PIMCO

Via Electronic Submission

January 13, 2016

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, File No. S7-16-15

Dear Secretary Fields:

Pacific Investment Management Company LLC ("PIMCO") appreciates the opportunity to respond to the U.S. Securities and Exchange Commission's ("SEC" or "Commission") proposed rule regarding open-end fund liquidity risk management and swing pricing (the "Proposal").[1] PIMCO supports the Commission in its efforts to seek to reduce risk by requiring mutual funds to adopt robust liquidity management programs.

PIMCO is registered as an investment adviser with the SEC and as a commodity trading advisor and a commodity pool operator with the U.S. Commodity Futures Trading Commission ("CFTC"). As of September 30, 2015, PIMCO managed approximately $1.47 trillion in assets 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 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 our clients, and both private and public funds that are offered to institutional and individual investors. In the case of all of these management services, PIMCO is engaged in long-term investment management of our clients' assets as a fiduciary.

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1 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).

I. Executive Summary

PIMCO supports the Commission's efforts, as the primary regulator of the U.S. mutual fund industry, in seeking to enhance investment manager and open-end fund liquidity risk management practices. Over the past several years there have been extensive discussions and review of the asset management industry and how asset managers, their products, and activities may affect domestic and global markets.[2] Mary Jo White, Chair of the Commission, has also outlined a robust regulatory agenda designed to enhance risk management in the asset management industry.[3] This agenda highlights the Commission's focus on portfolio composition risk and operational risk and PIMCO is pleased to offer its perspective on these important issues.[4]

PIMCO believes that liquidity risk management is a fundamental 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. Like other managers, PIMCO has had extensive risk management processes in place for many years, which is instrumental to how we manage our client portfolios. From this perspective, we welcome the SEC's focus on the topic of open-end fund liquidity risk management and appreciate the opportunity to provide comments. The following is a summary of our observations on certain requirements set forth in the Proposal, which we expand upon further in this letter:

- If funds are required to adopt liquidity risk management programs, it is important to understand that such programs inherently cannot be "one-size fits all." An investment manager needs flexibility to implement an open-end fund liquidity risk management

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2 *See* FSB, IOSCO, Consultative Document, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Jan. 8, 2014), http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf; FSB, IOSCO, Consultative Document (2nd), Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Mar. 4, 2015), http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf; FSOC, Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77,488 (Dec. 24, 2014).

3 Specifically, the Chair has indicated that the SEC staff is pursuing a robust agenda to improve its regulation of mutual funds and asset managers by (i) developing recommendations for the Commission to enhance data reporting for funds and advisers, including disclosure of fund investments in derivatives and the liquidity and valuation of their holdings, (ii) developing additional derivatives guidance for mutual funds, (iii) evaluating whether investment advisers should be required to create transition plans to prepare for a major disruption in their business, and (iv) considering ways to implement the Dodd-Frank Act's annual stress testing requirements for large investment advisers and large funds. *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) [hereinafter White 2014 Speech], http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VQr56X_n-70*;see also* Amendments to Form ADV and Investment Advisers Act Rules, Investment Advisers Act Release 4091, 80 Fed. Reg. 33,718 (proposed June 12, 2015) (to be codified at 17 C.F.R. pts. 275, 279); Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release 31,933, 80 Fed. Reg. 80,884 (proposed Dec. 28, 2015) (to be codified at 17 C.F.R. pts. 270, 274).

4 *See* Mary Jo White, Chair, SEC, Statement on Open-End Fund Liquidity Risk Management Programs and Swing Pricing (Sept. 22, 2015), http://www.sec.gov/news/statement/open-end-fund-liquidity-risk-management-programs--sept-22-2015.html.

program that is tailored to its business. This type of flexibility will improve the odds that these rules and processes do not otherwise harm overall market liquidity.

- Many asset managers establish minimum cash and cash equivalent targets as part of their liquidity risk management programs. Any requirements relating to minimum cash positions should be targets and not inflexible restrictions. Minimum cash targets should be established (and modified when necessary) by the investment manager (as opposed to a fund's board of directors) given the dynamic nature of the markets and the need to be nimble in managing this important characteristic of a portfolio. Boards of directors should periodically review the process to establish minimum cash targets as part of their review and oversight of the fund's liquidity risk management program.

- Asset managers generally view liquidity at the portfolio level. The proposed liquidity categorizations are unnecessarily prescriptive and will not provide meaningful data to the SEC. In addition, these categorizations are very subjective, cannot be predicted with any level of certainty and disclosure of this information will create investor confusion with no discernable regulatory benefit.

