

# PIMCO

## Via Electronic Submission

May 1, 2019

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

Re: Fund of Funds Arrangements, File No. S7-27-18

Dear Ms. 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 12d1-4 (the “Proposed Rule”) under the Investment Company Act of 1940, as amended (the “1940 Act”), regarding fund of funds arrangements for registered investment companies and business development companies.<sup>1</sup> Although PIMCO supports the Commission in its efforts to protect investors and commends it for its efforts in proposing an updated and more comprehensive approach to the regulation of fund of funds, we believe that the proposal goes beyond what is necessary to protect investors and will create significant disruption in existing fund of funds structures that have provided benefits for shareholders over an extended period of time.

PIMCO is registered as an investment adviser with the SEC and as a commodity trading advisor and commodity pool operator with the U.S. Commodity Futures Trading Commission. As of March 31, 2019, PIMCO managed approximately \$1.758 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. As of March 31, 2019, PIMCO managed 153 funds that were registered under the 1940 Act, with total assets of approximately \$417 billion. Of these registered funds, 19 funds with total assets of approximately \$28 billion are funds of funds that invest principally in other investment companies. PIMCO has comprehensive experience with the use and administration of funds of funds, as our funds of funds invest in a diverse pool of assets including affiliated mutual funds and exchange-traded funds (“ETFs”), unaffiliated mutual funds and ETFs, securities and other assets that are not securities. Further, PIMCO managed mutual funds, ETFs and closed-end funds serve as an underlying investment option for unaffiliated mutual funds and closed-end funds. In addition, PIMCO also utilizes central cash management short-term bond funds for managing excess cash within our open-end fund complex.

PIMCO believes that the Commission should carefully consider how the Proposed Rule may have unintended consequences for many fund of funds arrangements relative to the Commission’s policy

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<sup>1</sup> Fund of Funds Arrangements, Release No. IC-33329 (December 19, 2018), 84 Fed. Reg. 1286 (Feb. 1, 2019), available at <https://www.sec.gov/rules/proposed/2018/33-10590.pdf> (the “Proposing Release”).

objectives of streamlining and enhancing the regulatory framework applicable to funds of funds and creating a consistent and efficient rules-based regime for the formation and oversight of funds of funds.<sup>2</sup>

## I. Executive Summary

PIMCO believes that the Proposed Rule and concomitant rescission of Rule 12d1-2 under the 1940 Act and various exemptive orders under Section 12(d)(1) (together with the Proposed Rule, the “Proposal”) will fundamentally alter a significant portion of the existing fund of funds universe. While we do not believe that this was the Commission’s intent in advancing the Proposal, the result seems inevitable given that we, as well as many other firms, have created and operate customized fund of funds structures in reliance on both Section 12(d)(1) exemptive relief granted by the Commission and Rule 12d1-2. We offer the following comments and suggestions to assist the Commission in avoiding some of the disruptions that we believe will result from the adoption of the Proposal.

PIMCO’s comments focus primarily on a few major areas of the Proposal, which we believe are particularly problematic if adopted without changes. We are particularly concerned with the proposed rescission of Rule 12d1-2 and the exemptive orders under Section 12(d)(1):

- Pursuant to a Commission exemptive order, PIMCO operates short-term bond central funds that are used solely by our registered open-end fund complexes to invest excess cash in short-term fixed income obligations in an efficient and cost-effective manner (each a “Central Fund” and collectively, the “Central Funds”).<sup>3</sup> Based on our reading of the Proposal, the Central Funds would no longer be viable without a new Central Fund Order (or comparable relief within the Proposed Rule) since the majority of our funds that invest in our Central Funds can themselves be underlying funds of a series of established PIMCO funds of funds that rely on Section 12(d)(1)(G). Due to the limits in Section 12(d)(1)(B), the Proposed Rule would limit the ability of our existing funds to utilize the Central Funds, which would destroy the utility of our Central Funds. As detailed in our response, our inability to continue to utilize our Central Funds is expected to result in significant lost opportunities for shareholders.
- PIMCO also operates a number of funds of funds in reliance on Section 12(d)(1)(G) and Rule 12d1-2 and associated relief to invest in non-securities.<sup>4</sup> If these structures are forced to change how they invest by the rescission of Rule 12d1-2 and implementation of the Proposed Rule, it will significantly alter our fund of funds business and how we manage funds without providing any discernible investor protection benefits.

Further, we provide comments on several other issues under the Proposed Rule, including the imposition of a 3% redemption limit that does not exist today and which, when coupled with the

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<sup>2</sup> PIMCO is a member of both the Securities Industry and Financial Markets Association’s Asset Management Group (“SIFMA AMG”) and the Investment Company Institute (“ICI”), and is generally supportive of the comments submitted by SIFMA AMG and the ICI on the Proposed Rule.

<sup>3</sup> See, PIMCO Funds, et al., Investment Company Act Release Nos. 25220 (Oct. 22, 2001) (notice) and 25272 (Nov. 19, 2001) (order) (the “Central Fund Order”). Due to the proposed rescission of Section 12(d)(1)(A), (B), (C) and (G) exemptive orders issued by the Commission, it appears that the Central Fund Order will be rescinded.

