PIMCO

Via Electronic Submission

February 13, 2023

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, File Number S7-26-22

Dear Secretary Countryman:

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 amendments regarding open-end fund liquidity risk management and swing pricing ("Proposal").[1]

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. As of December 31, 2022, PIMCO managed approximately $1.74 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 registered investment companies offered to institutional investors and individual investors, private funds and separately managed accounts in accordance with specific investment guidelines and objectives specified by our clients.

I. Executive Summary

While PIMCO appreciates the Commission's efforts in seeking to enhance open-end fund liquidity risk management and anti-dilution practices, we have significant concerns with the Proposal. We believe that the Proposal in its current form would be deleterious to open-end funds and their investors and in particular will have a disproportionate adverse impact on fixed income open-end funds and their investors, many of whom are retirees or other individuals saving for financial goals. The Proposal will also likely reduce regulatory oversight of market liquidity and could increase liquidity risk. Accordingly, we recommend that the SEC not adopt the Proposal in its current form. If the SEC should determine to proceed notwithstanding the concerns discussed in this letter and shared by other market participants, we have included certain recommendations below.

[1] *See* Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, SEC Rel. No. IC-34746, 87 Fed. Reg. 77172 (proposed Nov. 2, 2022) ("Proposing Release").

Our perspective on these rules is informed by over 50 years of success as an active investment manager focused on fixed income in a variety of different asset classes and market conditions, with funds that are sold through a variety of different channels. Further, our perspective is global and reflects our experience managing funds in Europe that have utilized swing pricing. The following is a summary of our observations:

- Open-end funds are utilized by millions of Americans to meet their savings goals. The Proposal would fundamentally alter open-end funds to the detriment of individual investors, notwithstanding open-end funds' history of success meeting shareholder redemptions. Indeed, the Proposal's dramatic and prescriptive regulatory intervention discards the success of the liquidity risk management framework that the SEC adopted relatively recently and that reflected substantial industry input, without any convincing support or input from industry participants for doing so.

- The Proposal would place mutual funds at a significant disadvantage to other investment vehicles, favor certain investment strategies over others,[2] reduce market liquidity and resiliency, and result in regulatory arbitrage. It is critical that the SEC delay adoption of the Proposal until such time as other relevant regulators have agreed to adopt commensurate requirements to avoid individual investors voluntarily or involuntarily moving into investment vehicles lacking comparable liquidity risk management mechanisms and SEC oversight, and the increased systemic risk that could result from doing so.

- Aspects of the Proposal do not reflect or account for key characteristics of the fixed income markets and, therefore, will have a disproportionate adverse impact on fixed income open-end funds and their investors. We outline below several critical modifications that would be necessary if the SEC should determine to proceed with the Proposal.

II. Mutual Funds: A History of Success

Open-end funds have democratized cost-efficient investor access to professionally-managed, diversified portfolios and a variety of asset classes, and as a result have been emulated in a variety of jurisdictions. Indeed, open-end funds serve as the backbone for millions of Americans' savings plans, particularly due to their ability to produce returns and income over a long time horizon.

A key aspect and draw of an open-end fund is the ability for investors to redeem their shares on any given business day. Open-end funds have successfully honored redemption requests

[2] As described in more detail below, certain strategies are unavailable in certain vehicle structures, such as active fixed income strategies in a non-transparent exchange-traded fund ("ETF") structure. The hard close and swing pricing proposals are likely to incentivize asset migration to ETFs, meaning that the individual investors holding those migrating assets would lose access to such strategies in the registered open-end fund format to the extent a fund sponsor is unable or unwilling to offer them in a fully-transparent ETF structure. As discussed below, many active fixed income strategies are susceptible to front-running and free-riding risks and thus are incompatible with a fully-transparent ETF structure. Accordingly, we urge the SEC to first grant relief for non-transparent active fixed income ETFs to avoid this detrimental impact to individual investors.

for decades, including in March 2020, without material adverse impact to either market liquidity or open-end fund shareholders. As the SEC staff itself has stated, "though many observers have been concerned about bond funds' ability to meet redemption requests during periods of market stress, these concerns did not materialize during the period of market turmoil in March [2020]."[3] Further, while the SEC recognizes that in March 2020 "heightened volatility and demand for liquidity drove stress throughout the market, particularly in the bond fund and bank loan fund markets," the SEC staff has found that "bond fund redemptions did not materially disrupt this market or materially add to stresses experienced by the market."[4] In fact, rather than disrupting bond markets in March 2020, we believe fixed income funds provided an important source of liquidity for investors.[5] The SEC itself acknowledges that it "do[es] not have specific data about the dilution fund shareholders experienced in Mar. 2020."[6]

The Proposal's dramatic regulatory intervention would replace the SEC's relatively recently-adopted liquidity risk management framework with a substantially more prescriptive regime, upend mutual fund order flow dynamics and mandate a mutual fund net asset value ("NAV") adjustment mechanism untested in American markets. These steps would require a wholesale restructuring of the fund and intermediary ecosystem, are based on unfounded and inadequate justifications, and are without any convincing support in data. We are concerned that these requirements will fundamentally alter open-end funds to the detriment of retirees and other individual investors.[7] Notwithstanding that millions of Americans rely on the returns and income produced by their open-end fund investments, we believe that the Proposal will likely lead to lower

[3] *See* Division of Economic and Risk Analysis, U.S. Securities and Exchange Commission, "U.S. Credit Markets Interconnectedness and the Effects of the COVID-19 Economic Shock" (Oct. 2020), *available at* https://www.sec.gov/files/US-Credit-Markets_COVID-19_Report.pdf ("DERA Study") at 38. In fact, 100% of U.S. bond funds were able to meet redemptions during the March 2020 market turmoil, and while flows were heavy, they were managed and did not have knock-on, systemic effects. This was partially due to the existing regulatory structure for such funds, including the liquidity risk management rule. *See* Seidner, Cantrill, Chan and Wilding, "Lessons From the March 2020 Market Turmoil" (Feb. 11, 2021), *available at* https://global.pimco.com/en-gbl/insights/viewpoints/in-depth/lessons-from-the-march-2020-market-turmoil ("Lessons from 2020") at 2.

