PIMCO

Via Electronic Submission

May 29, 2015

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

Re: Consultative Document (2nd), Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions

Dear Sir or Madam:

Pacific Investment Management Company LLC ("PIMCO") appreciates the opportunity provided by the Financial Stability Board ("FSB") and International Organization of Securities Commissions ("IOSCO") to comment on the Consultative Document (2nd) on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions ("NBNI G-SIFIs") ("Second Consultation").

PIMCO is registered as an investment adviser with the U.S. Securities and Exchange Commission ("SEC") and as a commodity trading adviser and a commodity pool operator with the U.S. Commodity Futures Trading Commission ("CFTC"). As of March 31, 2015, PIMCO managed approximately $1.59 trillion in assets on behalf of millions of individuals and thousands of institutions in the United States and globally, including state retirement plans, unions, university endowments, corporate defined contribution and defined benefit plans, and pension plans for teachers, firefighters and other government employees. PIMCO manages both separately managed accounts ("SMAs") in accordance with specific investment guidelines and objectives specified by our clients, and funds that are offered to institutional and individual investors. In the case of all of these management services, PIMCO is engaged in the long-term investment management of our clients' assets as a fiduciary.

PIMCO does not engage in proprietary trading for its own account nor does it hold client funds on its balance sheet or provide balance sheet lending. Further, PIMCO is not engaged in activities outside of traditional investment management services, such as those related to securities lending (or indemnification thereof), pricing, technology or custodial functions. We have never used our balance sheet to support or guarantee performance of a fund in our 44 year history. Indeed, as a fiduciary to clients who are primarily saving for retirement, our principal goal is to make sound, long-term investments that will meet our clients' objectives and provide them with stable returns that are consistent with their risk preferences over their desired time horizons.

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PIMCO believes the Second Consultation does not accurately reflect the risks associated with investment funds or the asset management industry as a whole, nor does it provide a fair basis upon which the public can meaningfully provide comment.[1] We offer the following key points regarding the Second Consultation for consideration by the FSB and IOSCO (collectively, "FSB"), followed by our comments on specific materiality thresholds and indicators as set forth in the Second Consultation.

I. Broadly, the Second Consultation Represents a Significant Step Backward, Continues to Advance an Approach Based on Hypothetical Scenarios, and Could Have Material Unintended Consequences if Not Modified.

As a general matter, PIMCO, as a large, active market participant, has a vested interest in transacting in a stable, robust and deep financial market system in order to satisfy its fiduciary obligations to its clients. We are interested in seeing market fragilities addressed and systemic risk reduced through different avenues, including smart and effective regulation where appropriate. To this end, we have encouraged regulators to identify specific systemic risks about which they are concerned and to consider appropriate activities-based, industry-wide remedies.[2]

With that as context, we believe the Second Consultation represents a significant step backward by again suggesting a construct of entity-level designation while purporting to take an activities-based approach.[3] In addition, the Second Consultation fails to provide any empirical evidence as to why it continues to focus on investment funds[4] and fails to justify the inclusion of asset managers when the first consultative document ("First Consultation") argues that asset managers should *not* be included.[5] Further, it does not appear that any of the detailed and

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1 For purposes of this letter, we refer only to investment funds and asset managers.

2 *See* Letter from Douglas M. Hodge, Chief Executive Officer, Pacific Investment Management Company LLC to Secretariat of the FSB, regarding the First Consultation (Apr. 7, 2014) ("PIMCO's Comments to the First Consultation"), available at http://www.sec.gov/comments/am-1/am1-40.pdf.

3 *See* FSB, IOSCO, Consultative Document (2nd), Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, 8 (Mar. 4, 2015).

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

5 *See* FSB, IOSCO, Consultative Document, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, 30 (Jan. 8, 2014) ("First Consultation").

extensive comments submitted in response to the First Consultation were taken into consideration in the development of the Second Consultation. The Second Consultation appears to make sweeping claims that are based on hypotheticals and over-simplified assumptions that are not supported by empirical evidence. Indeed, the FSB effectively acknowledges that its analysis ignores the *probability* of a risk occurring in favor of a hypothetical economic impact.[6]

Moreover, the Second Consultation, similar to the First Consultation, fails to include any discussion of how entity-level designation would address systemic risk or provide any insight into the regulatory requirements and policy measures that would be imposed on a fund or asset manager to achieve those risk reductions. And yet, the Second Consultation insists that its focus is on "risks that are best addressed through a designation-based approach."[7] This is seemingly irreconcilable: the Second Consultation asserts that it focuses on risks in which designation would be the most effective tool, while at the same time it has yet to consider what designation would entail in the first place.

Without specificity, it appears that regulators will pursue a prudential-based regulatory regime, similar to the approach used for other designated companies and consistent with the assertions of the FSB in 2013, in which it declared that any financial intermediary not already regulated as a bank should be subject to bank-like prudential regulation.[8] As we have previously argued,[9] bank-like regulation is fundamentally incompatible with an asset manager's agency business model and its fiduciary duty to act in the best interests of its clients. Indeed, capital buffers *at the asset manager level* are not meaningful because asset managers generally do not engage in proprietary trading and client assets in the U.S. are segregated from the assets of the asset manager at all times. Similarly, capital requirements imposed at the *mutual fund or SMA level* are inconsistent with the asset managers' fiduciary duty to follow client mandates, meet certain investment criteria, and maximize outcomes for each individual client.

We believe that should the FSB proceed with designation and subsequent prudential regulation, there would be *significant unintended consequences* – for no discernible regulatory benefit – for the millions of retirees who depend on asset managers to manage their savings for retirement and other purposes. Indeed, for nearly 75 years in the U.S., the mutual fund vehicle has provided access to investments that would otherwise be unavailable for millions of people trying to save for retirement, educational expenses or other personal reasons. Designation would forever alter the mutual fund industry by unnecessarily increasing costs for investors and creating an uneven playing field among asset managers. This will invariably have the effect of

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6 Second Consultation, *supra* note 3, at 10.

7 Second Consultation, *supra* note 3, at 31.

8 Financial Stability Board, Strengthening Oversight and Regulation of Shadow Banking, ii (Aug. 29, 2013).

9 *See* PIMCO's Comments to the First Consultation, *supra* note 2.

increasing costs and limiting customer choice – and ultimately access to various retirement vehicles – for the millions of savers around the world who depend on these services. [10]

Instead of pursuing the designation approach outlined in the Second Consultation, we encourage the FSB to withdraw the Second Consultation and work with relevant home country regulators to address specific concerns and recommend enhancements to national activities-based regulation. Indeed, an activities-based approach has not only been pursued by the Financial Stability Oversight Council ("FSOC") and recommended as a best approach by the International Monetary Fund ("IMF"),[11] but we understand it is also being contemplated by the FSB.[12]

II. The FSB's designation process is flawed and could establish conflicting regulatory regimes.

As a matter of principle, the FSB should never act to adopt standards for designation on types of entities or financial products until the principal national regulator(s) for such products or entities has provided input and agreed that designation is appropriate. The expertise of the national regulator should play a significant role in the FSB's determinations and appropriate deference to the analyses and conclusions of national regulators on these issues should be shown. For the FSB to act in advance of such determinations would not only rob its members of the benefits of valuable insights provided by the local regulator(s), but more importantly, could result in inconsistent and conflicting regulation that applies across jurisdictions.

Since the overwhelming majority of entities likely to come within the scope of the FSB's findings are U.S.-based mutual funds and asset managers,[13] the FSB should suspend any judgment on the question of designation of mutual funds and asset managers until the SEC and the FSOC have finished their work on the asset management industry and reached conclusions on these matters. Indeed, the SEC is expected to advance rulemakings on asset management activities that are directly related to many of the areas of concern outlined in the Second Consultation, including liquidity management, derivatives, transition planning and stress tests.[14] Furthermore, the FSOC recently received extensive comments in response to its Notice Seeking

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[10] *See* Mike McNamee, Chief Public Communications Officer, ICI, How SIFI Designation Could Lead to a New Taxpayer Bailout, (May 14, 2014), http://www.ici.org/viewpoints/ci.view_14_financial_stability_05.print..