- Although swing pricing is utilized in other jurisdictions and may demonstrate certain anti-dilutive effects, we believe swing pricing would be problematic to implement in the U.S. due to numerous operational realities, including the delay in fund flow information at the time a fund's net asset value ("NAV") is calculated. In our view, this lack of information represents a serious impediment to the fair and effective implementation of swing pricing.

II. Funds Should Have the Flexibility to Adopt Tailored Liquidity Risk Management Programs

We are supportive of the Commission's goal of "creat[ing] a regulatory framework that would reduce the risk that a fund will be unable to meet its redemption obligations and minimize dilution of shareholder interests by promoting stronger and more effective liquidity risk management across open-end funds."[5] We agree that funds should be required to adopt a comprehensive liquidity risk management program to inform a manager's decisions of how to meet liquidity requirements while also managing the portfolio as provided in the fund's prospectus. We believe that managing liquidity in a prudent manner is a fundamental part of an investment manager's overall fiduciary duty to its clients.[6]

Although we support the goals of the Proposal to require funds to adopt a liquidity risk management program, we believe these programs should be developed using a principles-based approach and the specific terms of such programs should not be directed by rulemaking. We believe that investment managers should be provided significant flexibility to develop a program that is appropriate given the manager's client business and the board's role should be to review and approve such program. The program would reflect a "recognition of each fund's unique characteristics (*e.g.*, the nature of its investment objectives and strategies, portfolio holdings

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5 Proposal, 80 Fed. Reg. at 62,275.

6 *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963).

(including the means and frequency of trading those holdings), potential obligations, historical fund flows, and the composition of the investor base)," among other considerations.[7] These programs would complement certain basic principles and requirements that are currently in place, such as the 15% limitation on illiquid assets[8] and the various tools that are available to investment managers to provide liquidity and meet fund redemptions, such as: (i) using cash flows into the fund, (ii) using existing cash in the portfolio, (iii) opportunistic security sales, (iv) cross trades in accordance with rule 17a-7 under the Investment Company Act of 1940, as amended (the "Investment Company Act"), (v) credit facilities, (vi) redemptions in-kind, and (vii) inter-fund lending. There are also many additional factors that are considered when developing a liquidity risk management program and evaluating portfolio liquidity. The Proposal goes further in seeking to require an investment manager to consider a long list of factors, at a minimum, when reviewing and classifying the liquidity of a fund asset.[9] We believe that any final rule that dictates precise elements that must be considered when developing 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, which is approved by a majority of the independent directors of a fund's board.

There is precedent for the Commission allowing investment managers flexibility in developing fund policies and procedures. For instance, the Commission has required investment managers and mutual funds to adopt robust compliance policies and procedures under rule 206(4)-7 of the Investment Advisers Act of 1940, as amended (the "Advisers Act") and rule 38a-1 under the Investment Company Act and such policies must be reasonably designed to prevent violation of the federal securities laws.[10] In the Compliance Program Rule, the Commission affords investment managers significant discretion in adopting policies and procedures that are appropriate to the investment manager's business.[11] In fact, with regard to an investment adviser's program, the Commission stated in that release that such "policies and procedures [should] be *reasonably* designed to prevent violation of the Advisers Act, and thus need only encompass compliance considerations relevant to the operations of the adviser." In this regard, the Commission inherently acknowledged that an investment adviser is best suited to develop and tailor its policies and procedures to its business. We believe it is equally appropriate, if not more so, for the same paradigm to apply to liquidity risk management programs.

As noted in the Proposal, many investment managers in the industry have already adopted robust liquidity risk management programs. In our experience, these programs are typically predicated on a principles-based approach. The Proposal even acknowledges that some of the funds they observed in the industry with "more thorough liquidity risk management

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7 *Cf.* Investment Company Institute, Overview of Mutual Funds' Liquidity Management Practices to the Staff of the SEC, 3 (June 12, 2015).

8 Revisions of Guidelines to Form N-1A, Investment Company Act Release 18,612, 57 Fed. Reg. 9828, 9829 (Mar. 20, 1992) [hereinafter Revisions of Guidelines to Form N-1A].

9 Proposal, 80 Fed. Reg. at 62,305.

10 Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release 26,299, 68 Fed. Reg. 74,714, 74,715 (Dec. 24, 2003).

11 *Id.* at 74,715.

practices have appeared to be able to better meet periods of higher than typical redemptions without significantly altering the risk profile of the fund or materially affecting the fund's performance, and thus with less dilutive impacts."[12] We believe that this observation supports the notion that investment managers are capable of developing robust liquidity risk management programs using a principles-based approach and without the need for prescriptive requirements to dictate the granular elements of what those liquidity risk management programs must include.

