and might not return it to a counterparty.

Data showing that this is an actual, rather than theoretical, risk must be presented before the industry can comment on it in an effective manner. Most U.S. registered funds do not participate in lending agreements, except for securities lending. Even in the case of securities lending, U.S. registered funds typically receive cash or cash equivalents as collateral for loans where they are the lender. The collateral is then marked to market daily and if a fund did not return the collateral for some reason, the borrower presumably would have the securities it borrowed. Because there is no evidence that lending activities by U.S. registered funds have any systemic significance, we cannot support this indicator.

Indicator 4-3. – High frequency trading.

No PIMCO U.S. registered funds engage in high frequency trading. We also understand that, in general, very few U.S. registered funds engage in this type of activity.

Indicator 4-4. – Weighted average liquidity and susceptibility to runs.

We understand the premise, but not the actual perceived risk. In the U.S., registered open-end funds generally must retain at least 85% liquid assets at all times, closed-end funds are not subject to redemptions, and hedge funds typically have redemption restrictions. Moreover, open-end funds have several protections available in the face of runs such as the ability to suspend redemptions in times of stress (with the SEC's concurrence) and the ability to redeem in kind.

Indicator 5 – Cross-jurisdictional activities

Again, the Consultation points to no verifiable empirical data that proves funds that invest more globally could have a greater impact on systemic risk. The Consultation does not establish the fundamental premise that any one fund would have an impact domestically, much less globally. U.S. registered funds generally are sold primarily to U.S. investors. With regard to global counterparty risk, please see above with respect to counterparty risk generally. Moreover, recent agreements between the CFTC and multiple international regulators call for substituted compliance regarding certain swaps regulations. To date, the CFTC has reached substituted compliance determinations for six jurisdictions: Australia, Canada, the EU, Hong

King, Japan, and Switzerland.[50] Even more, jurisdictions across North America and Europe are beginning to implement legal entity identifiers to track swaps activities across borders.[51] As such, cross jurisdictional activities present far less risk than in the past. However, given the ever increasing transparency of these activities, we believe an analysis should first be conducted of such information to conclude that cross-jurisdictional activities even give rise to systemic risk concerns.

Q6-6. For "cross-jurisdictional activities", should "the fund's use of service providers in other jurisdictions (e.g. custody assets with service providers in jurisdictions other than where its primary regulator is based)" be used?

This indicator should only be considered to the extent that a fund's home country regulator does not have effective regulation in place concerning custody of fund assets. For example, U.S. registered funds are required to comply with section 17(f) of the 1940 Act and Rules 17f-5 and 17f-7 thereunder which set forth permissible categories of custodians for U.S. registered funds.

Q6-7. Is the definition of "net AUM" and "GNE" appropriate for assessing the "size" (indicators 1-1 and 1-2)?

No. See response to Indicator 1-1 above.

Q6-8. Is the definition of "investment strategies" sufficiently clear for assessing the "substitutability" (indicator 3-3)?

No, it is unclear what how the Consultation's defines "investment strategies."

Q6-10. Are there additional indicators that should be considered for assessing the relevant impact factors? For example, should "the fund's dominance in a particular strategy (as measured by its percentage of net AUM as compared to the total AUM" also be considered for "substitutability"? Similarly, should "leverage" or "structure" of a fund also be considered for assessing "complexity"? Please explain the possible indicators and the reasons why they should be considered.

Concerns about concentration and substitutability cannot be addressed until an investment fund's diversification is properly understood and accounted for, especially if an investment fund's size is going to be a material threshold indicator. If a large investment fund is highly diversified, its impact on any one asset class will be mitigated.

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50 See 78 Fed. Reg. 78864 (Dec. 27, 2013) (Australia), 78 Fed. Reg. 78852 (Dec. 27, 2013) (Hong Kong), 78 Fed. Reg. 78910 (Dec. 27, 2013) and 78 Fed. Reg. 78890 (Dec. 27, 2013) (Japan), 78 Fed. Reg. 78899 (Dec. 27, 2013) (Switzerland), 78 Fed. Reg. 78839 (Dec. 27, 2013) (Canada), 78 Fed. Reg. 78923 (Dec. 27, 2013) and 78 Fed. Reg. 78878 (Dec. 27, 2013) (EU), each available at http://www.cftc.gov/LawRegulation/DoddFrankAct/CDSCP/index.htm.

51 See CFTC Regulations Part 45 and the Legal Entity Identifier Regulatory Oversight Committee website at http://www.leiroc.org/.

As we explain in our Letter, any assessment methodologies must consider the adequacy and robustness of an investment fund's current regulatory regime in an effort to evaluate whether existing regulatory oversight can sufficiently mitigate any perceived systemic risks and to avoid redundant, superfluous and possibly conflicting regulation by multiple regulators. The FSB and IOSCO also must avoid encroaching on an investment fund's home regulator if that regulator has a history of effectively regulating the industry and has an expertise beyond that of other regulators.

Q6-11. Should certain indicators (or impact factors) be prioritised in assessing the systemic importance of investment funds? If so, please explain which indicator(s) and the reasons for prioritisation.

Size of the investment fund should be devalued in its importance in determining whether a fund is systemically important. Instead, the focus should be on the activities in which the investment fund is engaged and the overall risk exposure to the financial system those activities are creating. Most importantly, however, an investment fund's home country regulator should be considered before applying a designation to an investment fund that will hurt its shareholders and potentially contribute to certain of the risks the designation is aimed at preventing or mitigating.