[11] IMF, Global Financial Stability Report: Navigating Monetary Policy Challenges and Managing Risks, (Apr. 2015), http://www.imf.org/External/Pubs/FT/GFSR/2015/01/pdf/text.pdf.

[12] Press Release, Financial Stability Board, Meeting of the Financial Stability Board in Frankfurt, 2 (Mar. 26, 2015), http://www.financialstabilityboard.org/wp-content/uploads/Press-Release-FSB-Plenary-Frankfurt-final-26Mar15.pdf.

[13] Committee on Capital Markets Regulation, Nothing But the Facts: FSB-IOSCO Proposal for SIFI Designation, (Mar. 24, 2015), http://capmktsreg.org/app/uploads/2015/03/2015-03-24_Nothing_But_the_Facts_FSB_asset_managers.pdf.

[14] *See* Dave Grim, Acting Director, SEC, Div. of Inv. Mgmt., Remarks at the IAA Compliance Conference (Mar. 6, 2015), http://www.sec.gov/news/speech/remarks-iaa-compliance-conference-2015.html.

Comment on Asset Management Products and Activities (the "Notice"), which cover many of the issues raised in the Second Consultation.[15] It makes sense for the FSB to review results of the SEC and FSOC efforts before advancing its own potentially conflicting designation framework.

Should the FSB proceed in advance of the SEC and FSOC, it is at risk of creating an irreconcilable patchwork of conflicting international regulatory regimes for asset managers and the funds they advise. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), the FSOC is authorized to designate nonbank financial institutions as systemically important ("SIFIs"). The FSOC has not finalized the process for designating SIFIs and, as described in the Notice, is still considering whether and to what extent the activities of asset managers should be subject to designation. The FSOC has also asserted that its process for designating SIFIs is distinct from that of the FSB and that FSB designations have no legal effect in the United States.[16] Yet, this is inconsistent with the FSB's expectation that member countries adopt and implement the FSB's regulatory construct; indeed, FSB Chair Mark Carney recently stated that the FSB's decisions must receive "[f]ull, consistent and prompt implementation" by its member countries and those efforts will be subject to "enhanced monitoring of implementation and its effects across all jurisdictions."[17] As a result, any NBNI G-SIFI designation activities pursued by the FSB without regard for the FSOC's process would inevitably lead to conflicting regulation, would not otherwise reconcile with constitutional principles in the United States, and therefore could be subject to legal challenge. Avoiding such outcomes should be of paramount concern for a well-functioning international regulatory system.

III. The FSB fails to give serious consideration to the existing regulatory framework under which asset managers and their funds operate.

The Second Consultation fails to sufficiently consider the *existing* regulatory environment in which the asset management industry operates, despite numerous responses to the First Consultation highlighting the extensive regulation to which mutual funds and asset managers are subject.[18] Because the materiality thresholds as currently conceived would primarily capture U.S. asset managers and mutual funds, it is a critical flaw that the Second Consultation fails to consider the robust and effective U.S. regulatory framework under which

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15 Financial Stability Oversight Council: Notice Seeking Comment on Asset Management Products and Activities, 80 Fed. Reg. 7595 (Feb. 11, 2015). Comments on the Notice were due on March 25, 2015, whereas the Second Consultation was released on March 4, 2015.

16 *See* U.S. Dep't of Treasury, Financial Stability Oversight Council, Nonbank Designations – FAQs, Response to Question 11 *(Feb. 2015).* http://www.treasury.gov/initiatives/fsoc/designations/Pages/nonbank-faq.aspx#11.

17 Letter from Mark Carney, Chair, Financial Stability Board to G20 Finance Ministers and Central Bank Governors, 1 (Feb. 4, 2015), http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chair-letter-to-G20-February-2015.pdf.

18 *See* PIMCO's Comments to the First Consultation, *supra* note 2.

these entities operate – a framework that significantly mitigates the potential for funds and their managers to transmit systemic risk.

In the U.S., asset managers are subject to extensive regulation, including but not limited to the 1940 Act and rules thereunder, which regulates registered investment companies; the Investment Advisers Act of 1940, as amended, which imposes numerous fiduciary, disclosure and record-keeping obligations on investment advisers; the Securities Act of 1933 and Securities Exchange Act of 1934, which regulate trading and marketplace activities; the Commodity Exchange Act, which regulates the futures and swaps market; the Dodd-Frank Act, which requires the clearing of derivatives in addition to other risk-reducing measures; and the Employee Retirement Income Security Act ("ERISA") through their ERISA clients.

Similarly, the Second Consultation fails to acknowledge that the SEC's extensive regulatory regime for U.S. mutual funds – one that has successfully and solidly endured through nearly 75 years of multiple market cycles, business contractions and financial panics - directly addresses and mitigates funds' propensity to transmit risk systemically. These regulatory requirements include:

- **Strict requirements regarding the use of significant leverage:** U.S. mutual funds are subject to strict requirements regarding the use of leverage. For example, immediately after any borrowings for investment purposes, there must be at least 300% asset coverage for all borrowings of the fund (i.e., a mutual fund may maintain leverage through borrowing for investment purposes up to a maximum of 1.5 times the fund's total assets). Practically, many U.S. mutual funds engage in a minimal amount of leverage.[19]

- **Liquidity restrictions under applicable regulation:** U.S. mutual funds are restricted in their ability to hold illiquid assets as portfolios must hold at least 85% liquid assets and all diversified mutual funds must limit investments in a single issuer (generally limited to 25% of the fund's assets); moreover, U.S. mutual funds are not allowed to invest more than 5% in a single financial entity.[20] Further, "illiquid" securities in a mutual fund need to be congruent with the fund's objectives and must be able to be priced daily. This is in notable contrast to loans held on a bank's balance sheet.

19 Investment Company Act of 1940, 15 U.S.C. § 80a-18(f)(1) and (h). All statutory references to the 1940 Act are to 15 U.S.C. § 80a, and unless otherwise stated, all references to rules under the 1940 Act are to Title 17, Part 270 of the U.S. Code of Federal Regulations; *see* Dan Waters, Managing Director, ICI Global, Preliminary Observations: FSB Proposed NBNI G-SIFI Methodology for Investment Funds, 15, 18 (Mar. 2014).

20 *See* 1940 Act, 15 U.S.C. § 80a-5(b)(1); *Revisions to Guidelines to Form N-1A* Vol. 57 Fed. Reg. 9828 (Mar. 20, 1992) (limiting a fund's holding in illiquid assets to 15%); 15 U.S.C. § 80a-12(d)(3) and 17 C.F.R. § 270.12d3-1.

- **Straight-forward capital structure:** Open-end mutual funds maintain simple capital structures because they are prohibited from issuing senior securities and thereby avoid priority claim problems in the case of liquidation.[21]

- **Full collateralization of counterparty obligation:** Mutual funds must segregate or earmark assets equal to 100% of any obligation to a counterparty created through the use of derivatives, or enter into offsetting derivative positions.[22]

Additionally, the Second Consultation ignores the recent efforts that are designed to expressly reduce systemic risk, especially those codified in the Dodd-Frank Act. William Dudley, the President and CEO of the Federal Reserve Bank of New York has stated that "[s]ystemic risk is being reduced in a number of ways," in reference to new requirements for central clearing and margin requirements for swaps and enhanced regulation of central counterparties.[23] Similarly, SEC Chair Mary Jo White recently noted that Title VII of the Dodd Frank Act reduces systemic risk in the market, including through central clearing and margin requirements for derivatives.[24] We note that PIMCO was an early adopter of central clearing and began voluntarily clearing client swap transactions due to the benefits of counterparty credit risk reduction years before the requirements of the Dodd-Frank Act were effective.