[4] *See* DERA Study at 7.

[5] In times of market downturns, investors may withdraw from fixed income funds rather than lock in steeper losses in equity investments.

[6] *See* Proposing Release at n.40.

[7] The SEC's observations from the March 2020 period are unsuccessful at demonstrating failures of the existing structure or regulation of open-end fixed income funds. For example, the SEC cites emergency relief it provided to facilitate interfund lending and other short-term funding to help meet redemptions. Tellingly, the SEC acknowledged that "funds generally did not use" this relief. *See* Proposing Release at n.57 and accompanying text ("Although the Commission provided this relief for a period of time, we understand funds generally did not use it."). Funds relying on this and other emergency relief were required to notify the staff by email at IM-EmergencyRelief@sec.gov. The SEC's other observations – that fund managers held discussions with the SEC regarding various forms of relief (*e.g.*, for the imposition of redemption fees or actions to facilitate swing pricing), that the Federal Reserve intervened in the U.S. capital markets (with the implication that such intervention was necessary in part to rescue open-end funds when, in fact, the Federal Reserve utilized certain registered funds as a mechanism to inject liquidity into the markets for their underlying holdings), that the SEC views many funds' liquidity classification and reclassification processes as having been inadequate and slow during the March 2020 period, and that "more than a dozen" funds made Form N-RN filings during March 2020 – fall far short of justifying the SEC's enormously costly and disruptive proposed rewriting of open-end fund liquidity risk management and anti-dilution regulation, particularly with respect to open-end fixed income funds. *See* Proposing Release at 77182 – 83. For context regarding the SEC's statement that "more than a dozen" funds made Form N-RN filings during March 2020, the Investment Company Institute reports that there were more than 9,000 mutual funds and more than 2,000 ETFs at year-end for each of 2019 and 2020. *See* Investment Company Institute, 2022 Investment Company Fact Book (2022) at 21.

returns and decrease suitable investment options for certain investors altogether, thereby harming Americans' ability to save for retirement and other purposes.[8] Further, as we discuss in this letter, the Proposal will place mutual funds at a significant disadvantage to other investment vehicles, favor certain investment strategies, reduce market liquidity and resiliency, and result in regulatory arbitrage.

III. The Proposal Would Disadvantage the Mutual Fund as a Vehicle, Favor Certain Investment Strategies, Reduce Market Liquidity and Resiliency, and Result in Regulatory Arbitrage

The Proposal, though purportedly intended to improve liquidity risk management and mitigate dilution of shareholder interests, would likely drive large numbers of open-end fund investors to alternatives that are often less regulated, such as collective investment trusts ("CITs"), separately-managed accounts ("SMAs"), and private funds; favor certain investment strategies and limit the availability of others, including by favoring ETFs over mutual funds; reduce market liquidity and resiliency in many cases; and result in SEC-driven regulatory arbitrage. Ultimately, the result would be an increased cost of capital for drivers of our economy and fewer options for retirees and other individual investors to participate in their growth. For the reasons discussed below, we believe it is imperative that the SEC take a measured approach to moving forward with the Proposal and would suggest that the SEC replace this Proposal with a concept release. It is also critical that the SEC closely coordinate with other regulatory agencies to avoid the significant concerns noted below.

Key Impacts of Proposed Liquidity Risk Management Program Changes

- Certain aspects of the Proposal seem likely to reduce market liquidity, particularly in stressed environments. For example, the proposed value impact standard for non-exchange-traded investments – any sale or disposition that the fund reasonably expects would result in a decrease in sale price of more than 1% – would not only result in lower liquidity profiles for fixed income funds generally and particularly in stressed environments, but could also hamper funds' ability to provide liquidity to the market during such periods. In stressed environments when spreads are wider, a relatively greater percentage of fixed income securities may erroneously be considered illiquid under the proposed value impact standard (particularly when coupled with the proposed 10% stressed trade size presumption, the impact of which increases with fund size).[9] A

[8] *See* Proposing Release at 77251 ("[T]o the extent that investors seek particular risk exposures and returns that would be difficult for the affected funds to provide under the proposed amendments, the proposed amendments may drive them towards other investment vehicles that do not face daily redemptions . . . or to other vehicles or means of investing that are not subject to the liquidity rule, such as separately managed accounts or CITs. However, to the extent that these other vehicles or means of investing do not offer the same investment strategies or do not provide the same benefits and protections as the open-end funds to investors, investors may find such investment avenues less favorable compared to open-end funds. As a result, the set of investment options available to investors with particular risk-return preferences may decrease.").

[9] *See id.* at 77187 ("The proposed stressed trade size may . . . increase the number of investments that are subject to the 15% limit on illiquid investments") and 77189 ("In considering whether a sale is reasonably expected to result in a price decrease of more than 1%, the fund would be required to consider the size of the sale relative to the depth of the market for the instrument. As part of that analysis, we believe a fund generally should consider, among other things, the width of bid-offer spreads. This is because the width of bid-offer spreads is an important consideration in

fund at or near the 15% limit on illiquid investments (which is more likely under the proposed value impact standard definition and stressed trade size presumption) would be unable to act as a buyer for assets that it would have to deem illiquid as a result of the Proposal and potentially engage in forced selling that could cause a downward spiral in market liquidity.[10]

- The Proposal will constrain the investment strategies, and therefore the investment returns and income, that mutual funds and ETFs can offer to investors. For example, actively managed open-end funds would be disadvantaged relative to passive funds and other vehicles by the proposed expanded scope of "illiquid investments." As discussed in more detail below, this change would unduly restrict funds' ability to acquire newly-purchased investments that are briefly valued using unobservable inputs, to the detriment of actively-managed open-end funds commonly making such acquisitions.