<sup>4</sup> PIMCO Funds, et al., Investment Company Act Release Nos. 28331 (July 17, 2008) (notice) and 28356 (Aug. 12, 2008) (order). This relief is similar to the relief granted in *Northern Lights Fund Trust*, Staff No-Action Letter (pub. avail. June 29, 2015) (permitting funds to invest in futures contracts and other non-securities subject to certain conditions).

rescissions detailed above, will cause our existing fund of funds arrangements to significantly modify how they invest today, which in the extreme case could cause certain of these funds to no longer be viable. Further, we call the Commission's attention to the disparate treatment of affiliated funds when used as an underlying fund in a fund of funds structure. Finally, we also provide additional comments relating to the Proposed Rule, such as the inclusion of "interest expenses" as an element of "acquired fund fees and expenses" disclosure.

## **II. PIMCO's Comments**

### Overview of PIMCO's Funds of Funds and Benefits Relating to Funds of Funds

PIMCO manages 19 funds of funds that fall into several different categories that would be impacted by the Proposal. There are five principal types of PIMCO fund of funds products and structures that will be impacted by varying degrees as a result of the Rule Proposal:

1. "Pure" Section 12(d)(1)(G) funds of funds that do not rely on Rule 12d1-2 and associated relief;
2. Funds that invest in affiliated funds pursuant to Section 12(d)(1)(G) and in other assets in reliance on Rule 12d1-2 and associated relief;
3. Funds that invest in a combination of affiliated funds in reliance on Section 12(d)(1)(G) and other assets and unaffiliated funds in reliance on Rule 12d1-2;
4. Central Funds, which are short-term bond funds, that are utilized across PIMCO's open-end fund business to manage excess cash in an efficient manner for other PIMCO-managed funds; and
5. PIMCO open-end funds, closed-end funds and ETFs, which serve as an underlying investment option for third party mutual funds, ETFs and closed-end funds.

PIMCO manages funds of funds that invest exclusively in PIMCO mutual funds, PIMCO ETFs, government securities and cash items in reliance on Section 12(d)(1)(G). These funds do not currently rely on Rule 12d1-2 to invest in unaffiliated funds or securities. After the Proposed Rule is adopted, these funds can continue to operate as they do today, but if they ever elect to expand their investment strategy and purchase, for example, a derivative to equitize cash or a fixed income security to obtain a targeted exposure, these funds would have to comply with the Proposed Rule and would be subject to the 3% redemption limit. Additionally, the underlying funds to our Section 12(d)(1)(G) funds of funds utilize the Central Funds to manage any excess cash balances, and as such, if the ability to use the Central Funds were eliminated, these funds of funds would be indirectly impacted by the adverse impact on the underlying funds.

PIMCO also operates funds of funds that invest in affiliated funds and ETFs, while retaining the flexibility to invest directly in fixed income securities and derivatives. Further, these funds may utilize our Central Funds to manage any excess cash balances.

In addition, PIMCO operates funds of funds that invest in a combination of affiliated funds in reliance on Section 12(d)(1)(G) and other assets and unaffiliated funds in reliance on Rule 12d1-2. These funds also utilize our Central Funds to manage any excess cash balances.

The Central Funds operate in reliance on Section 12(d)(1)(G), Rule 12d1-2, the Central Fund Order and a separate Commission order that permits applicants who rely on Rule 12d1-2 to invest, to the extent consistent with its investment objective, policies, strategies and limitations, in financial instruments that may not be securities within the meaning of Section 2(a)(36) of the 1940 Act.<sup>5</sup>

PIMCO sponsored funds, which include open-end funds, closed-end funds and ETFs, serve as an underlying investment option for third party mutual funds and closed-end funds. These investments are principally made in accordance with a participation agreement. With respect to our ETFs, we typically rely on our exemptive relief,<sup>6</sup> while for other arrangements we utilize the investing funds' exemptive relief.

We believe that these fund of funds structures can provide a number of important, tangible investor benefits, including:

- *Cost Savings and reduced operational risk:* A fund of funds obtains exposure to an asset class by acquiring an underlying fund that invests in such assets rather than through direct investment. The underlying fund investing in such assets may have greater scale in such investments given its focus in a particular type of assets. Therefore, by acquiring the underlying fund, rather than individual assets, the fund of funds may be able to reduce costs. Additionally, for particular types of assets where a fund of funds itself may have less operational experience, including in any underlying fund specializing in that type of asset, such investment may also decrease operational risk. Since a fund of funds holds fewer individual assets, there are lower transaction fees for the fund and lower likelihood of operational errors.
- *Diversification:* A fund of funds can increase diversification by giving broad exposures to various underlying funds, which themselves have various underlying investments. For example, certain PIMCO funds of funds evaluate a wide spectrum of investments and tactically allocate among both traditional and alternative asset classes. This strategy may improve portfolio diversification and lead to attractive risk-adjusted returns, enhancing the purchasing power of investors' capital. Certain of PIMCO's funds of funds uniquely combine PIMCO's broad offering of global, actively managed strategies with tactical asset allocation expertise.<sup>7</sup>
- *Efficiency:* In addition to reducing transactions, a fund of funds structure creates efficiencies for investors by allowing them to purchase a fund of fund and gain exposure to various assets without having to purchase individual funds that address each asset class individually. For example, blend target date funds offer participants a comprehensive investment solution. Additionally, other PIMCO asset allocation strategies offer efficient ways to invest in particular types of assets.