Further, in addition to clearing requirements, the Dodd-Frank Act also requires that large users of derivatives are subject to registration requirements and attendant regulation as major swap participants ("MSPs"). Indeed, the MSP category was specially designed to address swap users that, by virtue of high levels of swaps or security-based swap activities, "create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets."[25] These derivatives market reforms are comprehensive and are specifically designed to reduce systemic risk and create transparency in the market.[26] In fact, there is a leverage component in the MSP threshold test that is designed to capture those entities that may cause systemic risks from their activities.

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21 *See* 1940 Act, 15 U.S.C. § 80a-18(f)(1).

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

23 William C. Dudley, President and CEO, Federal Reserve Bank of New York, Remarks at the 2013 OTC-Derivatives Conference, Paris, France (Sept. 12, 2013), http://www.newyorkfed.org/newsevents/speeches/2013/dud130912.html.

24 Mary Jo White, Chair, SEC, Mitigating Systemic Risk in the Financial Markets through Wall Street Reforms, Testimony Before the United States Senate Committee on Banking, Housing, and Urban Affairs (July 30, 2013), http://www.sec.gov/News/Testimony/Detail/Testimony/1370539733678.

25 7 U.S.C. § 1a(33) (2010); *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant*," 77 Fed. Reg. 30596, 30661 (May 23, 2012). We note that neither PIMCO nor any of our clients are MSPs.

26 *See* White, Testimony on Mitigating Systemic Risk in the Financial Markets through Wall Street Reforms, *supra* note 24.

Lastly, while PIMCO is not an active participant in the U.S. money market funds ("MMFs") business, we do note that concerns about MMFs' ability to transmit systemic rise have been explicitly addressed by the SEC in coordination with the FSOC. In fact, the SEC in March 2010, adopted amendments to Rule 2a-7 under the 1940 Act, which govern the operation of MMFs ("2010 Amendments").[27] Following the adoption of the 2010 Amendments, the SEC continued to evaluate the appropriate regulation of MMFs, adopting further amendments to Rule 2a-7 in August 2014 ("2014 Amendments").[28] The 2014 Amendments dramatically altered the regulation of MMFs by requiring that institutional MMFs with portfolios that were not limited to government securities operate on a floating NAV basis, effective as of October 2016.[29] Collectively, these efforts not only address the concerns surrounding the ability of MMFs to transmit systemic risk, but are also an example of effective activities-based, industry-wide regulation.

IV. Focus on U.S. mutual funds is misplaced and assertions about runs and contagion underscore the lack of understanding of the characteristics of mutual funds and how mutual fund managers manage risk and liquidity.

The Second Consultation's focus on mutual funds as a source of systemic risk is simply unfounded; it relies on hypothetical scenarios that have no proven basis, and lacks any robust analysis to support its claims. The Second Consultation justifies its focus on investment funds by asserting that mutual funds could transmit risk through three possible transmission channels of systemic risk should investment funds become distressed: 1) the counterparty channel, 2) the asset liquidation/market channel, and 3) the substitutability channel.[30] We will address these transmission mechanisms in turn in order to underscore why we believe the FSB's focus on funds is misguided.

1) Counterparty channel

Because U.S. mutual funds are limited in their ability to borrow and use leverage, any potential counterparty exposure to these funds is relatively small in terms of risk exposure. As mentioned above, mutual funds must segregate or earmark assets equal to 100% of any obligation to a counterparty created through the use of derivatives, or enter into offsetting derivative positions, thereby significantly limiting its counterparty exposure.[31] In addition to this requirement, U.S. regulatory structure also requires mutual funds to adequately manage their

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27 Money Market Fund Reform, 75 Fed. Reg. 10060 (Mar. 4, 2010). The 2010 Amendments, among other things, required MMFs to maintain a portion of their portfolios in instruments that can readily be converted to cash, to reduce the maximum maturity of portfolio holdings and to require additional reporting.

28 Money Market Reform; Amendments to Form PF, 79 Fed. Reg. 47736 (Aug. 14, 2014).

29 The 2014 Amendments also, among other things, (i) mandated liquidity fees for non-government MMFs in certain circumstances, and (ii) allowed for discretionary liquidity fees and the discretionary temporary suspension of redemptions by non-government MMFs under certain circumstances.

30 Second Consultation, *supra* note 3, at 32, 33, 34.

31 *See* SEC Release 10666, *supra* note 22.

exposures to counterparties through strict rules regarding custody of fund assets, thereby limiting a U.S. mutual fund's exposure to its counterparties.[32] In fact, U.S. mutual funds generally may only post collateral (both domestically and abroad) with qualified third-party custodians.

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

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

2) Asset liquidation/market channel

Although we do not agree with the FSB regarding all of the putative channels for investment funds to transmit systemic risk, we believe the Second Consultation's assertions about the asset liquidation/market channel, which it describes as the "impact of distress or liquidation of an investment fund on other market participants through asset sales that negatively impact market prices"[33] are the most overstated.

- ***Mutual funds do not have the structural characteristics that could lead to runs and investors in mutual funds are typically saving for retirement and have long-term horizons.***

The Second Consultation does not substantiate its assertions that mass redemptions will lead to "runs" and "forced liquidation" and "fire sales," which could lead to "self-reinforcing

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32 *See* 1940 Act, 15 U.S.C. § 80a-17(f) and rules thereunder, 17 C.F.R. § 270.17f-5 (2000). In addition to the statutory and regulatory requirements, when U.S. mutual funds post their assets as collateral for derivatives transactions, U.S. mutual funds generally enter into tri-party collateral control agreements with the U.S. mutual fund custodian and applicable counterparty, creating a security interest for the benefit of the counterparty. Only the U.S. mutual fund's custodian, and not the counterparty, has custody of the collateral. This requirement protects the U.S. mutual fund from the risk of default or insolvency of its counterparty and, accordingly, mitigates systemic risk.

33 Second Consultation, *supra* note 3, at 33.

movements for other investment funds, their counterparties and the wider market."[34] The Second Consultation fails to cite any example of a run on a floating NAV mutual fund, and does not explain how these alleged "self-reinforcing" feedback loops and "contagion" effects could take place (especially in the absence of leverage). In fact, the only references the Second Consultation does make to substantiate these claims are to the FSOC's Notice, which simply contains questions on asset management activities for public comment, and to a speech by Andrew Haldane, which ultimately references the widely-discredited report by the Office of Financial Research.[35]

PIMCO submits that there is no support for the principle that "runs" are an observable risk among floating NAV U.S. mutual funds. In fact, we are not aware of any instance in the nearly 75 year history of the 1940 Act where a U.S. mutual fund of any significance was unable to meet redemptions in accordance with applicable law.[36] Indeed, U.S. mutual funds are protected against any first-mover advantages based on the nature and operations of U.S. mutual funds' floating NAVs.[37]

Moreover, as acknowledged by the Second Consultation and supported by empirical data, investors in U.S. mutual funds tend to have longer-term investment horizons and are therefore less likely to seek redemptions in times of market stress or exogenous shocks. In 2013, according to the Investment Company Institute ("ICI"), an estimated 56.7 million households – or 46 percent of all U.S. households – owned mutual funds. Of these, 92 percent indicated that saving for retirement was one of their primary financial goals and 93 percent had exposure to mutual funds inside workplace retirement plans, individual retirement accounts and other tax-deferred accounts.[38] These investors have long-term horizons by definition and tend to purchase shares in mutual funds through retirement accounts through such mechanisms such as automatic payroll deductions, which typically continue even during stress periods. Additionally, these

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[34] Second Consultation, *supra* note 3, at 28, 31, 33.