It is important to understand that liquidity risk management programs cannot entirely mitigate all liquidity risk. The success of such programs, much like 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. For example, an investment manager recently announced that it would not be able to timely and fully meet redemptions for one of its open-end funds. While this event was certainly significant, the Commission utilized its power to suspend redemptions under section 22(e)(3) of the Investment Company Act and the event did not appear to cause any significant systemic market effects. Although we believe that this event further emphasizes the need for investment management firms to adopt robust liquidity risk management programs, it should not cause the Commission to conclude that it is in the interests of investors to adopt overly prescriptive rules rather than allowing investment mangers the flexibility to develop programs best suited to their funds 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. Dictating program specifics, including three day liquid asset minimums, the classification of securities (or portions thereof) and requiring subjective assessments of liquidity, do not assist an investment manager in meeting its fiduciary duty to a fund.

III. Three Day Liquid Asset Minimum Thresholds Should be Targets Set by the Investment Manager with Oversight of the Fund's Board

A. Three Day Liquid Asset Threshold

The Proposal would require the board of each fund to establish a three day liquid asset minimum as part of its liquidity risk management program. A three day liquid asset is defined as "any cash held by a fund and any position of a fund in an asset (or portion of the fund's position in an asset) that the fund believes is convertible into cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale."[13] The purpose of this requirement is to increase the likelihood that the fund will have enough liquid assets to meet redemptions without materially impacting the fund's NAV.[14]

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12 Proposal, 80 Fed. Reg. at 62,285.

13 *Id.* at 62,385 (citing proposed rule 22e-4(a)(8)).

14 *Id.* at 62,312. A fund would not be required to disclose the amount of its three day liquid asset threshold. We believe this is an appropriate paradigm given the sensitive nature of this subject and the extreme challenges this would present if the threshold changed often (*e.g.*, stickering prospectuses).

PIMCO supports the general principle of having a minimum cash (including cash equivalents) target[15] to ensure that an investment manager can meet shareholder redemptions, and this aspect of the Proposal is similar to how we manage liquidity in practice. We believe, however, that having a minimum three day liquid asset threshold serve as a prescribed minimum cash floor is overly burdensome and may cause an investment manager to maintain excessive cash in the portfolio when it may not be in the best interest of the fund to do so. Investment managers need the flexibility to manage fund portfolios, including cash, in light of the fund's prospectus and current market conditions, while also taking into consideration shareholder redemption activity, among other things. Requiring an inflexible amount of cash to be maintained at all times prevents an investment manager from making investment decisions based on current information, which may work against the interests of shareholders.

Further, we believe that the proposed three day liquid asset minimum should be a minimum cash target that is established by the investment manager, and not a fund's board of directors. Cash management is inherently a portfolio management function, which is guided by the investment manager's views of the market and overall portfolio risk factors rather than static limits established by a board that cannot be not involved in day-to-day portfolio management decision making. If the Commission feels that a three day liquid asset minimum is a vital part of a liquidity management program, we would suggest the following alternatives: (i) a cash target should be established by the investment manager, (ii) the fund's board should periodically be apprised of the manager's minimum cash targets and its process to establish such targets, (iii) there should not be a restriction on purchasing non-three day liquid assets if a fund's three day liquid assets goes below the target, and (iv) if a fund goes below its minimum cash target, the manager should be afforded a reasonable period of time (in the discretion of the manager) to reposition the portfolio in a prudent manner, even if such repositioning includes investing in non-three day liquid assets during that period.

The Proposal acknowledges that establishing an excessive three day liquid asset minimum "may unnecessarily constrain the fund's returns and investment in certain assets [may frustrate] investors' goals in choosing to invest in the fund."[16] We believe this would very much be the case. Having excess cash in a portfolio would likely result in a consistent lag in fund performance against its prospectus benchmark because the portfolio manager is not able to deploy the assets consistent with the fund's overall investment strategy. First and foremost, the investment manager's primary focus is to manage each fund in accordance with the fund's disclosed investment objective and strategy. The investment strategy and how the manager pursues that strategy is explicitly set forth in the fund's prospectus and that is what investors are purchasing when they buy shares of a fund. In our experience, shareholders look to the investment manager to actively manage any cash in a portfolio. Under the Proposal, the investment manager's cash judgments will be constrained. An investment manager must be able to implement its best judgment about how to invest a fund's assets and determine the appropriate percentage of assets that should be held in liquid instruments to meet redemptions.