Notwithstanding the existence of clear investor benefits in fund of funds structures, we believe that investors will be negatively impacted if PIMCO is forced to make changes to our funds of funds that will result in less efficient and effective products that produce inferior results while providing no additional protection for shareholders. Based on our experience, as both an investing fund and an underlying fund to unaffiliated third party funds, we are not aware of any potential or actual conflicts that

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<sup>5</sup> PIMCO Funds, et al., *supra* note 4.

<sup>6</sup> Pacific Investment Management Company LLC and PIMCO ETF Trust, Investment Company Act Release Nos. 28948 (Oct. 20, 2009) (notice) and 28993 (Nov. 10, 2009) (order).

<sup>7</sup> As a more specific example of the benefits of funds of funds, we offer a fund of funds that provides access to PIMCO's different liquid alternatives strategies in an efficient and cost-effective manner through a single fund.

have occurred in our funds based on these arrangements. As drafted, the only PIMCO funds of funds that will be able to continue to operate as they do currently would be pure Section 12(d)(1)(G) funds; however, even with these funds, as noted above, the underlying investment options for such pure funds of funds would be adversely impacted as a result of their inability to continue to use our Central Funds. The other types of funds of funds will be required to alter (in certain cases significantly) their investment programs or structures, which may lead to continued operations in a more costly and less efficient manner, which may make these funds less effective for shareholders.

#### Rescission of PIMCO's Central Fund Order

We disagree with the Commission's proposed rescission of exemptive orders that permit arrangements allowing funds to invest cash in short-term bond funds that have a dollar-weighted average portfolio maturity of no more than 3 years, without specifically adding conditions to the Proposed Rule that would permit such short-term bond funds to be used for cash management purposes.<sup>8</sup> As written, the Proposed Rule would, in fact, only allow investment in money market funds, which would severely limit portfolio management flexibility in managing cash for other funds. Additionally, the Proposing Release specifically notes "proposed rule 12d1-4 would permit arrangements where an acquired fund invests in another fund beyond the statutory limits for short-term cash management purposes" with no mention of why the Commission would narrow the types of vehicles that have been permitted in the past.<sup>9</sup> If the Proposed Rule is adopted as proposed, we believe that the Central Funds, which are used by all of our open-end mutual funds, including all of the funds of funds, would be required to close or convert to money market funds subject to Rule 2a-7, or PIMCO may be forced to completely restructure its fund of funds arrangements to avoid these three-tiered structures. Any of these outcomes would result in a substantial loss in efficiency for all funds and we believe could lower returns for shareholders as a result of less effective cash management.

As drafted, the amendment to Rule 12d1-1 would provide an exception permitting an acquired fund to invest in another fund "[f]or short-term cash management purposes pursuant to [Rule 12d1-1] *or exemptive relief from the Commission*".<sup>10</sup> Historically, under various fund of funds exemptive orders, the SEC has similarly permitted acquired funds to invest in money market funds under Rule 12d1-1 and short-term bond funds under exemptive relief from the Commission. What is puzzling here, however, is given the Commission's stated intention to rescind all orders granting relief from Sections 12(d)(1)(A), (B), (C), and (G) of the 1940 Act, with the exception of interfund borrowing and lending orders, it would appear that the exemptive orders that permit short-term cash management investment through short-term bond funds would likewise be rescinded, which would then call into question the portion of the exception related to "or exemptive relief from the Commission." Further, there is no mention or request for comment on the issue of the rescission of such exemptive orders or any discussion if the Commission

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<sup>8</sup> See, e.g., Putnam American Government Income Fund, Investment Company Act Release Nos. 26200 (October 1, 2003) (notice) and 26414 (April 9, 2004) (order). When the Commission adopted Rule 12d1-1 in 2006, it did not rescind such orders.

<sup>9</sup> Furthermore, if in fact the intention is to only permit short-term cash management vehicles other than money market funds under newly-designed exemptive relief, there is no mention of what conditions that may differ from current exemptive relief would be involved, how existing funds using these short term bond funds for such purposes could expeditiously obtain such new relief without adversely impacting existing shareholders or any mention of why a rule that is seeking to simplify existing requirements and rescind existing orders would require new exemptive orders in an area where there has been no concerns raised in the proposing release.

<sup>10</sup> Proposing Release at 194 (emphasis added).

desires new types of exemptive orders to meet this section of the Proposed Rule or whether funds with existing orders could simply amend their orders to meet such new conditions.

In 2008, PIMCO created its first Central Fund designed solely to manage short-term cash across our entire 1940 Act fund complex in reliance on the Central Fund Order.<sup>11</sup> Since that time, we have launched two additional cash management funds, each designed to efficiently and effectively manage excess cash balances for our registered fund complex. Today, PIMCO operates two Central Fund vehicles designed solely for our registered open-end funds that have assets under management of approximately \$26.7 billion as of March 31, 2019. Each Central Fund operates based on an explicit framework that contains specified structural safeguards imposed by the SEC, such as: the fund is only available to funds advised by PIMCO, the investing fund will not be subject to sales load, redemption fee, distribution fee, the board will consider any fees charged by the Central Fund and determine that there are no duplicative management fees, the board of the investing fund will consider the fees charged, if any, by the Central Fund and no more than 25% of any investing fund's assets may be invested across the Central Funds.