- The proposed reclassification of less liquid investments as illiquid would be highly disruptive, particularly to certain high yield and emerging market funds, as well as bank loan-focused funds, and would significantly limit investor access to these and certain other markets through registered open-end funds. To the extent multiple open-end funds with investment strategies focused on less liquid investments faced liquidation or conversion to other product structures (potentially with the loss of investor capital), markets for these assets would simultaneously face increased sales and fewer buyers. The result may be an SEC-driven liquidity crisis and a drawdown in asset prices that would harm the very shareholders the SEC seeks to protect. Indeed, these harms could significantly outweigh any theoretical dilution experienced by fund shareholders that the Proposal seeks to avoid. In the long run, fewer participants in these markets will translate to a higher cost of capital, imposing significant drag on U.S. economic growth and U.S. investors' savings plans.

Key Impacts of Proposed Swing Pricing Requirements

- The swing pricing proposal would likely push certain intermediaries and individual investors to transition from mutual funds to other vehicles (such as CITs, SMAs or private funds) that are generally subject to less rigorous liquidity and anti-dilution regulation. This dynamic could cause a perverse outcome in that the liquidity and swing

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analyzing the costs of selling a security and thus whether a sale would result in a price decrease exceeding 1%. For example, a sale would be more likely to result in a price decline of more than 1% if the trade size is large in relation to the market for that instrument or if bid-ask spreads are wide, or if both are the case. Wide, or widening, bid-ask spreads may indicate a lower level of demand for the instrument, which makes it more likely that a sale of the instrument would result in a price decline of more than 1%.").

[10] More generally concerning the proposed liquidity rule amendments, we are concerned that they reflect an understanding, or at least expectation, concerning fund liquidity management that fails to fully reflect or appreciate current liquidity management practices (in particular, the requirement to bucket assets into SEC-prescribed categories, which would be made even more rigid by the Proposal, does not necessarily reflect how funds plan for liquidity needs). The liquidity rule provides a standardized baseline, but it does not necessarily reflect all the key aspects of many funds' liquidity management practices. We believe a better understanding of these practices, which could be obtained through the types of outreach recommended in this letter, would make for a better informed, and more effective, approach to modifying the liquidity rule or providing guidance on liquidity risk management.

pricing rule amendments may lead to more assets being subject to fewer liquidity and anti-dilution requirements, which would reduce regulatory oversight of market liquidity and could be detrimental to individual investors.

  - Additionally, the swing pricing proposal would likely incentivize asset migration to ETFs. However, currently, there is no ability to implement non-transparent active fixed income ETFs, and as the SEC has recognized, active fund management using certain proprietary investment strategies is subject to front-running and free-riding risks in a fully-transparent ETF structure.[11] Active strategies that are not offered in an ETF structure would, as a result, be unavailable to individual investors who are driven by regulation to migrate their assets to ETFs. We believe this result would be particularly detrimental to individual investors seeking fixed income exposure, where active management can be particularly beneficial to shareholders.[12]

- The prescriptive aspects of the Proposal also will lead to unintended, harmful consequences. For example, the requirement to engage in swing pricing on any day that a fund experiences any degree of net redemptions, would have significant unintended consequences. The swing pricing proposal could also unfairly disadvantage certain investors and negatively impact shareholder behavior. For example, retirement investors with automatic withdrawal arrangements could receive lower NAVs during periods of outflows despite their not having actively engaged in redemption behavior for years or even decades in many cases. In addition, the swing pricing proposal could cause runs on funds if investors seek to time redemptions to avoid receiving lower NAVs (such as if they believe outflows could increase and want to avoid larger NAV swings). Similarly, individual investors seeking to redeem from an underperforming fund would face a higher likelihood of downward NAV adjustments reducing the value of their shares being redeemed. Mandated swing pricing in the event of any daily net redemptions also could, perversely, cause a vicious cycle of increased sale pressure on a fund, as it would necessarily weigh on fund NAV performance and make the fund less attractive to investors.

- The hard close component of the swing pricing proposal also would favor certain fund intermediary business models over others. For example, self-clearing firms would be advantaged over introducing firms, which likely would need to establish earlier order

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[11] *See, e.g.*, Invesco Capital Management, et al., File No. 812-15070, SEC Rel. No. IC-34087 (Nov. 6, 2020) at paragraph 18; T. Rowe Price Associates, Inc. and T. Rowe Price Equity Series, Inc., File No. 812-14214, SEC Rel. No. IC-33685 (Nov. 14, 2019) at paragraph 34; Natixis ETF Trust II, et al., File No. 812-14870, SEC Rel. No. IC-33684 (Nov. 14, 2019) at paragraph 34; Fidelity Beach Street Trust, et al., File No. 812-14364, SEC Rel. No. IC-33683 (Nov. 14, 2019) at paragraph 34; Blue Tractor ETF Trust and Blue Tractor Group, LLC, File No. 812-14625, SEC Rel. No. IC-33682 (Nov. 14, 2019) at paragraph 34; Precidian ETFs Trust, et al., File No. 812-14405, SEC Rel. No. IC-33440 (Apr. 8, 2019) at paragraph 34.

[12] *See, e.g.*, Baz, Mattu, Moore and Guo, "Bonds are Different: Active Versus Passive Management in 12 Points" (Apr. 10, 2017), *available at* https://www.pimco.com/en-us/insights/viewpoints/research/bonds-are-different-active-versus-passive-management-in-12-points; James Moore, "Bonds Are Different" (Feb. 8, 2017), *available at* https://www.pimco.com/en-us/insights/viewpoints/bonds-are-different.

> cut-off times.[13] Investors may also be more likely to invest directly rather than through an intermediary, potentially reducing the prevalence of financial advice, which could harm individual investors. Further, the Proposal could make it more difficult to move from one fund or intermediary to another, thereby limiting investor choice.

The examples noted above illustrate that the SEC should coordinate closely with other relevant regulators, as well as market participants, to ensure that open-end mutual funds are not placed at a disadvantage by virtue of the Proposal and that individual investors are not pushed into other investment vehicles, many of which currently lack comparable liquidity risk management and anti-dilution mechanisms or SEC oversight. Indeed, we applaud Chair Gensler's recent comments regarding coordination with other regulators "to mitigate possible regulatory arbitrage between" open-end funds and CITs in connection with the Proposal,[14] and urge the SEC to follow through on such statements by not adopting the Proposal until other regulators have acted to impose similar requirements.