[35] Second Consultation, *supra* note 3, at 33, n.46 and n.48.

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

[37] Historical experience suggests that funds experience drastically increased redemptions for only two reasons: (i) when investors are concerned about a specific event at the fund or adviser whether it be fraudulent, organizational, etc.; or (ii) when investors become concerned about the asset class as a whole. Assuming those predicates, an NBNI G-SIFI designation would not mitigate the risk of drastic redemptions when investors exit a particular asset class, as they would be pulling money out of any fund invested in the asset class, not just the larger funds (which, in fact, may be in a better position to withstand a run).

[38] *See* ICI, 2014 Investment Company Fact Book, 102, 107 (54th ed. 2014).

investors also may engage in dollar-cost averaging and portfolio rebalancing, which in fact can have a counter-cyclical stabilizing effect.[39]

Data from the financial crisis supports this. Even during the highly volatile period of 2008, redemptions from U.S. mutual funds were limited, demonstrating the long-term investment horizons of investors in U.S. mutual funds. Specifically, in September, October and November of 2008, the worst period of the financial crisis, U.S. mutual funds experienced net redemptions of approximately $60 billion, $128 billion and $41 billion, respectively, on a net asset base of almost $5.8 trillion.[40] These funds returned to positive net purchases of approximately $25 billion in January 2009.[41]

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

- ***Even if mass redemptions were to occur and prices were to decline, we do not believe they would lead to a systemic event given the unlevered nature of mutual funds.***

We believe the Second Consultation conflates *investment risk* with *systemic risk*. Investment risk –which describes the risk that investors can lose (or make) money because of declining (or rising) prices – is well-understood and well-documented, as pointed out in the First Consultation: "investment management is characterised by the fact that fund investors are knowingly exposed to the potential gains and losses of a fund's invested portfolio . . . fund investors decide, based on full-disclosure, to take on investment risks."[42] Indeed, asset managers and the funds they advise do not – and are not meant to – function as banks, in which depositors expect a complete return of their capital; instead, investors retain asset managers and their funds to pursue their investment goals and preferences through the management of investment risk.

Moreover, while price declines may occur - and in doing so may exhibit investment risk, they do not, particularly in vehicles such as mutual funds, pose systemic risk. While investors may lose invested capital, those losses have limited spill-over effects to the rest of the financial

39 *See* Paul Schott Stevens, President & CEO, ICI, Response to the FSOC's Notice Seeking Comment on Asset Management Products and Activities (FSOC-2014-0001), 20 (Mar. 25, 2015) ("ICI Response to the FSOC's Notice Seeking Comment on Asset Management").

40 *See* ICI, *Long-Term Mutual Fund Flows Historical Data* (2013); ICI, 2013 ICI Investment Company Fact Book, 144 (53rd ed. 2013).

41 *See* ICI, 2013 Investment Company Fact Book, *supra* note 40, at 94.

42 First Consultation, *supra* note 5, at 29.

system given that mutual funds are prohibited from using substantial leverage, have little, if any, uncollateralized counterparty exposure, and are required to hold primarily liquid assets. Indeed, these mitigating factors address the primary ways in which a market participant can have a systemic impact on the system as outlined in a Federal Reserve Bank of St. Louis report on systemic risk.[43] In this sense, the worst case scenario for a fund is for its value to go to zero and for investors to lose invested capital – not a desirable outcome, but also not a systemic event. Indeed, as described in the First Consultation, "fund investors absorb the negative effects that might be caused by the distress or even the default of a fund, thereby mitigating the eventual contagion effects in the broader financial system."[44]

Even by the FSB's own admission, "no mutual fund liquidations led to a systemic market impact throughout the observation period [2000 to 2012]."[45]

- ***Asset managers actively manage for liquidity and redemption risk; liquidity management is an integral part of portfolio construction.***

The Second Consultation's assertions about "runs," forced asset sales and contagion effects also fail to recognize how asset managers actually manage liquidity and redemption risk, and in doing so, efficiently process risk and liquidity for the market as a whole. In our experience, liquidity management is a dynamic, iterative process that we perform daily and is an interaction between our risk management and portfolio management teams. Every day, cash (and cash-like) buffers are reinforced based on several considerations, including the strategy of the fund, the liquidity of the underlying assets, the past historical redemption activity of the fund, the macroeconomic landscape, and the way in which the strategy may react to different shocks (e.g., a significant interest rate shock).

In addition to these cash buffers, portfolio managers frequently deploy other techniques to manage liquidity as a fundamental part of portfolio construction, including buying short-term securities (which are self-liquidating), increasing liquidity buffers with cash inflows, and choosing the most liquid instrument to gain a specific exposure (e.g., a Treasury bond vs. an interest rate swap). These liquidity management practices are employed on an ongoing basis both to meet the daily redemptions of the funds we advise as well as when we are raising liquidity in order to make large asset allocation shifts (e.g., selling out of Treasury bonds and buying corporate bonds). These robust – and we believe universal – best practices around liquidity management for investment fund managers are simply reinforced by the SEC's regulations and guidance on these issues.[46]

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[43] *See* James Bullard, Christopher J. Neely, and David C. Wheelock, *Systemic Risk and the Financial Crisis: A Primer*, Federal Reserve Bank of St. Louis Review, 403, 408-09 (Part 1) (2009) ("St. Louis FRB Paper").

[44] First Consultation, *supra* note 5, at 29.

[45] First Consultation, *supra* note 5, at 30, n.38.

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

Further, when a fund experiences redemptions, even heavy redemptions, these liquidity management practices allow for the fund's portfolio manager to meet two sets of obligations – to the shareholder who is potentially redeeming *and* to the shareholders who remain invested in the fund. In other words, portfolio managers will meet the liquidity needs of the redeeming investor but will also maintain risk exposures in order to meet the ongoing needs of the fund. The portfolio manager may use these aforementioned techniques (derivatives markets, self-liquidating securities, fund inflows or cash buffers) to meet redemption requests and to ensure that risk exposures are maintained, but also may use outflows as an opportunity to rebalance out of securities he/she no longer wants the fund to own. Further, the portfolio manager may use redemption activity to add to *less* liquid holdings in order to ensure that risk exposures are maintained and to capitalize on market distortions, especially if asset prices are declining.

Data from the ICI corroborates these observations. For instance, its analysis of cash holdings in credit bond funds finds that cash ratios (as measured by the holdings of cash as a percentage of a fund's assets) remained in positive territory and have been relatively stable over the past 15 years, even during periods of significant redemption activity.[47] If the Second Consultation's assertions that fund managers would necessarily deplete the most liquid assets, such as cash, were correct, cash ratios would have declined significantly during times of heavy redemptions. In actuality, this is the opposite of what has been observed: during the financial crisis, cash ratios actually *rose* during this period of time (from 6.3% to 11.9%).[48]

- ***Regulators should consider the PIMCO experience in their assessment of redemption risk.***

One of the hypothetical scenarios the Second Consultation refers to as a source of possible concern is the impact from "reputational risk caused by a fund manager's distress or liquidation, which may be transmitted…through forced asset sales if redemptions cannot be met in a timely manner. . . ."[49] We would encourage the FSB to examine what occurred in the days and weeks after the sudden departure of PIMCO's co-founder and CIO as a strong counterexample to some of these concerns and a real-life case study for regulators to consider.

As is widely known, PIMCO's flagship fund, the Total Return Fund experienced heavy redemptions in the days and weeks surrounding the departure of PIMCO's co-founder and CIO from the firm; the Total Return Fund saw $23.5 billion in net redemptions in September 2014 and $27.5 billion in October 2014, specifically concentrated in the days surrounding the announcement.[50] While these redemptions were large, PIMCO was able to meet them in an

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47 *See* ICI Response to the FSOC's Notice Seeking Comment on Asset Management, *supra* note 39, at 29.