The Central Funds offer daily liquidity with a high quality liquidity management portfolio. Some of the important benefits of the Central Funds are:

- *Management Efficiencies and Improved Investment Characteristics:* By investing cash balances in a Central Fund, an investing fund avoids the issues associated with direct investments in other types of securities. Cash held for the benefit of an individual fund at any particular time may not be large enough to make the direct investment of the cash in short-term debt securities economical. Also, allowing PIMCO funds to invest in the Central Fund is more efficient and administratively less burdensome than separately investing cash of each fund in short-term debt securities directly.
- *Reduction in Operational and Transaction Costs:* The use of our Central Funds reduces the costs for shareholders by increasing scale and diversification. As a result, of its size and the resulting efficiencies (e.g., fewer transactions spread across a larger asset pool), the Central Funds should have lower transaction and operational costs as compared to managing excess cash in each portfolio individually. If we were forced to manage the excess cash balances in each of our funds individually rather than through a commingled Central Fund, PIMCO managed funds would have significantly more transactions, which would result in increased costs and operational risk with no shareholder benefit. For illustrative purposes only, over the last two years, our Central Funds have engaged in over 30,000 transactions; if we multiple that number of transactions into each one of our underlying funds, we would be adding over 3.5 million additional transactions in our mutual fund complex. As illustrated by our example, such increased trading would significantly raise each fund's transaction costs and introduce increased operational risk.
- *Increased Potential Returns:* The Central Funds have produced returns that are higher than a comparable money market fund. In general, large pools of investments generally earn a better return due to stronger negotiating position and increased investment opportunities. We

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<sup>11</sup> Prior to 2009, we utilized existing short-term bond funds that were not created for the sole purpose of managing cash collateral for our 1940 Act registered vehicles. The Commission staff has permitted these central fund arrangements for over 20 years. In fact, in recent years, the staff has issued no-action letters that provide for investments in central funds that are not cash management funds. *See, e.g., Franklin Templeton Investments*, Staff No-Action Letter (pub. avail. Apr. 3, 2015); *Thrivent Financial for Lutherans and Thrivent Asset Management LLC*, Staff No-Action Letter (pub. avail. Sept. 27, 2016).

compared the returns of our Central Funds over the last 1-, 3- and 5-year periods and found that the Central Funds' annual returns were approximately 40-50 bps higher than those of a comparable money market fund investment. If we are forced to liquidate our Central Funds and rely solely on money market funds as central cash management funds, our shareholders may lose out on this value that they are receiving for no additional identifiable benefit.

If the Central Fund Order is rescinded as suggested in the Proposal, PIMCO's mutual funds will no longer be able to avail themselves of the aforementioned benefits. As noted above, this result will have a detrimental impact on our shareholders without any added investor protection benefit. We believe that rescission of the Central Fund Order would increase costs and reduce investor returns, as noted above. PIMCO believes that this is just one of several unintended consequences of the Proposal, and we urge the Commission to reconsider the rescission of the Central Fund Order. To the extent the Commission determines to move forward with the rescission of Section 12(d)(1) exemptive orders, PIMCO strongly believes that the Commission should codify existing central fund exemptive and no-action relief that is relied upon by many funds of funds into any final rule. In particular, relief to invest in central funds is beneficial to investors since they provide investments in these efficient and cost-effective central funds. This would be consistent with recent staff guidance.<sup>12</sup> In addition, we are aware of numerous other fund companies that have created large central funds for cash management purposes in reliance on these exemptive orders and no-action letters. Such funds provide a clear benefit for shareholders while carrying few of the discernable risks that are enumerated in the policy reasons behind Section 12(d)(1).

PIMCO strongly believes that the use of central funds, particularly – short-term bond funds that have long been allowed by exemptive orders for decades – is an important tool that provides significant investor benefits for the reasons noted above.<sup>13</sup> PIMCO makes regular use of its central funds relief and has built substantial products that drive efficiency and returns for shareholders, and rescinding the PIMCO Central Funds Order would deprive investors of the benefits it provides without any added investor-protection benefit.<sup>14</sup> In addition to permitting funds to use central funds for cash management, we also strongly believe that the Commission should consider expanding the ability of funds to use central funds for other asset classes, such as collateral management or for holding exposure to commodities. Further, the benefits described above for a cash management Central Fund may be available for other asset classes in which scale and diversification are even more imperative and impactful. As a result, we recommend that the Commission take steps to allow and promote the use of central funds rather than restrict their use going forward.

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<sup>12</sup> For instance, in the *Thrivent* letter, the SEC staff explicitly provided no-action relief that permits investment of cash by an acquired fund in a short-term bond fund under conditions identical to prior exemptive relief.

<sup>13</sup> See, e.g., the *Thrivent* and *Franklin Templeton* letters, *supra* note 11. PIMCO believes that central funds other than for cash management purposes deriving from the *Franklin Templeton/Thrivent* line of letters should be permitted without limit, particularly if they involve affiliated funds and there is no duplication of fees or potential for overreach. Further, relief relating to investments in affiliated private central funds (e.g., the *TIAA* order and *Nicholas-Applegate* no-action letter) (TIAA-CREF Funds, et al., Investment Company Act Release Nos. 31807 (Sept. 8, 2015) (notice) and 31861 (Oct. 6, 2015) (order); *Nicholas-Applegate Mutual Funds*, Staff No-Action Letter (pub. avail. Aug. 6, 1996)) and relief permitting affiliated foreign funds to invest in US registered investment companies beyond the limits of 12(d)(1)(A), (B) and (C) (the *Dechert* letters), should not be rescinded as they provide additional flexibility in structuring fund of funds arrangements. See, *Dechert LLP*, Staff No-Action Letter (pub. avail. Aug. 24, 2009); *Dechert LLP*, Staff No-Action Letter (pub. avail. Mar. 8, 2017).