IV. The Proposal Does Not Reflect How Fixed Income Markets Operate and Would Disproportionately Adversely Affect Fixed Income Funds and Their Investors

Underlying much of the Proposal are assumptions that do not accurately reflect key characteristics of fixed income investments and related market data. Although the SEC recognizes these characteristics at times in the Proposal, the Proposal ultimately fails to appropriately account for them. We are concerned that this disconnect will disproportionately adversely impact fixed income open-end funds and the individual investors that invest in them. Below, we have highlighted certain areas in the Proposal that we believe will be particularly harmful to fixed income open-end fund investors.

Asset Class Classification. Notwithstanding that the SEC essentially endorses an asset class approach elsewhere in the Proposal,[15] the Proposal calls into question whether funds may continue to use current, well-established methodologies to classify fixed income securities for purposes of Rule 22e-4(b)(1)(ii) even where funds and/or their vendors have sought to tailor classifications to particular groups of securities. The proposal to require examination of each security on a daily basis in isolation ignores the realities of fixed income markets and how such instruments trade. A fundamental characteristic of fixed income markets is that each unique security, of which there are many, may not trade daily and the salient information when anticipating how such instrument will trade is not the historical information about how that instrument has traded but information about how instruments with similar characteristics have traded (*i.e.*, related securities with similar characteristics are often the best proxy for determining how an instrument will trade).[16] The issue

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[13] *See* Proposing Release at 77212.

[14] *See* Gary Gensler, Chair, SEC, Prepared Remarks Before the Financial Stability Oversight Council: Annual Report (Dec. 16, 2022) ("Gensler FSOC Remarks").

[15] The SEC proposes to permit the swing pricing administrator to apply estimates of market impact factors to all investments with the same or substantially similar characteristics rather than on an investment-by-investment basis.

[16] It is noteworthy that the SEC has not proposed to deem as *per se* illiquid securities priced using Level 2 inputs under U.S. GAAP since Level 2 inputs include: (i) quoted prices for similar assets or liabilities in active markets; (ii) quoted prices for identical or similar assets or liabilities in markets that are not active; (iii) inputs other than quoted prices that are observable for the asset or liability, such as interest rates, yield curves, implied volatilities and credit spreads; and (iv) market-corroborated inputs. *See* Financial Accounting Standards Board Accounting Standards Codification (ASC) Topic 820, 820-10-35-48.

is not one of expertise, sophistication or building out new capabilities – indeed, we understand that liquidity classification vendors currently utilize versions of asset class classification in their models for certain asset types.

The common theme of utilizing data on comparable securities and other market characteristics reflects the nature of fixed income markets, which are characterized by numerous individual issues that do not regularly trade but for which there is meaningful demand, and thus, liquidity. Yet, the SEC seems to ignore these realities of fixed income investments and related market data. Because the Proposal relies on assumptions that are misaligned with the nature of fixed income investments, the Proposal's effect on fixed income open-end funds will deviate from the SEC's intentions, and fixed income open-end funds will be disproportionately adversely affected. Indeed, the characteristics of fixed income investments and related market data strongly support the continued availability of asset class classification and, as noted in our recommendations below, make it critical that any final rules adopted by the SEC continue to allow the use of this methodology.

Value Impact for Liquidity Classification and Market Impact for Swing Pricing. As discussed in more detail below, the prescriptive, one size fits all paradigm in the Proposal does not work for value impact or market impact. Rather, continuing a principles-based approach to the value impact standard is most appropriate, and market impact should not be a required part of calculating a swing factor, particularly in light of the nature of fixed income market data.

Notwithstanding well-understood variations in expected price impact across various asset classes, the SEC proposes to impose a uniform 1% sale price impact threshold for determining a significant change in the market value of any non-exchange-traded investment. At the same time, the SEC acknowledges that funds currently utilize a range of approaches in determining value impact for fixed income securities, including consideration of "groups of comparable securities, asset class characteristics and volatility, number and depth of market makers, bid-offer spread size, volume of the security or similar securities, and elasticity of prices in the security or similar securities."[17] Indeed, the SEC recognizes the necessity of subjective judgment and modeling based on non-issue-specific data in determining price impact for bonds[18] and, as noted above, has not proposed to deem as *per se* illiquid securities priced using Level 2 inputs under U.S. GAAP. Further, we believe there are significant limitations in liquidity classification vendors' ability to source or provide high quality data using the prescriptive methodology the SEC has proposed with respect to fixed income securities, either generally or on a security-specific basis. Therefore, as noted in our recommendations below, it is critical that the SEC not overturn the flexible approach to value impact it adopted only relatively recently as part of Rule 22e-4, which the SEC staff

[17] Proposing Release at 77188. The SEC staff's guidance on this topic recognizes that "price impact assumptions are subjective, due to the variety of inputs that may reasonably be used by any fund or portfolio manager." *See* Investment Company Liquidity Risk Management Programs Frequently Asked Questions ("Staff FAQs") at Question 22.

[18] The SEC notes that certain data for "a single bond issue would not be representative because it does not represent the full pool of liquidity available for a debt security, since bonds are split into many different issues and differ from common shares" and that "funds and liquidity classification vendors would still be able to choose which price impact model to use for their classifications" under the proposed value impact standard. Proposing Release at 77251. The SEC further acknowledges that some "assets . . . do not have readily available recent price information, and funds may have to use subjective judgment in determining the sale amount that constitutes a significant change in market value." *Id.*

further articulated in the Staff FAQs, and the methodologies and processes in which funds heavily invested to implement Rule 22e-4.