15 For purposes of this Letter, cash targets should include cash equivalents as defined by the investment manager, as part of its liquidity risk management program.

16 Proposal, 80 Fed. Reg. at 62,314.

Because liquidity conditions are fluid (and the price of liquidity always fluctuates), PIMCO actively monitors and maintains a high level of focus on sustaining adequate levels of liquidity to meet investor redemption needs and potential margin calls. To the extent that a particular fund pursues an investment strategy that involves a higher degree of investment in less liquid assets, PIMCO actively seeks to mitigate any associated liquidity or redemption risks, through its daily liquidity management processes. PIMCO's liquidity monitoring goes beyond testing for the 15% maximum limit on illiquid securities.[17] PIMCO uses proprietary models to estimate the impact of large market movements and the fund's cash needs due to such movements, among other forms of stress testing. We also evaluate historical fund flows to model investor behavior over time under different market conditions. These tools, among others, allow PIMCO to ensure that our funds maintain sufficient liquidity, while seeking to minimize any potential liquidity drag on investor performance.[18]

PIMCO already utilizes cash (and cash-like) buffers, which are re-evaluated daily based on a number of 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 through stress testing (*e.g.*, a significant interest rate shock). These decisions also are informed at the firm-wide level based on the macro views of PIMCO's Investment Committee and implemented by its risk management professionals. In addition to these cash buffers, portfolio managers frequently deploy other techniques to manage liquidity as a fundamental part of portfolio construction, such as buying short-term securities, increasing liquidity buffers with cash inflows, and choosing the most liquid instrument to gain a specific exposure (*e.g.*, purchasing a bond vs. obtaining exposure in another manner, such as a future or a swap). These liquidity management practices are employed on an ongoing basis both to meet the daily redemptions of the funds we advise and when we are raising liquidity in order to make large asset allocation shifts. These best practices in fund liquidity management are reinforced by the SEC staff's guidance on these issues.[19]

Liquidity risk is only one risk factor among many in a fund that a portfolio manager must monitor. A portfolio manager needs to constantly balance the various risk factors in the portfolio and manage each parameter individually. At times, the relative importance of liquidity risk may be much less than managing other risk factors (*e.g.*, interest rate risk) on a given day. In our experience, there could be times when a portfolio should, in the best interests of its shareholders, hold lower than its targeted cash minimum.[20] Under the Proposal, the manager would be unable to purchase less liquid assets when such acquisition would result in a fund having less than its

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17 *See* Revisions of Guidelines to Form N-1A, *supra* note 8 at 9,829.

18 Certain PIMCO funds also have lines of credit in place. This is a tool that can be used to meet redemptions in instances such as when instruments held in the fund are sold and the settlement period is after the date the shareholder's redemption proceeds are required to be delivered.

19 *See* SEC, Div. of Inv. Mgmt., No. 2014-01, IM Guidance Update, Risk Management in Changing Fixed Income Market Conditions, (Jan. 2014), https://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf.

20 The Proposal acknowledges there could be a number of instances in which a fund's portfolio liquidity declines due to circumstances outside the manager's control, such as meeting redemptions or a decline in market value. Proposal, 80 Fed. Reg. at 62,315.

prescribed minimum cash amount.[21] This aspect of the Proposal is problematic for a number of reasons.

First, it forces the portfolio manager to potentially make an investment decision to increase liquid assets, which may not be in the best interests of the portfolio. There can be very good investment reasons for allowing a portfolio to temporarily fall below a minimum cash target. For example, a portfolio manager may be aware of an impending large inflow into the fund that would replenish any minimum cash shortfall. It is counterintuitive to require a portfolio manager to make portfolio construction decisions based on an inflexible requirement without any discretion to make decisions based on real-time information available to the portfolio manager.

In addition, the inflexible requirement that an investment manager cannot purchase less liquid assets when a fund has lower than its cash minimum amount will undoubtedly result in intra-day compliance violations. Investment managers oftentimes have multiple trades occurring in a portfolio at the same time and they cannot always control the timing of the execution of such transactions. This aspect of the Proposal would put managers in an untenable position of having unintentional violations of this requirement. We therefore believe that if the Commission were to require a fund to adopt a minimum cash requirement, this amount should be established by the investment manager as a target and the manager should be afforded a reasonable period of time (in the manager's discretion) to reposition the portfolio in a prudent manner if a fund temporarily does not meet the target. This will ensure that a fund manager can make tactical decisions for the portfolio given market conditions and still ensure that the fund is able to meet any minimum cash requirements.