<sup>14</sup> PIMCO also believes that the limits in the *Franklin Templeton/Thrivent* line of letters could be expanded (for example to match the limits for central funds used for cash management purposes to 25% of the underlying central fund's shares or even without limit like in Rule 12d1-1).

## Rescission of Rule 12d1-2

We disagree with the proposed rescission of Rule 12d1-2, which allows our funds of funds to invest in a more diverse set of securities and other investments, without adding similar broad flexibility into Rule 12d1-4. The flexibility of funds of funds to invest in PIMCO funds, securities and other instruments pursuant to Rule 12d1-2 and associated relief allows these funds to target exposures and effectively manage risk. As noted above, PIMCO operates a number of different fund of funds structures, and 15 of our 19 funds of funds have the flexibility to invest in a broad array of affiliated and unaffiliated funds, as well as securities and derivatives. If the Proposal is adopted, certain PIMCO funds of funds will be required to either: (1) restructure their holdings to eliminate investments in unaffiliated mutual funds, fixed income securities, and derivatives, or (2) operate pursuant to the Proposed Rule, but potentially become subject to (a) the 3% redemption limit with respect to both affiliated and unaffiliated funds and (b) the control and voting provisions with respect to unaffiliated funds. In both scenarios, these funds will be required to alter their operations as a result of a rule whose stated goal is to streamline regulation and protect investors. However, in our experience, the existing structure has been highly beneficial and neither confusing nor harmful to shareholders.

As noted above, 15 of the PIMCO funds of funds operate with an investment strategy that may rely on the flexibility provided under Rule 12d1-2 and the associated relief, which can be very valuable in enabling a fund to achieve its strategy goals. For example, blended funds of funds have the flexibility to use derivatives or unaffiliated ETFs to gain equity exposure in a cost efficient manner, rather than allocating to another PIMCO mutual fund in situations where allocating to such affiliated fund would be less efficient. Similarly, in certain strategies, like relative value strategies such as a merger arbitrage strategy, it may be most efficient to allocate to individual equities, and when targeting a basket of equities it can be more efficient to gain exposure through the use of a derivative. Additionally, for risk management purposes, PIMCO funds may use various derivatives to hedge currency exposure and to manage duration at the portfolio level. PIMCO expects that altering these funds as a result of the Proposal could lead to sub-optimal incentives for funds relating to the 3% redemption limit that is discussed in more detail below.

PIMCO strongly believes that the SEC should retain Rule 12d1-2 either in its current state with an expansion to permit non-securities in accordance with the *Northern Lights* no action letter or by incorporating the substantive flexibility of Rule 12d1-2 in the Proposed Rule. Rule 12d1-2 provides Section 12(d)(1)(G) funds of funds with flexibility to invest without limit in affiliated funds and to invest in unaffiliated funds, securities and money market funds. The Proposed Rule could address the same substantive flexibility as Rule 12d1-2 through revisions to the Proposed Rule designed to preserve the structure of existing Rule 12d1-2 funds, such as by exempting funds of funds from any redemption limit when holding affiliated underlying funds. Like many fund complexes, PIMCO has developed customized fund of funds arrangements that rely on a combination of statutory provisions, rules and a custom Section 12(d)(1) exemption that would be rescinded under the Proposal. These arrangements have provided diverse and beneficial products to shareholders and will be significantly disrupted if the Proposed Rule's common approach is adopted. Therefore, we recommend that the Commission consider whether a more targeted and tailored approach is more appropriate in light of this well-developed area in order to prevent these disruptions.

### Imposition of 3% Redemption Limit on Fund of Funds

More generally, PIMCO believes that the 3% redemption limit should be eliminated since it does not provide protections that are aligned to the substantial cost it will impose for shareholders, especially when considering its impact on blended affiliated funds of funds that invest in securities and other assets as discussed above. To our knowledge, the 3% redemption limit does not exist in any existing fund of funds rule, order or no-action letter. In imposing the 3% redemption limit, the Commission will force sponsors like PIMCO to alter their carefully constructed and well-functioning fund of funds arrangements. This is especially true of affiliated fund of funds arrangements where existing fiduciary obligations provide little opportunity or incentive to exert undue influence or overreach. Further, we are not aware of any over-reaching by a manager that would warrant such rulemaking, and we believe this provision actually runs counter to the best interests of investors and should be eliminated.<sup>15</sup>

In our view, the 3% redemption limit is harmful to investors, especially retail investors, since it limits investor choice and portfolio management flexibility. To the extent other investors are able to redeem acquired fund shares ahead of fund of funds investors, the funds of funds may hold an increasingly large (and illiquid) position in an acquired fund (if there is an event causing a rush to redeem an individual acquired fund's shares, the funds of funds will have to continue to hold an increasingly illiquid asset). Moreover, the 3% limit disadvantages registered investment companies relative to other large investment vehicles that can redeem without restriction. In addition, the 3% limit could also negatively impact target date funds when they make scheduled glidepath changes. Target date funds are often held by retirement plan investors who will be disadvantaged if target date funds are subject to the 3% redemption limit and unable to implement scheduled portfolio rebalances. The limit may also lead to more problems, generally, in the investment process. For example, if a larger fund tries to allocate to a smaller fund, the limit would come into place quickly and force the fund to gain the desired exposure in a less efficient way, or potentially forgo the exposure altogether. The redemption would also slow a fund of fund's ability to shift investments across underlying funds, to the extent the manager thinks it is in the best interest of the fund of funds to do so.