The nature of fixed income market data and its relation to liquidity is equally relevant to the market impact proposal for swing factor determinations. Similar to its value impact discussion, the SEC acknowledges that "it may be difficult to produce timely, good faith estimates of" scientifically precise market impact.[19] We wholeheartedly agree and would go one step further—we do not think it is practical, and it would particularly adversely impact fixed income funds, to require that market impact be calculated daily and included in the swing factor (at particular prescribed levels of flows) in a high-quality manner within the time constraints of calculating and disseminating a fund's net asset value.[20] As we have noted above, we believe there are significant limitations not only on being able to source such information, but then also to rapidly layer on such information for purposes of timely calculating and then disseminating a fund's net asset value. For these reasons, we are also not aware of a settled practice amongst European funds, whose swing pricing experience the Proposal approvingly cites, to include market impact as part of their swing pricing mechanisms. Further, given the significant vendor limitations, any requirement to include market impact as part of a swing factor when swing pricing would be of greatest relevance, such as during periods of market stress, would likely demand significant involvement by investment professionals under highly compressed time periods, which is not practical in light of intermediary NAV dissemination requirements and may distract from other critical investment professional functions during such periods. Therefore, as noted in our recommendations below, it is critical that any final rule not require market impact be included as part of calculating a swing factor.

V. If the SEC Determines to Proceed with the Proposal, Certain Steps are Critical to Avoid Even Greater Unnecessary Disruption to Fixed Income Open-End Funds

A. Broad-Based Recommendations

Approach. If the SEC determines to proceed with the Proposal, we would encourage the SEC to take an approach that differs in kind, not just degree. Initially, the SEC could take a more deliberate approach to potential rule amendments by first undertaking an economic study to determine whether and what changes may be supported empirically. In this regard, the SEC should consider replacing the Proposal with a concept release in order to better facilitate broader stakeholder engagement prior to overturning requirements the SEC only relatively recently adopted and on which funds spent significant time and resources to implement.[21] To the extent the

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[19] *Id.* at 77206.

[20] *See, e.g.*, *id.* at nn.35 – 38 and accompanying text. Under the Proposal, calculating market impact and including it in a swing factor could not proceed until flow data is received and it is determined whether the relevant threshold (inflow swing threshold or market impact threshold) is met for application of market impact. At best, this leaves only a short window of time before NAV dissemination.

[21] The SEC has recent experience gathering public comments and input on a broad range of issues relevant to challenging regulatory considerations for funds and drawing on such comments and input in designing regulation. *See e.g.*, Use of Derivatives by Investment Companies under the Investment Company Act of 1940, SEC Rel. No. IC-29776, 76 Fed. Reg. 55237 (Aug. 31, 2011) ("2011 Concept Release") ("The Commission intends to consider the comments to help determine whether regulatory initiatives or guidance are needed to improve the current regulatory regime for funds and, if so, the nature of any such initiatives or guidance"); Use of Derivatives by Registered Investment Companies and Business Development Companies, SEC Rel. No. IC-34084, 85 Fed. Reg. 83162 (Nov. 2, 2020) ("2020 Derivatives Release") at n.1 and accompanying text ("The rules we are adopting reflect these considerations, and are also informed by the Commission's ongoing exploration—particularly over the past decade—

SEC believes certain funds' liquidity risk management programs failed to operate as required, the SEC should consider focused guidance targeting those particular perceived shortfalls rather than rewriting the foundations of the liquidity risk management rule for all open-end funds. The SEC could also further encourage formal, periodic stress testing of fund portfolios and could establish parameters for such stress testing.

Regulatory Coordination to Prevent SEC-Driven Regulatory Arbitrage. As previously noted, the SEC also should coordinate closely with other relevant regulators, as well as market participants, to ensure that open-end funds are not placed at a disadvantage by virtue of the Proposal and that individual investors are not pushed into other investment vehicles, many of which currently lack comparable liquidity risk management and anti-dilution mechanisms or SEC oversight and may not offer investors the same types of investment strategies as open-end funds do today. We urge the SEC to follow through on the recent SEC Chair statement on avoiding regulatory arbitrage[22] by not adopting the Proposal until other regulators have acted to impose similar requirements.

Transition Periods. If the SEC determines to proceed with the Proposal, it should provide for extended transition periods for the entire proposed set of rules in light of the scale and complexity of the proposed amendments and their impacts across the entire open-end fund and intermediary ecosystem. A transition period of at least three years for each component of the Proposal would be more appropriate and realistic.

B. Targeted Recommendations

We would further urge the SEC to consider additional targeted recommendations below.

1. Liquidity Rule Amendments

a. Asset Class Classification and Value Impact Definition

As discussed previously, we believe that any final rulemaking should take into account the differences between fixed income and equity markets and allow for an approach that can accommodate all types of trading. Considering the realities of fixed income market data, as described above, and the critical importance of asset class classification to fixed income funds, any final rule amendments should preserve funds' ability to classify investments by asset class. Further, the SEC should clarify in any final rule amendments that the determination of value impact for non-exchange-listed investments is a principles-based determination that need not be based on a fixed amount or percentage and that may utilize any data that the liquidity risk management program administrator considers reasonably appropriate to the determination.

b. Liquidity Classifications: Method for Counting Number of Days

If the SEC's goal is for a uniform approach concerning when day counting begins for liquidity classification purposes, it should require that funds begin counting on the day following the date of classification (following the counting approach of a "T+" convention). Such an

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of the benefits, risks, and costs associated with funds' current practices regarding derivatives" (citing the 2011 Concept Release)).

[22] *See* Gensler FSOC Remarks.

approach would be consistent with the Commission's prior guidance on day counting for purposes of liquidity classifications. For example, in adopting the current liquidity rule, the Commission explained that the language used in liquidity classification definitions was intended to clarify that classifications should take into account sale and settlement in current market conditions, rather than solely considering post-trade settlement period (*i.e.*, not *just* considering trade date (T) + some number of days).[23] This guidance does not suggest that the day counting approach of a "T+" convention (day 1 being the day following the relevant event) was the incorrect approach to determining the number of days for purposes of the classification definitions. To the contrary, the Commission's references to this convention in this discussion strongly suggest that such counting approach was expected to be the convention for liquidity classification purposes.