48 *Id.*

49 Second Consultation, *supra* note 3, at 33.

50 *See* Press Release, Pacific Investment Management Company LLC, PIMCO Statement Regarding September Total Return Fund Net Flows, 1 (Oct. 1, 2014); *see* Press Release, Pacific Investment Management Company LLC, PIMCO Statement Regarding October Total Return Fund Net Flows, 1 (Nov. 4, 2014).

orderly, timely way, while also maintaining risk exposures and maintaining and dynamically replenishing its cash buffers across its mutual funds. There were no "fire sales" or "forced selling," and PIMCO never had to – or even considered – supporting the Total Return Fund or any of its other funds. Additionally, PIMCO was in close contact with its regulators and other relevant governmental entities throughout this period of time. The net impact of the experience is that PIMCO was able to serve both its departing clients and existing clients during this unusual and difficult time.

There were several reasons why PIMCO was able to manage these heavy redemptions in an orderly manner– the majority of which are not unique to PIMCO but endemic to all asset managers. For one, as a large asset manager with a fiduciary obligation to act in the best interests of our clients, liquidity risk and redemption risk are a primary – not ancillary – focus, especially when managing investment vehicles that enjoy daily redemption rights. As such, PIMCO actively manages liquidity on a daily and intra-daily basis and constructs portfolios with liquidity as a principal consideration. As described above, these tools include choosing the most liquid instrument to gain a certain exposure (e.g., a derivative instrument versus a physical bond), selecting self-liquidating securities, and using fund inflows to add to cash buffers. Indeed, these are the same practices we use to raise liquidity in order to make large asset allocation shifts (e.g., selling out of Treasury bonds and buying corporate bonds). Moreover, the prevailing regulatory framework, which restricts the use of leverage, regulates sector and security concentration, and limits the percentage of illiquid assets means that the composition of our commingled funds are legally required to be positioned to meet daily liquidity needs.

Related to this point, in the midst of the heaviest of redemptions, despite the Second Consultation's concerns about asset sales exerting "downward" pressure on market prices, the bond market's performance continued to be driven by macroeconomic and geopolitical issues, not PIMCO's redemption activity. Indeed, the Barclays Aggregate Bond Index returned nearly one percent for October 2014, the month following the senior leadership transition at PIMCO. With respect to the Total Return Fund's performance, for the six months following the transition, ending March 31, 2015, the Total Return Fund beat its benchmark and outperformed 91% of its peers based on the Morningstar Intermediate-Term Bond Fund Category, underscoring PIMCO's ability to meet its obligations to its clients during this period of time.

3) Critical function/Substitutability channel

We do not believe the critical function/substitutability channel is a valid transmission channel of systemic risk and was rightfully excluded in the First Consultation.[51] The mutual fund industry in the United States is large, dynamic, competitive and highly substitutable; indeed, in the FSB's own words: "the investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies (funds are highly substitutable)."[52]

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[51] First Consultation, *supra* note 5, at 29.

[52] First Consultation, *supra* note 5, at 30.

In 2013 alone, there were more than 800 sponsors of mutual funds in the United States, and new funds are launched – and liquidated – on a frequent basis; according to the First Consultation, "from 2000 to 2012, on average 671 new funds were launched *per year*, compared to an average of 291 liquidations."[53] Additionally, the mutual fund industry is not highly concentrated: as of December 2013, the mutual fund industry in the U.S. had a Herfindahl-Hirschman Index ("HHF Index"), a commonly-accepted measure of market concentration, of 481 indicating that it is not a concentrated industry (companies with less than 1,000 index score are considered to be less concentrated). Moreover, there has been significant turnover among top mutual fund companies in the industry. According to ICI's 2014 Investment Company Fact Book, "of the largest 25 fund complexes in 2000, only 13 remained in this top group in 2013."[54]

The Second Consultation speculates that an investment fund may provide "a highly tailored investment strategy or may serve as a significant source of liquidity to particular asset classes." While there are certainly bespoke investment funds, these typically are found in hedge fund space and have commensurate liquidity and lock-up provisions that are well-understood by their investor base. Moreover, U.S. mutual funds have concentration limits that preclude them from holding too much of a specific sector and security, thereby preventing them from providing a systemic source of liquidity to any specific sector or security.

V. Materiality thresholds for investment funds continue to rely on size and do not accurately measure a fund's risk.

As stated before,[55] we do not believe the entity designation – either as it applies to mutual funds or asset managers – is an appropriate approach; not only would entity designation *not* reduce systemic risk, it would lead to unintended consequences for the millions of retirees and savers that the asset management industry serves. Instead, we believe the FSB should proceed with an evaluation of activities that could give rise to systemic risk. An activities-based approach is more likely to address specific concerns than the concept of utilizing arbitrary thresholds and indicators as set forth for both mutual funds and asset managers in the Second Consultation. With that said, should the FSB decide to pursue this approach, it should to take the following concerns into consideration:

- ***Absolute materiality thresholds are misleading and will lead to false positives***. The $100 billion materiality threshold is arbitrary and says little about the riskiness of a fund. Using such a rigid threshold says nothing about the size of the underlying asset class in which the fund trades, the liquidity or diversification of the asset class, not to mention the regulatory framework under which the fund operates. Simply looking at the size of a fund without taking consideration the size of the market in which it operates or the nature of its benchmark, among other things, will lead to false positives – i.e., identifying funds that present little risk to the financial system and potentially imposing additional costs to

[53] First Consultation, *supra* note 5, at 30, n.38 (emphasis added).

[54] ICI, 2014 Investment Company Fact Book, *supra* 38, at 27.

[55] *See* PIMCO's Response to the First Consultation, *supra* note 2.

underlying investors. For instance, as of 3/31/2015, PIMCO's flagship fund, the Total Return Fund, had a market value of $117 billion but is managed to a benchmark with a market capitalization of $16.8 trillion, meaning that the Total Return Fund represented less than 0.7% of that index for that time period.

- ***Unadjusted gross notional exposure (GNE) is misleading and is not reflective of risk.*** As the Second Consultation concedes, "adjusted GNE may better reflect the actual risks posed by the investment portfolio of a fund."[56] Nevertheless, the Second Consultation proceeds to use the unadjusted GNE metric throughout – both in the materiality thresholds and the indicators. This metric materially overstates the potential risk of derivatives exposure. Gross notional exposure does not take into consideration the risk mitigating effects of netting derivatives or whether derivatives are centrally cleared. Moreover, and most importantly, GNE does not make an adjustment for the sensitivity to changes in interest rates (measured by duration), which in the fixed income markets is typically the primary risk factor.

  For instance, if a mutual fund uses Eurodollar futures (which have a duration of ¼ of a year), which are very short-term, liquid fixed income instruments to take a position on the front-end of the yield curve, its risk exposure will be very different from a fund that takes a position in 30 year bond futures, which have a duration of approximately 14 years. Yet, because GNE does not make any sort of duration adjustment, the GNEs of the two funds could look very similar, even though the risk profiles would be very different. Should the FSB proceed with using GNE, we would assert that this measure must take into account netting agreements, whereby exposure between the same counterparties can be netted to determine overall exposure, consider the effect of clearing arrangements, and allow for an adjustment for duration (using for instance a 7 or 10 year equivalent adjustment).

VI. Inclusion of asset managers for possible designation is misguided. Asset managers are different from banks with different business models and activities, making designation and subsequent regulation inappropriate.

We do not agree with the FSB's decision to proceed with its "dual approach," which includes a separate methodology for the consideration of asset managers as NBNI G-SIFIs with no substantive justification or empirical support. The FSB itself is sending mixed messages on the issue. The First Consultation argues why asset manager designation is not appropriate, specifically, because economic "exposures are created at the fund level" and a fund "is a separate legal entity from its manager" and "as a result, the assets of a fund are not available to claims by general creditors."[57] The recent IMF report on financial stability corroborates this, asserting that "[m]utual funds and most other investment vehicles have few direct solvency linkages with

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56 Second Consultation, *supra* note 3, at 39.