PIMCO also believes that being limited to redeeming 3% of an acquired fund's shares will have implications for the funds' Rule 22e-4 liquidity risk management programs because certain acquired fund investments may be deemed illiquid even where the acquired fund is highly liquid. We acknowledge that whether an underlying fund is in fact illiquid depends on its reasonably anticipated trade size. However, even if a locked-up position were not deemed illiquid, any amount of fund assets that are locked-up will impact how the fund of funds is in fact managed, especially if an acquired fund's assets shrink further, thereby further reducing the ability of the fund of funds to redeem.

As noted above, PIMCO feels strongly that if the Commission staff is unwilling to revise the 3% limit, the Commission, at a minimum should not be applied to affiliated funds of funds (whether relying on Section 12(d)(1)(G) or otherwise), because in the case of affiliated funds, the adviser is a fiduciary with respect to both the acquiring fund and the acquired fund, there is little likelihood of overreach. For example, the Proposed Rule would treat the conceptually identical investment in an affiliated mutual fund differently if the PIMCO fund of funds held a single security, derivative or unaffiliated fund in its

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<sup>15</sup> Because PIMCO owes fiduciary duties to both the acquiring fund and the acquired fund in an affiliated fund of funds arrangement, there is little risk of overreach or undue influence. In fact, as noted in the Proposing Release with respect to voting and control issues, the Commission does not believe that affiliated funds of funds raise the concerns of undue influence that underlie Section 12(d)(1). Proposing Release at 38.

portfolio. This is an inequitable result that places affiliated fund of funds arrangements where the adviser is a fiduciary to both the acquiring and acquired fund on par with unaffiliated arrangements where the interests of the acquiring fund and acquired fund are not necessarily aligned. The SEC has not explained why this type of affiliated fund of funds raises concerns that necessitate a redemption limit or restriction. We believe this disparate treatment will limit portfolio managers and negatively impact shareholders.

PIMCO believes that, if fiduciary duty considerations offer sufficient protection from undue influence to obviate the need for an affiliated fund of funds to surrender its voting rights (i.e., through mirror or pass-through voting) and to except affiliated funds of funds from the considered limit, they should also be sufficient to mitigate the risks of undue influence associated with such a fund redeeming more than 3% of an affiliated acquired fund's shares.<sup>16</sup> The Commission has acknowledged that fiduciary concerns are reduced where, as with these funds, the same adviser acts as adviser to both the acquiring and acquired funds.<sup>17</sup> Forcing these funds to either restructure to avoid the 3% redemption limit or to operate within this arbitrary limit is unfair and detrimental to investors. We believe that this disparate treatment in applying the 3% redemption limit is particularly puzzling as affiliated funds are exempted from the Proposed Rule's limitations on control and voting guidelines given the existence of fiduciary protections.

#### Investment by Unaffiliated Funds

We do not believe that the 3% redemption limit is needed for the protection of a fund of funds' investment in unaffiliated funds. We would note that such language or protections is not included in existing exemptive orders and it is our belief that it is unnecessary.

We believe that the current regime, which utilizes participation agreements to govern the investment of fund of funds into unaffiliated funds, remains the most logical solution for the future state for unaffiliated fund. Currently, PIMCO has participation agreements that allow unaffiliated funds to invest in our mutual funds, closed-end funds and ETFs. Further, we use participation agreements to allow our mutual funds to invest in third party ETFs and mutual funds. In our view, the current participation agreement regime has worked well to protect against potential harms related to control, undue influence, overreach, and threats of large scale redemptions, and PIMCO is unaware of any obvious problems with existing fund of funds arrangements. To the extent the Commission believes that the current participation agreement process is not effective, we propose that the Commission instead adopt a principles-based approach where the acquiring fund in a fund of funds arrangement is prohibited by rule from seeking to exercise control over an acquired fund, exerting undue influence on an acquired fund, overreaching an acquired fund or considering the compensation received by the acquiring fund or its affiliates in determining to invest in an acquired fund. The rule could also require that the adviser act in the best interest of the acquiring fund in making an investment in an acquired fund. These requirements, coupled

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<sup>16</sup> When proposing amendments to Rule 12d1-2 in 2008 to expand the ability of Section 12(d)(1)(G) funds to invest in non-securities, the Commission did not include a 3% redemption limit in the proposed amendments. *See* Exchange-Traded Funds, Investment Company Act Release No. 28193 (Mar. 11, 2008) at 85. PIMCO is unclear as to what changed circumstance prompted the Commission to suggest such a drastic and disruptive change to how most funds of funds, including affiliated funds of funds, operate.