Additionally, the proposed day counting approach would effectively reduce the number of days in each classification category. Thus, like many other parts of the Proposal, the proposed day counting approach would cause artificial deterioration of fund liquidity profiles and, without any apparent support other than consistency across funds (which could just as easily be achieved by requiring that funds begin counting on the day following the date of classification), make it more challenging for funds to comply with their highly liquid investment minimums and the 15% limit on illiquid investments. This unnecessary change, particularly when viewed in concert with the Proposal's other changes, would constrain investment strategies and unduly diminish fund return prospects to the detriment of individual investors. Moreover, it could adversely impact market liquidity by forcing funds to dispose of assets to avoid hitting the cap on illiquid securities (which could be caused by market movements and occur more often under the Proposal's prescriptive requirements).

c. Stressed Trade Size

We oppose a requirement to measure and manage fund liquidity on a daily basis to the extreme stress level represented by the proposed 10% stressed trade size. The SEC notes its belief "that requiring a fund's classification model to assume the sale of larger-than-typical position sizes would better emulate the potential effects of stress on the fund's portfolio"[24] but fails to justify its proposal for assuming sale sizes that are so dramatically larger-than-typical.[25] As the SEC briefly acknowledges, the proposal likely would lead to portfolio rebalancing,[26] result in lower returns and higher tracking error, drive investors to other vehicles that offer less regular liquidity and

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[23] *See* Investment Company Liquidity Risk Management Programs, SEC Rel. No. IC-32315, 81 Fed. Reg. 82142, 82175 (Oct. 13, 2016) ("Liquidity Rule Adopting Release") ("We also understand that funds often consider which portfolio investments can be sold and settled on a T + 1 to T + 3 basis when determining their very liquid investments. While such an analysis may be useful, our decision to define highly liquid investments to include any investment that the fund reasonably expects to be convertible into cash in current market conditions in three business days or less is founded in our belief that funds should understand what portion of their investments are convertible to cash in a short period of time taking into account current market conditions, not solely on which asset transactions can be settled in three days or less from the trade date.") (emphasis added).

[24] Proposal at 77187; *see also id.* at 77183.

[25] *Id.* at 77187 (describing the proposal as reflective of "weekly outflows at the 99th percentile" and noting the SEC's estimate that "a random fund in a random week has approximately a 0.5% chance of experiencing redemptions in excess of the 10% stressed trade size.").

[26] *Id.*

potentially decrease suitable investment options for certain investors altogether.[27] Any benefits of the 10% stressed trade size[28] would be outweighed by these adverse results, reflecting a proposal that is disproportionate to the risks that it seeks to address.

The proposed requirement to apply a uniform percentage sale assumption to all holdings in a fund's portfolio also would shift liquidity classifications further from the realities of fund liquidity management rather than closer for many funds. The SEC seems to believe that funds' current application of the reasonably anticipated trade size requirement may estimate that "trading [will] be satisfied largely by selling the fund's most liquid investments, resulting in smaller assumed trade sizes for purposes of classifying the fund's less liquid investments" and inappropriately improving funds' liquidity classification profiles.[29] The SEC fails to recognize that such an approach often does reflect funds' reasonable expectations for liquidity management and that, for many funds, assuming a uniform percentage sale of all assets across a fund's portfolio would rarely, if ever, align with the reality of liquidity management.

Rather than its proposed draconian approach, the SEC should consider more focused adjustments to the current "reasonably anticipated trade size" construct to address the issues that the SEC perceives. Alternatively, the SEC could provide updated guidance describing factors or data that may be considered in establishing presumed trade size estimates,[30] such as highest daily flows over a set period, and permit funds to adjust such estimates upward in the liquidity risk management program administrator's discretion.

d. Illiquid Investments: Newly-Purchased Investments

It is common for certain newly-purchased investments to be valued using unobservable inputs for a brief period until the fund's pricing vendor establishes coverage of the instrument, at which point the investment is expected to be valued using Level 2 inputs. The SEC should clarify in any final rule amendments that the treatment of investments fair valued using unobservable inputs as illiquid investments is not intended to capture investments reasonably considered by the liquidity risk management program administrator and (as applicable) fair valuation designee as likely to be valued using observable inputs (*i.e.*, Level 2) within 30 days.

e. Exemptive Relief to Continue Current Funds or Convert

Should the SEC proceed to remove the "Less Liquid" category under the liquidity rule and shift such assets into the "Illiquid" category notwithstanding the concerns we have laid out here, a

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[27] *Id.* at 77251 ("[T]o the extent that investors seek particular risk exposures and returns that would be difficult for the affected funds to provide under the proposed amendments, the proposed amendments may drive them towards other investment vehicles that do not face daily redemptions . . . or to other vehicles or means of investing that are not subject to the liquidity rule, such as separately managed accounts or CITs. However, to the extent that these other vehicles or means of investing do not offer the same investment strategies or do not provide the same benefits and protections as the open-end funds to investors, investors may find such investment avenues less favorable compared to open-end funds. As a result, the set of investment options available to investors with particular risk-return preferences may decrease."). Further, most "Main Street" investors do not have direct access to CITs and SMAs and would be blocked from accessing professional asset management in many types of investment strategies that they can access today.

[28] *See id.* at 77187, 77250, 77266.

[29] *See id.* at 77187.

[30] *See* Liquidity Rule Adopting Release at 82181 – 82182; *see also* Staff FAQs at Questions 19 – 21.

number of funds likely would be forced to liquidate or convert to a different vehicle structure absent relief to continue operating under their current strategies and liquidity parameters. The SEC should provide such relief to avoid the investor impact of asset price declines that could result from open-end funds needing to dispose of these investments and the significant curtailment of investor access to these markets through registered open-end fund products. Indeed, the SEC has, on a number of prior occasions, "grandfathered" existing registered open-end funds with respect to rules that would make extinct certain fund offerings.[31] If the SEC declines to provide such relief, then it should provide express exemptive relief from applicable shareholder requirements for such open-end funds to convert to monthly or quarterly interval funds subject to Rule 23c-3 (or exemptive relief therefrom to act as monthly interval funds).