B. Board Oversight

The Proposal seems to conflate the role of the investment manager and the role of the board in terms of the three day liquid asset minimum proposal. Investment managers invest cash by seeking out attractive investment opportunities while mitigating risk and complying with all applicable requirements. We support the principle that a fund's board should be responsible for *overseeing* an investment manager's liquidity risk management processes, however, we do not believe that a board should have the responsibility for *establishing* this necessarily dynamic portfolio investment parameter. This is not the traditional role of the board. In fact, the SEC's Division of Investment Management has expressly recognized that a board should not be required to "make determinations that call for a high level of involvement in day-to-day activities."[22] We believe that this philosophy equally applies in this context. A fund's board should not be assigned responsibility for what is a core function and competency of a fund's investment manager. Managing liquidity is necessarily a day-to-day task that is a key part of the investment decision-making process and is most appropriately performed by an investment manager that is hired and overseen by the fund's board.

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21 Proposed rule 22e-4(b)(2)(iv)(C).

22 SEC, Div. of Inv. Mgmt., Protecting Investors: A Half Century of Investment Company Regulation, 266 (1992), https://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf.

Investment managers, including PIMCO, work to provide information to support our fund boards in their important oversight functions. In this regard, an investment manager can provide enhanced reporting to the board regarding the investment manager's views of market liquidity and the funds' overall liquidity positioning. Further, an investment manager could provide reports to the board on any exceptions in meeting these targets, the rationale for such exceptions and remedial actions to address the exceptions. This would give the board the ability to understand and oversee the investment manager's views on market liquidity and the cash positioning of the funds while not putting the board in a position where it is ostensibly making investment decisions. We believe this is a much more appropriate paradigm given the respective roles of the investment manager and the board.

IV. The Proposed Liquidity Categorizations are Too Prescriptive and Public Disclosure of the Categories as Proposed Would Create Investor Confusion

A. Liquidity Categorizations

An investment manager 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. We do believe, however, that the Proposal is unnecessarily prescriptive in mandating how the investment manager evaluates liquidity. One of the most onerous aspects of the Proposal is the requirement to review each of a fund's portfolio positions by considering certain specified factors and classifying the liquidity of each portfolio position, or portion of a portfolio position, based on the number of days within which the fund could convert a position to cash without materially affecting the value of the investment. The proposed liquidity classification categories are convertible to cash within (i) 1 business day, (ii) 2-3 business days, (iii) 4-7 calendar days, (iv) 8-15 calendar days, (v) 16-30 calendar days, or (vi) more than 30 calendar days.[23] Such a granular classification of portfolio instruments is not productive and will not result in the Commission's desired result of improving liquidity management.

While we disagree with the need to implement the proposed classification system, if the Commission ultimately believes that the classification is a crucial element to an effective liquidity risk management program, the Commission should adopt a more pragmatic approach. As an alternative to the Proposal, we believe that an investment manager could identify a fund's cash or other assets that are available to meet redemptions within 0-1 business days and 2-7 calendar days. This would be relevant information regarding the assets that are available within the settlement time for a typical shareholder redemption and the maximum time period that is permissible to satisfy redemptions under the Investment Company Act.[24] All assets not falling within those classification categories would be put into a separate category. If there are

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23 Proposed rule 22e-4(b)(2)(i).

24 Under section 22(e) of the Investment Company Act, a fund has up to seven days to pay redemption proceeds. 15 U.S.C. § 80a-22(e). We note that the Proposal cites to rule 15c6-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") in a number of instances and appears to infer that for fund transactions conducted through a broker-dealer, the Exchange Act rule reduces the time to meet investor redemptions to within three business days. Notwithstanding the Exchange Act rule, the time that a fund has to meet investor redemptions continues to be seven days, as set forth in section 22(e).

additional concerns about the portion of a fund portfolio that is considered to be illiquid (if applicable),[25] one additional option is to include a category that classifies the amount of assets that are within the 15% maximum category for illiquid securities. We believe this paradigm is much more representative of how portfolio managers and risk managers view portfolio liquidity. 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 the SEC staff in overseeing fund liquidity risk management practices. Further, even under our proposed alternative, we believe that this information will provide shareholders and the market with a materially false sense of comfort by these classifications systems.