<sup>17</sup> The Commission stated in the Proposing Release that "in cases where the arrangement involves funds that are advised by advisers that are control affiliates, we do not believe that the acquiring fund adviser generally would seek to benefit the acquiring fund at the expense of the acquired fund (nor do we believe that the acquiring fund would seek to influence the acquired fund through its ownership interest in the acquired fund)." Proposing Release at 41.

with a requirement to adopt policies and procedures designed to provide oversight to investments in acquired funds, including compliance with the above factors, should provide the Commission with assurances that acquiring funds are not taking advantage of acquired funds.

#### Other Issues Raised by the Proposal

*Clarification Regarding Certain Structures.* PIMCO believes that the SEC should clarify that collateralized debt obligations (CDOs), collateralized loan obligations (CLOs) and similar structures that rely on Section 3(c)(7) would not be subject to the limits on investing in Section 3(c)(1)/3(c)(7) vehicles. PIMCO funds may invest in vehicles that use this structure and for the same reasons that existing SEC staff guidance excludes such structures from the requirement to disclose them as part of acquired fund fees and expenses (“AFFE”) disclosure,<sup>18</sup> these structures should be outside the scope of the Proposed Rule. We note that the FAQs on AFFE provide that “AFFE is intended to include the expenses of investments in investment companies, hedge funds, private equity funds, and other entities traditionally considered pooled investment vehicles.”<sup>19</sup> Similarly, these types of structured finance vehicles do not implicate the concerns raised by investments in pooled investment vehicles and should be excluded from the Proposed Rule’s limits on investments in Sections 3(c)(1) and 3(c)(7) funds.

*Acquired Fund Fees and Expenses.* In the Proposing Release, the Commission asks about separating out interest expense, noting that closed-end funds and BDCs are often subject to interest expense. However, we note that this is not just a closed-end fund and BDC issue but an issue for open-end funds as well.

A similar issue was recently addressed in a recent Investment Company Institute comment letter relating to SEC questions on the investor experience.<sup>20</sup> We agree with the substance of the ICI comment letter and believe that fee disclosures should be changed to better distinguish between items that represent true operating expenses rather than investment expenses. We support eliminating the need to include certain investment-related AFFE expenses in fee tables, including investment-related expenses.

In light of the ongoing discussion of AFFE and its appropriateness in the fee table, we have some additional comments that we believe are appropriate to share on this topic although these topics may technically be outside the scope of this particular Rule Proposal. We note that the fund fee table is intended to illustrate to investors the “expenses that [investors] pay each year as a percentage of the value of [their] investment.”<sup>21</sup> While many traditional components of the “other expenses” line item (*e.g.*, audit, legal, custody, and transfer agency fees) are often predictable operating costs that normally do not vary significantly from year-to-year, interest expense is more akin to a portfolio transaction cost in that it lacks the same predictability year-to-year. AFFE, interest expense and other portfolio transaction costs (such as brokerage commissions) are largely driven by a fund’s investment strategies and techniques, which may vary significantly from year to year in response to changing market conditions.

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<sup>18</sup> See Staff Responses to Questions Regarding Disclosure of Fund of Funds Expenses, available at <https://www.sec.gov/divisions/investment/guidance/fundfundfaq.htm>. (May 23, 2007).

<sup>19</sup> *Id.*

<sup>20</sup> See Comments of the Investment Company Institute on SEC Request for Comment on Fund Retail Investor Experience and Disclosure (File No. S7-12-18), available at <https://www.sec.gov/comments/s7-12-18/s71218-4932121-178430.pdf>.

<sup>21</sup> Item 3 of Form N-1A.

In our view, there is no practical reason that AFFE and interest expense should be treated differently from other types of portfolio transaction costs for disclosure purposes (which are not required to be disclosed in the fee table), and we believe that such treatment provides investors with an incomplete and potentially misleading picture of the costs and benefits of a particular fund’s investment strategy. For example, interest expense is typically incurred when borrowings can be utilized to generate positive returns net of the interest expense. Disclosing this expense in the fee table, without corresponding information addressing the positive returns generated by the investment strategy net of such interest expense or acquired fund fee, does not provide adequate context for investors to understand why the expense is incurred and that it may ultimately benefit the fund and investors in the form of higher net returns. Accordingly, we believe that these expenses should be included in the SAI and in the financial statements as of the historical period in time during which those expenses were incurred.

In our experience, funds implementing fixed income investment strategies often incur interest expense from certain financing transactions (*e.g.*, reverse repurchase agreements) in which the fund receives cash from an approved counterparty, generally on a short-term basis. These financing transactions are typically part of a broader portfolio management strategy to generate additional returns for the fund net of interest expense. Without the appropriate context, an investor cannot know that a fund incurs this interest expense solely in the pursuit of additional returns, and that the returns of the strategy, net of interest expense, are intended to be positive, particularly as compared to alternative strategies that do not generate interest expense. Any concern that investors may not be aware of interest expense were it not included in the fee table can be alleviated with appropriate narrative disclosure regarding fees not reflected in the fee table, such as interest, brokerage commissions and fees to financial intermediaries. Consistent with this general approach to informing investors that they may bear other types of fees and expenses outside of those enumerated in the fee table, interest expense should be omitted from the AFFE in the table like all other portfolio transaction expenses.

Finally, we note that certain similar economic transactions receive different accounting treatment regarding whether interest expense is reported. For example, Fund A may use an instrument that generates interest expense, while Fund B may use a less efficient/more costly instrument that does not generate interest expense but provides the fund with the same economic exposure. An investor may incorrectly believe that Fund A is more expensive and choose to invest in Fund B simply because of the funds’ different treatment of interest expense in their total expense ratios.