2. Swing Pricing

a. Market Impact

As discussed previously, when considered closely in light of the nature of fixed income market data, it is apparent that the proposed requirement to consider market impact in establishing a swing factor should not be adopted. Permitting asset class-based market impact factor determinations is a step in the right direction, but it does not resolve the significant challenges to achieving reasonably accurate estimates of market impact for fixed income investments. While the SEC's goal of precisely apportioning potential dilution is laudable, if the solution requires estimations and guesswork with a significant margin for error, magnified by the short timeframe between NAV calculation and NAV dissemination, the Commission may only succeed in randomizing when shareholders bear more or less of this risk and undermining confidence in mutual funds as an investment vehicle for individual investors. Tellingly, we are also not aware of a settled practice amongst European funds, whose swing pricing experience the Proposal approvingly cites, to include market impact for fixed income securities as part of their swing pricing mechanisms.

To the extent the SEC determines it is necessary for market impact related to fixed income investments to be reflected in a fund's swing factor, it should clarify that the consideration of market impact related to fixed income investments is a principles-based consideration that need not be based on a fixed amount or percentage, that may utilize any data that the swing pricing administrator considers reasonably appropriate to the consideration, and that may be undertaken periodically (*e.g.*, quarterly) in the swing pricing administrator's discretion.

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[31] *See, e.g.*, 2020 Derivatives Release at 83218 (providing an exemption from the limit on fund leverage risk in Rule 18f-4 that permits existing "over-200% leveraged/inverse funds to continue operating at their current leverage levels" in recognition of the "unique circumstances facing these funds, which have existed for years under Commission exemptive orders prior to [the Commission's] reconsideration of [its] regulatory approach regarding fund derivative use under section 18 and [the Commission's] adoption of a new approach for such regulation under rule 18f-4" and which "would have to significantly change their investment strategies if they were required to comply with Rule 18f-4's relative VaR test," subject to certain conditions); *see also* Exchange-Traded Funds, SEC Rel. No. IC-33646, 84 Fed. Reg. 57162, 57197 – 57198 (Sept. 25, 2019) (providing an exception from the rescission of certain exemptive relief that permitted ETFs to operate as feeder funds in master-feeder structures by "grandfather[ing] existing master-feeder arrangements involving ETF feeder funds).

b. Adopt a Principles-Based Approach

To the extent the SEC determines to require swing pricing, the Proposal's prescriptive requirements – including mandatory swing pricing on any day there are net redemptions, the 1% market impact threshold and mandated mechanism for determining market impact, and the 2% inflow swing threshold – should be replaced with principles-based guidelines that better recognize the need to balance precision that may be possible in a theoretical, ideal world with funds' practical ability to operationalize swing pricing in a timely, effective and efficient manner. Such guidelines should provide critical flexibility in setting these thresholds based on how funds have set up their portfolios and determining swing factors and should permit funds to determine their swing factors quarterly.

Similarly, NAV swings should not be a requirement for all net inflows above the 2% threshold, as there are ways to efficiently equitize cash and gain exposure without undue transaction costs, and there may be instances in which a fund's portfolio managers believe it would be in the fund's best interests to hold cash. Funds also should be able to set their own net outflow swing thresholds, as requiring NAV swings for relatively insubstantial net outflows is likely to result in a higher incidence of errors (NAV swings in the wrong direction) and would impose significant operational burdens and costs for minimal anti-dilution benefit. Further, many smaller flows can be covered in the normal course by the fund's receipt of income or maturing investments without the need to sell securities, so zero trigger swing pricing on any net redemptions creates unrealistic and unnecessary costs for redeeming shareholders. Similarly, the SEC should recognize that substantial anti-dilution benefits can be achieved without mandatory inclusion of market impact in determining swing factors.[32]

c. If the SEC Determines to Mandate Swing Pricing, a Hard Close is Necessary for Swing Pricing to be Practical but Harms Mutual Funds as an Investment Product

The SEC should also carefully consider the interaction of the proposed swing pricing and hard close amendments with the competitive positioning of mutual funds relative to other investment products and investor confidence in the mutual fund product. To the extent that, notwithstanding the concerns and suggestions we have raised elsewhere in this letter, swing pricing is mandated by the SEC, PIMCO considers a hard close essential for proper functioning of this new regime, and we would not be supportive of requiring or permitting the use of estimated or indicative flows for mandatory swing pricing. PIMCO believes that using indicative or estimated flow data, together with a safe harbor and/or a lower degree of confidence standard, is incompatible with a sensitive mandatory swing pricing mechanism, as it would be all the more likely to result in a fund swinging its NAV in the wrong direction or significantly miscalculating the market impact, and thus, the swing factor. Irrespective of legal liability, such a misaligned swing pricing mechanism would undermine the integrity of, and confidence in, the mutual fund product, further encouraging investor migration to alternatives such as CITs, SMAs, ETFs and private funds. Conversely, it is critical that the Proposal's mandatory implementation and prescriptive parameters, as described above, not be adopted if the SEC determines instead to permit swing pricing-related determinations to be based on indicative flow or estimated flow data, provides a

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[32] *See* section IV (discussing the significant challenges to achieving reasonably accurate estimates of market impact for fixed income investments).

safe harbor from liability under certain circumstances, or adopts a lower standard for the swing pricing administrator's degree of confidence in determining whether the fund has net purchases or net redemptions and the amount thereof.