57 First Consultation, *supra* note 5, at 30.

[asset management companies]. [Asset management companies'] own balance sheets are legally separate from those of the mutual funds they manage, as required by regulations."[58]

We believe the Second Consultation's revised dual approach underscores a fundamental lack of understanding of the asset management industry and reflects an inappropriate comparison with the banking industry. To this end, we believe it is worthwhile to provide a brief review of the U.S. asset management industry and how it is different from the banking industry. While we believe the FSB likely appreciates these differences between banks and asset managers, we nevertheless think they are worth reemphasizing.

- ***Traditional asset managers function as fiduciary agents on behalf of their clients, not as principals.*** Unlike banks, whose business models are predicated on functioning as principals by using their own balance sheets to make loans and support trading activities, traditional asset managers function as agents, providing investment advice to savers and retirees globally for a fee. They do not use their own balance sheet assets to trade for their own account, to guarantee performance of a fund, or to provide financial support to a fund. Asset managers do not typically function in a counterparty capacity; any derivatives or securities lending arrangements are legally separate and do not appear on the balance sheets of asset managers.[59] In those instances in which asset managers may use their own capital to provide seed funding to new funds, the investments are usually immaterial relative to the size of their balance sheets; indeed, managers typically only provide the minimum amount of capital to establish a track record and reevaluate the investments on a frequent basis.[60]

- ***"Assets under management" bear no relation to the assets on a balance sheet.*** An asset manager's assets under management ("AUM") are completely separate from the assets on its balance sheet. In PIMCO's case, its AUM represents the assets of the thousands of client accounts we manage, such as public retirement systems, corporate pension plans and university endowments and foundations, and of millions of individual investors. Client and fund assets are held in separate accounts at a third-party custodian of a client's choosing. These accounts are legally separate and therefore any losses incurred by one client (or fund) will not affect the assets of another client (or fund). Client and fund accounts are managed in accordance to strict guidelines that are dictated by the client (or fund prospectus), which cover risk and return objectives, benchmark selection, concentration of a sector and the types of securities a client account or fund can hold.

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[58] IMF, Global Financial Stability Report, Navigating Monetary Policy Challenges and Managing Risks, at 114.

[59] A possible exception to this is if an asset manager indemnifies against losses in their securities lending program. PIMCO does not function as a securities lending agent and therefore does not have any sort of indemnification arrangement in this area.

[60] In PIMCO's experience, these seeding programs are typically less than $5 million and are revisited on a quarterly basis; additionally, in PIMCO's case, these are held on its parent's balance sheet, not its own.

- ***Asset managers do not function as shadow banks – they do not guarantee a return <u>of</u> (or a return on) capital. They are not financial intermediaries, do not use leverage, and do not rely on short-term funding.*** Unlike a bank or a finance company, asset managers do not function as financial intermediaries (e.g., do not make markets), they do not depend on leverage as part of their business model (where investment banks were levered approximately 25 to 1 and commercial banks were levered 12 to 1 before the crisis[61]), they are not dependent on short-term markets for the on-going functioning of their businesses (their corporate structure is usually mostly equity financed), and they do not function in a principal fashion in transactions to counterparties. Moreover, asset managers do not engage in maturity transformation, i.e., borrowing in the short-term markets and lending long, nor do they guarantee the performance of the funds on which they advise.

- ***Asset managers do not enjoy a federal subsidy.*** Unlike banks, which in the U.S. are subsidized in several ways, including through depository insurance via the Federal Deposit Insurance Corporation and access to the Federal Reserve's discount window, the asset management industry is not subsidized at any level, does not have any sort of implicit or explicit government guarantee and therefore does not have any sort of taxpayer backstop. Indeed, unlike other banks (and non-banks), asset managers were not recipients of any of the "bailout" money allocated during the financial crisis in the U.S.

- ***Resolution of an asset manager is straightforward.*** Asset managers have several unique characteristics that make their resolution straightforward; they include:

    - Asset managers do not have physical control or direct access to client or fund assets; clients and funds use their own independent third-party custodians whom they have selected, and as such, client and fund custody accounts exist completely independent from the asset manager. Should the asset manager fail, client and fund assets would remain at their respective custodians without disruption; neither the manager nor the custodian would be forced to liquidate client assets, and clients would simply select new advisers to take over the management of their assets.

    - Counterparty agreements and exposure are in clients' names, not that of the asset manager. PIMCO, like other traditional non-bank asset managers, does not have a proprietary trading desk and does not use its own balance sheet to trade or intermediate client transactions. Rather, PIMCO enters into transactions with counterparties on behalf of its clients, not its own behalf. Legally, the agreements governing these trades are between the client on whose behalf PIMCO is transacting and the given counterparty; as a result, PIMCO does not have any direct counterparty exposure. In the event PIMCO failed, the obligations in client trading agreements would still be enforceable between the client and its counterparties. As more trading moves to central clearing, there will be less need for bi-lateral transactions, which should reduce concerns further regarding asset manager relationships to

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61 St. Louis FRB Paper, *supra* note 43, at 408-09.

counterparties.

- o Asset managers do not function as market utilities. Unlike financial market utilities, asset managers do not play a central role in the day-to-day functioning of providing liquidity or setting positions. It is widely understood that because of their activities, custodians and clearinghouses, which do function as market utilities, sit at the center of transactions. As a result, the removal of an asset manager would not impact the system like the removal of a custodian or central clearing facility.

- o Traditional asset managers have very straightforward business models with typically very small balance sheets that are in line with other service provider businesses. As a result, their resolution, unlike a more complex entity, would be rapid and orderly.

VII. Asset managers do not pose systemic risks, and materiality thresholds and transmission mechanisms are inappropriate and should be reconsidered.

We believe the materiality thresholds and transmission mechanisms proposed for asset managers in the Second Consultation are flawed and do not appropriately reflect the fundamental operations of the asset management industry. Our primary concerns are elaborated on below.

- ***Assets under management materiality threshold***

The AUM materiality threshold for asset managers[62] as proposed in the Second Consultation suffers from the same deficiency as those put forth for investment funds. It adheres to a bigger-is-riskier approach without offering any empirical evidence that asset managers that manage a larger pool of assets pose greater systemic risk. Indeed, the primary reason the Second Consultation proposes an AUM figure is that "publicly available data is more readily available" versus balance sheet data.[63] We believe this is not a valid foundation on which to promulgate public policy.

By relying on an AUM threshold, the Second Consultation appears to treat assets under management as a single pool of assets that are deployed on a monolithic basis at the sole discretion of the asset manager. In practice, however, and as discussed above, a firm's AUM reflects an aggregation of smaller pools of assets, which are owned by many separate and distinct clients. These clients are separate legal entities; they have separate and distinct investment mandates, guidelines and risk parameters; their assets are custodied at third-party custodians of their choosing; and they make deliberate decisions about redemptions and contributions which are, in many cases, directed by separate boards of directors.

Moreover, asset managers are contractually and legally obligated as fiduciaries to make investment decisions that are appropriate for, and in the best interests of, each particular client based on the parameters and restrictions specified by their clients. Accordingly, AUM should be

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[62] Second Consultation, *supra* note 3, at 51.

[63] *Id.*

considered as a collection of distinct and separate mandates and pools of assets with idiosyncratic guidelines and risk tolerances and not as a single monolithic amount, over which an institutional asset manager has discretion.