The chart below illustrates similar investments that result in different accounting treatment and, therefore, different approaches to disclosure of interest expense in the AFFE fee table:

<u>Interest Expense</u>	<u>Non-Interest Expense</u>
Reverse repurchase agreements	Securities lending
Sale buy backs (bond forwards)	Bond future rolls and mortgage dollar rolls (TBAs)
Short sales of equity	Total return swaps giving short equity exposure
Tender option bonds (TOBs) created by a fund	TOBs purchased in the market

We believe that excluding interest expense from the fee table, while disclosing such information in the SAI and in the financial statements, provides investors with pertinent, clear and concise information in the fee table about the management fees and operating costs of their investment while continuing to disclose interest expense elsewhere. This approach will not reduce the total current mix of information that is disclosed, but will reduce investor confusion and avoid misleading investors regarding their ongoing costs of owning a fund.

*Section 17.* PIMCO believes that the Commission should clarify that Section 17 concerns should not be implicated by fund of funds investments. There is some confusion regarding whether Section 17 is applicable to fund of funds investments, and PIMCO recommends that the Commission attempt to explain that when a fund makes investments or redemptions in another fund in reliance on the Proposed Rule or within the limits of, or in reliance on, Section 12(d)(1)(A), (B), (C), (E), (F) or (G), Section 17(a) and Section 17(d)/Rule 17d-1 concerns would not be implicated. We believe that it also would be helpful if the SEC provided relief, or clarified that relief was not necessary, from Sections 17(a) and 17(d) and Rule 17d-1 when funds invest in affiliated funds within the statutory limits of Section 12(d)(1) (e.g., within the limits of Section 12(d)(1)(A)) or in reliance on statutory exemptions from Section 12(d)(1) (e.g., in reliance on Section 12(d)(1)(F) or Section 12(d)(1)(G)). The policy arguments for relief in such circumstances are the same, and restrictions on such transactions frustrate the Congressional intent behind the adoption of more progressive Section 12(d)(1) provisions in 1996.<sup>22</sup>

*Private and Foreign Funds.* The Commission request, comment on whether the Proposed Rule should be expanded to permit foreign and private funds to invest under the Proposed Rule. While we are generally supportive of such expansion, we would strongly suggest that any private and foreign fund investments under the Proposed Rule in closed-end funds and BDCs should be subject to Section 12(d)(1)(C)-type limits if the Proposed Rule is expanded to include such funds. PIMCO believes that if private funds or foreign funds can invest in closed-end funds, then the Proposed Rule should require that such funds act within the limits of Section 12(d)(1)(C) as if they (and other private funds and foreign funds with the same investment adviser) were registered funds. We are aware that certain activist shareholders have developed multiple private fund structures that are designed to avoid investment limits applicable to closed-end funds. We also believe that the Commission should clarify that efforts to circumvent applicable limitations are inconsistent with Section 48 of the 1940 Act and will not be permitted.

### **III. Conclusion**

PIMCO believes that the Proposal will result in several unintended consequences and, therefore, recommends that the Commission make a number of changes to the Proposal. Specifically, we believe that the rescission of Rule 12d1-2 and various 12(d)(1) exemptive orders will needlessly alter a significant portion of the existing fund of funds universe. While we do not believe that this was the Commission's intent in advancing the Proposal, we think the result will be significant disruption to the well-established, well-functioning and highly customized fund of funds structures in existence today. We accordingly recommend that the Commission revise the Proposal to ensure that funds of funds be able to continue to make use of efficient and cost-effective central funds. In addition, we recommend that the Commission eliminate the 3% redemption limit in the Proposed Rule, as this limit does not exist in any existing statute,

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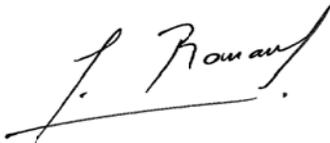
<sup>22</sup> The Commission has granted similar relief for sub-advised relationships. See, e.g., *T. Rowe Price Associates, Inc.*, Staff No-Action Letter (pub. avail. July 10, 2008), available at <https://www.sec.gov/divisions/investment/noaction/2008/troweprice071008-17a.pdf>

rule or relief of which we are aware. This limit is particularly problematic for affiliated funds of funds, for which the Commission has acknowledged a reduced concern that acquiring funds will exert undue influence. Finally, we suggest that the Commission make changes to various other provisions and clarify certain issues such as acquired fund fee and expense disclosure and the applicability of Section 17 to fund of funds transactions.

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We thank the Commission for the opportunity for us to comment on the Proposed Rule 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,

A handwritten signature in black ink, appearing to read "E. Roman", written over a horizontal line.

Emmanuel Roman  
Chief Executive Officer

cc: Honorable Jay Clayton, Chairman, U.S. Securities and Exchange Commission  
Honorable Hester M. Peirce, Commissioner, U.S. Securities and Exchange Commission  
Honorable Robert J. Jackson, Jr., Commissioner, U.S. Securities and Exchange Commission  
Honorable Elad L. Roisman, Commissioner, U.S. Securities and Exchange Commission  
Ms. Dalia Blass, Director, Division of Investment Management, U.S. Securities and Exchange Commission