The necessity of a hard close for mandatory swing pricing, together with its impact on the broader mutual fund distribution and intermediary ecosystem, underline how critical it is for the SEC to coordinate with other applicable regulators before going forward with the Proposal to avoid placing mutual funds at a competitive disadvantage, creating regulatory arbitrage, reducing regulatory oversight of market liquidity and disadvantaging those using clearing brokers (such as by subjecting "Main Street" investors to different cutoff times).

d. Non-Transparent, Active Fixed Income ETFs

As described in more detail above, the swing pricing and hard close proposals would likely incentivize asset migration to ETFs, but there currently is no ability to implement non-transparent active fixed income ETFs. Because certain active strategies are susceptible to front-running and free-riding risks in a fully-transparent ETF structure, and thus are not offered as ETFs, fixed income investors migrating to ETFs because of the SEC's regulatory intervention would lose access to these strategies as currently offered in the mutual fund structure. If the SEC determines to proceed with the swing pricing and hard close proposals, it should avoid this detrimental impact to fixed income investors by first granting relief for non-transparent active fixed income ETFs.

e. Bid Pricing

The SEC asks whether it should require all funds to use bid pricing, either instead of or in combination with a swing pricing requirement.[33] The SEC should not mandate the use of bid pricing. In many cases, midpoint pricing can result in more accurate net asset values, and relying solely on bid pricing can result in fund share purchase price anomalies.[34]

3. Reporting

a. Form N-PORT Amendments

PIMCO continues to believe that many of the concerns acknowledged by the SEC related to more frequent portfolio holdings publication, such as the potential for front-running and free riding, warrant maintaining the current Form N-PORT public publication frequency.[35] The fact that some funds voluntarily publish portfolio holdings more frequently demonstrates only that those funds have determined, with respect to their particular portfolios, that the benefit of more frequently publishing portfolio holdings information outweighs the accompanying risks; it in no way supports the notion that all funds derive a benefit from more frequent disclosure or that all

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[33] *See* Proposing Release at 77207 (question 83).

[34] *See also* ASC 820-10-35-36C – 36D (discussing pricing conventions where fair value inputs are based on bid and ask prices, and (i) permitting, but not requiring, bid pricing for asset positions, (ii) permitting the use of mid-market pricing or other pricing conventions that are used by market participants as a practical expedient for fair value measurements within a bid-ask spread, and (iii) noting that the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value).

[35] *See* Proposing Release at 77227 – 77228.

funds can disclose such information more frequently without significant risks of front-running and free riding to the detriment of their shareholders.

In addition, since Form N-PORT was adopted, several complex items have been added to the form, including those related to the liquidity risk management rule and derivatives rule. The proposed Form N-PORT updates associated with the recent Names Rule proposal and ESG Rule Proposal would further increase the form's complexity. The increased data required in Form N-PORT filings, and such data's complexity, make the review of such data all the more important and challenging. To help ensure sufficient time for appropriate data reviews and pre-filing error corrections, and in order to prevent immaterial inconsistencies between a fund's Form N-PORT and Form N-CSR filings for periods with the same end date (which could result in unnecessary uncertainty and create inefficiencies), we would recommend a more extended Form N-PORT filing deadline after month end, such as 45 days generally and 60 days for any periods for which a Form N-CSR will be filed.

b. Public Reporting of Aggregate Liquidity Classifications and Swing Factor Amounts

PIMCO opposes the proposed public reporting of aggregate liquidity classifications and, if the SEC adopts the swing pricing amendments as proposed, public reporting of swing factor amounts. The SEC indicates that experience with the liquidity rule and the SEC's proposals for liquidity classification updates sufficiently address concerns over investor confusion or misunderstanding that were previously cited in support of eliminating public reporting of aggregate liquidity classifications.[36] We disagree and believe that, if anything, the SEC's proposed changes to liquidity classifications would mask significant remaining subjectivity in the classification exercise. The SEC does not support its assertion that the public may benefit from granular swing factor data[37] (which likely would be voluminous in light of the proposed thresholds for application of swing factors), and PIMCO believes that, like aggregate liquidity classifications, there is greater risk that such data likely would present interpretive issues for the public. Relatedly, PIMCO is concerned that public disclosure of comparatively larger swing factors by certain funds could adversely influence investor redemption behavior, potentially exacerbating redemption pressures.

4. Preservation of SEC Staff Liquidity Rule Guidance

If the SEC determines to amend the liquidity risk management rule,[38] it should preserve existing SEC staff guidance that Form N-RN filings are not necessary in connection with exceedances of Rule 22e-4's 15% limitation on illiquid investments due solely to foreign securities market holiday closures lasting seven or more calendar days.[39] None of the proposed changes to the liquidity risk management rule would alter the fact that, as the SEC staff stated, the "liquidity risk to a fund holding investments in those securities markets . . . differs from the liquidity risk

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[36] *See id.* at 77230; *see also* Investment Company Liquidity Disclosure, SEC Rel. No. IC-33142, 83 Fed. Reg. 31859, 31861 (Jun. 28, 2018).

[37] *See* Proposing Release at 77231.

[38] *See id.* at 77234 (question 230).

[39] *See* Staff FAQs at Question 34.

[Form N-RN] is designed to flag."[40] Indeed, liquidity management generally is not a function of one-to-one matching of asset sales with redemption payments, and a fund with foreign market exposures can "plan its liquidity risk management relating to the market closure in advance."[41]

5. Cross Trades

Finally, given the SEC's focus on liquidity, we urge the SEC to expediently re-allow fixed income holdings to be eligible for cross trading under Rule 17a-7 under the Investment Company Act of 1940, subject to appropriate conditions.[42] Cross-trades serve as an important liquidity risk management tool.[43]

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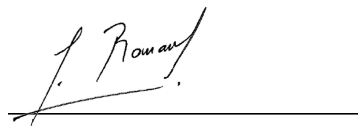
We thank the Commission for allowing us to comment on the Proposal and appreciate in advance the Commission's diligent consideration of our comments. Please feel free to contact us if we can provide any assistance to you in the further evaluation of these critically important issues.

Sincerely,



Emmanuel Roman
Chief Executive Officer

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[40] *See id*.
[41] *See id*.
[42] The SEC's recent Rule 2a-5 rulemaking foreclosed this useful portfolio and liquidity management tool for most fixed income instruments. *See* Good Faith Determinations of Fair Value, SEC Rel. No. IC-34128, 86 Fed. Reg. 748 (Dec. 3, 2020) at nn.358, 362, 493 and accompanying text.
[43] *See, e.g.*, PIMCO, Comment Letter, Staff Statement on Investment Company Cross Trading (Apr. 9, 2021), *available at* https://www.sec.gov/files/pimco.pdf.