Regulators have previously recognized that in the banking context, higher assets may reflect higher levels of lending for a bank, and potentially higher risks to the financial system from a default of that bank. However, for an asset manager, greater assets under management result in higher fees for the manager, increased resources for important functions such as risk management and operations, and greater efficiencies for its clients through economies of scale, which are collectively indicative of greater stability – not increased risk.[64] Moreover, the recent IMF report's finding reaffirms the idea that the size of an asset manager does not increase the average contribution of systemic risk.[65]

- ***Transmission channels***

1) Counterparty transmission channel

We do not believe the Second Consultation's postulation that asset managers can transmit systemic risk through the counterparty channel is valid. As stated above, asset managers typically do not function as principals, and as such, do not have counterparty exposure. While asset managers may arrange derivatives exposure for their clients, those contractual arrangements are between the client and the counterparty. As such, should an asset manager fail, the obligations in a client trading agreement would still be enforceable between the client and its counterparties.

2) Asset liquidation/market channel

Similarly, we do not believe the asset liquidation/market channel is applicable as a possible transmission channel of systemic risk for traditional asset managers. As the Second Consultation concedes, "asset managers tend to have small balance sheets and the forced liquidation of their own assets would not generally create market disruptions."[66] The IMF, in its recent evaluation of the asset management industry, found that the balance sheets of asset managers are in fact much smaller than the clients for whom they manage money.[67] Moreover,

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64 In fact, Moody's Investors Service has proposed a new methodology for evaluating the credit quality of asset managers. In that proposal, Moody's notes that "[a]sset management tends to be a highly profitable business evidenced by average industry margins in the high 20s (%) due to a high proportion of variable costs to fixed costs, which provides flexibility in maintaining high levels of profitability in all types of market conditions." Moody's Investors Service, Request for Comment: Global Rating Methodology for Traditional and Alternative Asset Managers, 10 (Oct. 15, 2013).

65 IMF, Global Financial Stability Report: Navigating Monetary Policy Challenges and Managing Risks, at 115.

66 Second Consultation, *supra* note 3, at 48.

67 IMF, Global Financial Stability Report: Navigating Monetary Policy Challenges and Managing Risks, at 114, n.33.

asset managers, given their agent function, typically do not have significant "off-balance sheet activities," despite the (unsubstantiated) claims made by the Second Consultation.

The Second Consultation also theorizes that asset managers could transmit risk should an asset manager run into financial distress because of operational or reputational issues, which could translate into substantial redemptions from the funds it advises.[68] We have not observed this in practice, and in fact, over the past twenty five years, only a handful of traditional asset managers with meaningful assets have closed - and all did so with little systemic impact. Moreover, as discussed previously, the data shows that U.S. asset managers have been able to handle redemptions during different market events without problem.[69] In fact, PIMCO's own experience typifies this point. In connection with the transition of senior management in September 2014, the Total Return Fund absorbed $23.5 billion and $27.5 billion in net redemptions in September and October of 2014, respectively, much of which was specifically concentrated in the days following the transition. As discussed previously, PIMCO was able to meet these redemptions while also maintaining risk exposures and maintaining and dynamically replenishing its cash buffer in the fund. We are not aware of any material impact this may have had on the industry, let alone the financial system as a whole.

If in theory, however, an asset manager were to face financial distress and see commensurate redemptions, there are many tools available to the asset manager – and specifically to the funds they advise – to mitigate any deleterious impact. Indeed as laid out in the First Consultation, investment funds have ways to meaningfully control drastic redemption activity in extreme events, which can include, depending on the national regulation, "swing pricing, anti-dilution levies, redemption gates, side-pockets, redemptions in kind or temporary suspensions."[70] Moreover, should a fund board become concerned about an asset manager's ability to manage a fund, the fund board could simply terminate the manager and select a new adviser to manage the fund assets, merge a fund's assets with another similarly managed fund or decide to orderly liquidate the assets and return them to the underlying investors. While these are not common practice, they remain important tools should an asset manager face distress.[71]

Similarly, should a client become concerned about an asset manager's ability to manage portfolios, the client can simply terminate the asset manager's trading authority and transfer that authority to another manager, transition manager or simply manage the assets in-house. This transition process is straightforward, happens with regular frequency, and can be executed on an immediate basis if need be, since a client's assets are held at a third party custodian account, which exist independently from the asset manager. As such, should an asset manager run into

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[68] Second Consultation, *supra* note 3, at 49.

[69] *See* ICI Response to the FSOC's Notice Seeking Comment on Asset Management, *supra* note 39, at 29.

[70] First Consultation, *supra* note 5, at 30.

[71] These various tools at a fund board's discretion were outlined in the First Consultation. *Id.* at 30.

distress, the client's assets would remain at the custodian without disruption. Importantly, under this scenario, neither the manager nor the custodian would be forced to liquidate a client's assets

3) *Substitutability channel*

Lastly, as discussed above, the asset management industry is highly substitutable and competitive with a HHF Index of 481 as of December 2013. Moreover, a recent McKinsey & Company report notes that the competition within asset management is "fierce" but also dynamic: according to the report, four of the top 10 firms who had attracted the most retail mutual fund flows between 2004 and 2008 fell off the leaderboard over the subsequent five years.[72]

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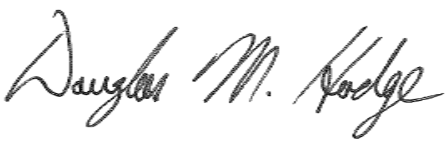
We thank the FSB for allowing us to comment on the Second Consultation and appreciate in advance the FSB's diligent consideration of these comments. Please feel free to contact us if we can provide any assistance to you in the further evaluation of these very important issues.

Sincerely,



Douglas M. Hodge
Chief Executive Officer

[72] McKinsey & Company, The New Imperatives: Gaining An Edge in North American Asset Management, (Dec. 2014).

APPENDIX

PIMCO's Views on Materiality Thresholds and Indicators

As discussed in more detail above, PIMCO strongly believes the FSB should focus on asset management activities that could potentially give rise to systemic risk rather than regulation of individual entities. Moreover, we believe that entity designation would have vast unintended consequences by establishing inconsistent regulatory regimes for participants within the asset management industry and by raising costs and limiting choice for investors – all without creating any discernible benefit in terms of a reduction of systemic risk. To that end, we disagree with the proposed materiality thresholds as well as the indicators proposed in the Second Consultation. Below we expand on the areas that we believe are particularly deficient, focusing primarily on the thresholds and indicators for investment funds.

<u>Materiality thresholds for investment funds</u>

We do not believe the size of an investment fund is correlated with the risks it may pose to the financial system. The Second Consultation provides no support for the presumption that investment funds or asset managers pose higher risks merely based on the fact that their NAV or AUM, respectively, exceeds an arbitrary threshold. Indeed, the First Consultation concedes the size threshold is based on an unproven "theory."

Nevertheless, the two materiality threshold options ("Option 1" and "Option 2") for investment funds proposed in the Second Consultation continue to adhere almost exclusively to a size construct. Although Option 1 attempts to include a leverage component in its calculation, it does so arbitrarily and is not based on any analysis or connection to any current regulatory standard. Indeed, the proposed 3:1 leverage ratio is as arbitrary as the $100 billion of AUM threshold also included under Option 1. Moreover, the 3:1 leverage ratio is vastly lower than any other globally recognized leverage ratio; for instance, it is significantly lower than that promulgated by the FSOC, which is 15:1 on $50 billion of assets, or by Basel III, which puts forth a minimum total leverage ratio of 3% on total assets. Without any justification, the materiality threshold for investment funds seems to propose a significantly lower leverage ratio for no other apparent reason than to cast the widest net possible to capture a large number of investment funds.