We also disagree with the requirement that the classifications include the concept of converting a holding to cash without "materially affecting the value." We believe this is an unworkable standard given the dynamic and ever-changing nature of the financial markets and the many different factors that impact security values. Further, materiality is rarely subject to a single definition and therefore it would be difficult to apply those determinations consistently across funds, much less across investment managers. Market impact cannot be predicted or measured accurately and any changes in an asset's price can stem from market forces as well as from exogenous or idiosyncratic events. In this regard, it seems that the Proposal is conflating the notions of liquidity and valuation. Mutual fund vehicles are not bank-like deposits where depositors expect a guarantee in value. Instead, mutual fund shareholders are entitled to their proportionate share of the fund's NAV on the day of redemption but there is no guarantee of what that value will be. We believe tying liquidity and valuation is a fundamental flaw in the framework of this aspect of the Proposal.[26]

Evaluating portfolio liquidity daily (and more often, if necessary) is a fundamental part of the portfolio management and risk management process. Mutual funds are daily redemption vehicles, and as such, a portfolio manager must position a portfolio to be able to meet any shareholder redemptions. That said, we do not believe that the approach put forth in the Proposal is consistent with general industry views and practices regarding portfolio and liquidity risk management. There are many different ways to evaluate liquidity risks, and investment managers have many tools available to them in performing this analysis. This includes both quantitative and qualitative analysis, including but not limited to, assessment of trading volumes, credit quality, pricing, the macroeconomic landscape, and applying haircuts to collateral.[27] In addition, bond liquidity is distinct from equity liquidity where the value of a bond may be heavily influenced by the valuation of correlated bonds. Further, at times, certain portfolio characteristics can be more relevant than others in the context of the holistic management of a

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25 An illiquid asset is any asset that may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment. *See* Revisions of Guidelines to Form N-1A, *supra* note 8 at 9,829.

26 Chair White has acknowledged the need to balance the measures used to mitigate risk with the fundamental objectives of investing. She notes that "[j]ust as our regulatory program evolves, so too must our understanding of the balance that program strikes between reducing undue risks and preserving the principle of "reward for risk" that is at the center of our capital markets." *See* White 2014 Speech, *supra* note 3.

27 For a more robust discussion of these tools, *see* Investment Company Institute, Overview of Mutual Funds' Liquidity Management Practices to the Staff of the SEC, *supra* note 7, at 3-11.

client portfolio, such as adjusting a portfolio risk factor (*e.g.*, duration) if that is not in line with the portfolio construction ideology. Effective risk management requires a constant balancing of risk factors, which are continuously reviewed and adjusted considering the totality of the portfolio.

Our portfolio and risk management team evaluates client portfolios holistically when considering our ability to generate liquidity in client and fund portfolios. Daily, our portfolio risk management team assesses fund liquidity 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.

The Proposal sets up a requirement to bucket portfolio holdings to force a rigid classification system without any real analysis of how to address a fund's liquidity issues. There is nothing in the proposed classification system that would on its own reduce the risk of not having sufficient liquid assets to meet redemptions. We do not believe it is productive for the SEC to require asset managers to implement a classification system that may not be meaningful to the investment manager's liquidity analysis and will not also yield any helpful data for the SEC staff; it is not an efficient or effective use of manager resources.

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 co-founder and CIO,[28] along with other periods of abnormally high volatility. While our approach to liquidity management may not currently contemplate the very prescriptive requirements of the Proposal, it demonstrates that a one-size fits all approach is not necessary to have effective liquidity risk management.

B. Disclosure

The Proposal also seeks to require a fund to disclose information about its liquidity risk and risk management program in Form N-1A, Form N-CEN and Form N-PORT on a 60 day lag.[29] In addition to enhanced monitoring by the Commission, the Proposal indicates that such disclosure "would permit investors (particularly institutional investors), as well as academic researchers, financial analysts, and economic research firms, to use the liquidity-related data

[28] *See* PIMCO Comment Letter on the Consultative Document (2[nd]), 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.

[29] Proposal, 80 Fed. Reg. at 62,370 (specifying proposed Items 11(c)(7)-(8) of Form N-1A; proposed Items B.7, C.7 and C.13 of proposed Form N-PORT; and proposed Item 44 of proposed Form N-CEN).

reported on Form N-PORT to evaluate fund portfolios and related risks."[30] While we understand the SEC's desire to obtain this information, we do not believe the public disclosure of security level liquidity information is in the best interests of the public because it will be inconsistent across funds and managers, which will cause confusion. Further, as portfolio liquidity is fluid and dynamic, the information will be stale when disclosed and therefore will not provide investors with any meaningful information. As noted above, the classifications themselves may not relate to actual liquidity of bonds at any given time and they imply a false sense of precision due to the dynamic nature of the markets. We therefore believe that the disclosure of these classifications can be affirmatively misleading to investors.

Given the very subjective nature of assigning specific liquidity characterizations as proposed, there is a very high likelihood that investment managers will categorize numerous instruments in inconsistent manners. This does not mean that those judgments are incorrect or otherwise not valid, but this type of conflicting information will not be useful, and in fact could be harmful, to the Commission, investors and/or the public. We believe public reporting will create significant investor and public confusion and will lead to more questions than answers. This is true for two reasons. First, requiring reporting on a position basis (or a portion thereof) will result in circumstances in which a particular security may appear in multiple classification categories across different funds creating unnecessary confusion and new risks. Second, the information will be disclosed on a delayed basis as of a single point in time. This, by definition, will lead to the reporting of stale information by the time it is disclosed, which will not be useful to investors to evaluate overall portfolio liquidity as it very possibly could have changed in a material way. Accordingly, we do not believe there is any utility in publicly disclosing this information as proposed or comparing asset managers' classifications of assets with the possible exception of those assets in the most liquid categories and those that are categorized in the illiquid category as we have suggested (albeit there could still be some legitimate differences in those classifications among asset managers).

We understand that the SEC may be seeking to adopt some of the principles that were included in the money market reform amendments where, in 2016, money market funds will be required to publically disclose each business day on the fund's website the percentage of total assets invested in daily liquid assets and weekly liquid assets (as defined in amended rule 2a-7 under the Investment Company Act).[31] Additionally, money market funds will be required to report information on the liquidity of their portfolio securities on Form N-MFP.[32] In the case of money market funds however, it is important to consider that investors purchase these vehicles for the express purpose of keeping their assets in a very liquid portfolio, whereby investors' understanding of the construction of the portfolio and the liquidity profile is much more important. These investors are much more sensitive to investment risk and view capital preservation as the paramount concern. We do believe that fundamentally this is a significant distinguishing factor when considering the amount and form of liquidity related disclosure for non-money market funds.

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30 *Id.* at 62,294.

31 *See* 17 C.F.R. § 270.2a-7(h)(10)(ii).

32 *See* Form N-MFP Items C.21, C.22 and C.23.

V. There are Significant Operational Challenges to Implement Swing Pricing – in Particular the Lack of Fund Flow Information

The Proposal also seeks comments on whether the Commission should permit funds (except money market funds and ETFs) to use "swing pricing," which is "a process of adjusting the net asset value of a fund's shares to pass on to purchasing or redeeming shareholders more of the costs associated with their trading activity."[33] The Proposal asserts that the use of swing pricing "could protect existing shareholders from dilution associated with such purchase and redemption activity and could be another tool to manage liquidity risks."[34] We are supportive of the desire to ensure that all shareholders are treated fairly in terms of sharing mutual fund costs and expenses, however we do not believe that swing pricing can be effectively implemented given current market conventions because fund flow information is not available at the time a fund strikes its NAV.

As proposed, there are significant challenges to implement swing pricing due to a lack of flow information when striking a fund's NAV. The Proposal acknowledges that "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 any particular day."[35] However, it is impossible for an investment manager to know, or even reasonably estimate flows given the lack of transparency in fund flows at the time a fund's NAV is calculated, generally 4 P.M. Eastern Time, each business day the market is open for trading.

Most funds 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 after the calculation of the fund's NAV (oftentimes, the morning after the NAV is calculated) ("T+1"). These orders are transmitted through Fund/SERV, which is a part of the Depository Trust & Clearing Corporation ("DTCC").[36] As a great deal of fund flow information is sent over the DTCC system and provided to a fund on T+1, it is impossible to know net fund flow information on the date the NAV is calculated (unless a fund is not sold through any Intermediaries). According to the 2014 DTCC annual report,[37] there were $4.9 trillion in Fund/SERV settlements and 217 million mutual fund transactions, which includes 117 million Defined Contribution Clearance and Settlement transactions ("DCC&S Transactions"). The DCC&S Transactions, which are approximately 54% of all mutual fund volume, is provided to the funds on T+1 and those transactions are not known to the fund when the NAV is calculated.

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33 Proposal, 80 Fed. Reg. at 62,276.

34 *Id.* at 62,286.

35 *Id.* at 62,328-29.

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

37 DTCC, 2014 Annual Report, 40-41 (2015), available at http://www.dtcc.com/annuals/2014/wealth-management-services/index.php.

Given that a tremendous amount of transaction information is provided to the fund industry on T+1, a fund could reasonably believe that there is a net outflow on the day the NAV is calculated when on T+1, after receiving the flow information from Intermediaries, there actually could be 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, the shareholders who redeemed that day would receive their redemption proceeds utilizing a swung NAV, which means that the redemptions would be processed using a lower NAV. This could result in certain shareholders being unnecessarily penalized or extensive reprocessing of fund transactions. In our experience, net fund flows can vary significantly once we receive Intermediary information on T+1. In fact, the Proposal acknowledges this challenge in stating that "the deadline by which a fund must strike its NAV may precede the time that a fund receives final information concerning daily net flows from the fund's transfer agent or principal underwriter . . . ."[38] Therefore, we believe it would be challenging at best to calculate whether to swing the NAV of a fund on any given day with any level of confidence that the fund is acting on accurate information.

We also note that there would be a disconnect between the timing of receipt of final fund flow information on T+1 and any transactions that are conducted in response to the net flows. For example, while the Intermediaries submit their flow information on T+1, the shareholders that have purchased or redeemed through that net number are provided with the prior day's NAV. Once the fund receives this information on T+1, a portfolio manager may put on trades in response to that information (and therefore incur transaction costs to generate liquidity) on T+1, which is the day after the NAV is calculated for such orders.[39] Accordingly, there can be no actual correlation between the amount of 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.

Although the Proposal suggests that those responsible for determining whether net purchases or net redemption have exceeded the fund's swing threshold may proceed on the basis of information obtained "after reasonable inquiry," we are not certain how this standard can be satisfied given the lack of shareholder flow information. The Proposal suggests arranging for "interim feeds of flows from its transfer agent or distributor in order to reasonably estimate its daily net flows for swing pricing purposes."[40] We are unaware at this time that such functionality exists and we believe it would take significant time and technology resources for funds to access this type of information. Therefore, we believe that imposing swing pricing without sufficient information to reasonably estimate fund flows is contrary to the intended goals

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38 Proposal, 80 Fed. Reg. at 62,329.

39 It is not uncommon for a shareholder to give a fund advance notice of a large impending transaction so the portfolio manager may increase liquidity to meet that order. This typically is done well in advance so that the portfolio manager would be able to reposition the fund and generate the cash necessary to fulfill the order (in the case of a redemption).

40 Proposal, 80 Fed. Reg. at 62,341.

of the Proposal and does not advance the Proposal's goal to prevent dilution and protect investors.

The Proposal points out that swing pricing has been used in European jurisdictions with some level of purported success.[41] In contrast to the U.S. mutual fund transaction processing practices described above, we note however that there is much greater knowledge of shareholder transaction information in Europe at the time that a fund strikes its NAV. This is because the vast majority of fund transactions are provided directly to a fund's service provider (as opposed to through Intermediaries) on the same date the order is given by the shareholder. In addition, many UCITS funds finalize NAV calculations on a T+1 basis so once the fund has determined that a swing is necessary based on the flow information received on the trade date, the service provider then has additional time to calculate the NAV and swing the NAV, if necessary, in order to process shareholder transactions.

We have not utilized swing pricing for funds we manage in European jurisdictions. Rather, we have implemented what we believe is an equitable method of managing any potential dilution impacts on non-redeeming shareholders in response to material shareholder flows that are in excess of pre-determined thresholds. As acknowledged by the Proposal, a mutual fund's NAV is generally calculated as of the close of the fund's primary market, but the fund's NAV will not generally reflect changes in holdings of the fund's portfolio assets and changes in the number of the fund's outstanding shares until the first business day following the fund's receipt of the shareholders' purchase and redemption request. Unlike in the U.S., many UCITS fund shareholder transactions are provided directly to the fund's service provider, which results in more timely receipt of the orders, but also well in advance of the close of primary markets. This provides the opportunity for an investment manager to respond to shareholder flows and reflect the changes in portfolio assets and associated costs in the current NAV next computed after receipt of the orders to purchase or redeem. Essentially, this results in an NAV calculation on a T+0 basis and eliminates the need to use the less precise swing pricing estimates.

The same T+0 basis for NAV calculation could be applied to the U.S. mutual fund industry if shareholder order cutoff times were adjusted to allow for sufficient time for investment managers to respond and reflect the changes in portfolio assets and reduce the potential need for estimated adjustments to NAV. However, the potential impacts and operational challenges of such an alternative concept, or other market conventions already utilized in certain jurisdictions (such as dual pricing), have not been evaluated to compare and contrast the potential costs and benefits associated with each. We also recommend that the Commission consider allowing for more time to consider potential alternatives that may benefit the U.S. mutual fund industry before permitting the use of swing pricing.

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41 The Proposal notes that many funds organized as UCITS have adopted swing pricing and some firms commented favorably regarding the use of swing pricing in Europe. *Id.* at 62,327.

We thank the Commission for allowing us to comment on the Proposal and appreciate in advance the Commission's diligent consideration of our comments. 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