Additionally, we find the $200 billion threshold in gross assets under management ("GAUM") in Option 2 to be similarly inappropriate because it relies on the misguided gross notional exposure ("GNE") method. A leverage metric is only useful insofar as it actually measures risk, and by the Second Consultation's own admission, "an adjusted GNE may reflect better the actual risks posed by the investment portfolio" than that of an unadjusted GNE.[73][1] Accordingly, we believe GNE should be adjusted to take into account duration, netting agreements as well as whether or not derivatives are centrally cleared. Indeed, these adjustments are consistent with the approach put forth in the Basel III framework, which makes

[1] Second Consultation, *supra* note 3, at 39.

allowances for both the maturity profile of securities as well as for netting agreements. [2] We believe an adjusted GNE should be used for all relevant indicators and thresholds.

Further, while we appreciate that Option 2 tries to incorporate a relative size metric, we do not agree with the way in which it purports to do so. Both the substitutability and fire sale approaches are too ambiguous and seem to be set exceedingly low for no apparent empirically-based reason. Moreover, the data upon which these metrics rely (e.g., average trading volume) is often difficult to source for the fixed income market (for instance, much of the data from TRACE is not complete and often is reported with a lag). We believe that a much more efficient and less ambiguous way to identify potential 'dominant players' in the market would be to identify those funds that are benchmarked against a large index (measured by market capitalization) and have an NAV that is a substantial percentage of that index. We also believe that the FSB should consider the size of the derivatives market linked to the underlying market/index of a particular fund as well as the size of the fund relative to the universe of funds that invest in a similar strategy. Lastly, we believe that the diversification of a fund is a key consideration that has failed to be incorporated in either option; typically, the more diverse a fund is, the less impact it would have on any one asset class.

Interconnectedness indicators

We have concerns about the over-reliance on the GNE methodology in this section, and for the reasons in section V, we do not believe that GNE is a good assessment of risk, especially within the fixed income market. As the Second Consultation concedes, "portfolios with large derivatives positions will usually exhibit a ratio of GNE to NAV that is significantly larger than what financial leverage alone would show." We would advocate for the FSB to use an adjusted GNE metric, which would result in a measure that is more reflective of true risks to the system.

In addition to over-reliance on unadjusted GNE, certain of the terms used throughout the interconnectedness indicators are ambiguous. For instance, we are unsure whether regulators would measure "total net current credit exposure" at the fund level or on a per counterparty basis. Because investment funds manage counterparty exposure at the agreement level with each broker, it would be inappropriate to measure "total net current credit exposure" at the aggregate investment fund level. Typically, the more counterparties an investment fund has, the less exposure each counterparty will have to the investment fund, as the risk of default in the market is diffused. Therefore, a total net number across counterparties is not a meaningful indicator. Each counterparty exposure should be looked at on a per counterparty basis. Any counterparty that does not have a meaningful exposure to an investment fund should not be considered as a factor that contributes to systemic risk. Moreover, the Second Consultation should consider risk management and other practices, such as daily mark-to-market collateralization, that asset managers put into place to reduce overall counterparty risk.

Substitutability indicators

[2] *See* Basel Committee on Banking Supervision, Basel III leverage ratio framework and disclosure requirements (Jan. 2014).

The discussion on substitutability seems to be overly reliant on undefined metrics, such as daily trading volume and turnover, which we do not believe are necessarily reflective of systemic risk. For one, daily trading volume is not a reliable metric as it can be difficult to obtain and inaccurate for many sectors within the fixed income market and is often measured on a lag. Moreover, since it is a short-term measure, daily trading volumes can be misleading as they may be driven by technical factors and may not capture more secular changes in trading activity. Additionally, not all fixed income instruments trade on a daily basis because of their more bespoke nature. As a general matter, we believe using the underlying size of a sector's market capitalization is a more stable metric than daily trading volume.

Similarly, we do not believe turnover as described in the Second Consultation is an effective metric, as a fund's turnover can be skewed by transactions that are simply maintaining exposures in a portfolio, such as the rolling of futures or to-be-announced securities. Generally, data suggesting the relevance of these indicators would need to be provided to show that a fund with a high turnover ratio and trading volume would cause a market disruption should it fail. Should the FSB find it necessary to keep this indicator, it should consider adopting a definition of turnover that excludes short-term securities, derivatives, and sale buy-backs.

Additionally, we believe it is important that the FSB consider the number of funds that exist for the same mandate and the relative size of those funds (measured as market value). While a fund may be the largest of its type, it may be small relative to the overall universe of funds in a sector. As such, it would be easily substitutable by other managers (via in-kind transfers of assets, etc.).

Complexity indicators

The Second Consultation's efforts to measure complexity also fall short in several ways. For one, the Second Consultation does not sufficiently define what it means by "liquidity" or how it would purport to measure the "time needed to liquidate a proportion of an investment fund at reasonable prices."[2] Liquidity is a nebulous and dynamic concept and is not necessarily intrinsic to a specific instrument. Moreover, where the Second Consultation is more defined, it adheres to liquidity concepts as promulgated by Basel III.[3] We believe applying a bank-like construct as it pertains to the measurement of liquidity merely underscores the FSB's lack of understanding of the mutual fund industry, which unlike banks, do not materially engage in leverage and do not promise a return *of* invested capital.

This section also adheres to the undefined – and we believe misguided – notion of relative trade volumes for non-centrally cleared derivatives. A fund's relative trade volumes of derivatives are not necessarily indicative of the fund's positioning or of its risks – in fact, trade volumes can be skewed by "maintenance trades" (i.e., trades used to maintain specific positions), such as rolling overnight repurchase agreements or futures positions.

[3] Second Consultation, *supra* note 3, at 43.

[4] Second Consultation, *supra* note 3, at 44.

Further, this section fails to appreciate how dynamic liquidity management is in practice and how metrics that typically are used in a vacuum to provide a snapshot of liquidity, such as "unencumbered cash," generally fall short in providing an accurate indication of a fund's liquidity. Indeed, cash buffers are managed on a daily and intra-day basis and are dependent on positioning, investor activity, and market movements; as such, a snapshot of cash at a particular time may not give regulators an accurate reflection of a fund's liquidity profile.

Cross-jurisdictional indicators

The Second Consultation cites no empirical data that proves funds that invest more globally could have a greater impact on systemic risk. The Second Consultation does not establish the fundamental premise that any one fund would have an impact domestically, much less globally.

As it relates to counterparties across jurisdictions, we believe this would only be applicable should regulatory regimes be disparate, and even then, it would not necessarily reflect that there is systemic risk. Other regulators have already taken steps to alleviate potential cross-jurisdictional issues facing global firms, as recent agreements between the CFTC and multiple international regulators call for substituted compliance regarding certain swaps regulations. To date, the CFTC has reached substituted compliance determinations for six jurisdictions: Australia, Canada, the EU, Hong Kong, Japan, and Switzerland.[4] Even more, jurisdictions across North America and Europe are beginning to implement legal entity identifiers to track swaps activities across borders.[5] As such, cross jurisdictional activities present far less risk than in the past. However, given the ever increasing transparency of these activities, we believe an analysis should first be conducted of such information to conclude that cross-jurisdictional activities even give rise to systemic risk concerns and even if there are such concerns, the home regulatory should be given deference to consider and develop an appropriate regulatory regime in those instances.

Other considerations

As we advocated in our response to the First Consultation, we believe that any assessment methodology must consider the adequacy and robustness of an investment fund's current regulatory regime in an effort to evaluate whether existing regulatory oversight can

[4] *See* Comparability Determination for Australia: Certain Entity-Level Requirements, 78 Fed. Reg. 78864 (Dec. 27, 2013); Comparability Determination for Hong Kong: Certain Entity-Level Requirements, 78 Fed. Reg. 78852 (Dec. 27, 2013); Comparability Determination for Japan: Certain Entity-Level Requirements, 78 Fed. Reg. 78910 (Dec. 27, 2013); Comparability Determination for Japan: Certain Transactional-Level Requirements, 78 Fed. Reg. 78890 (Dec. 27, 2013); Comparability Determination for Switzerland: Certain Entity-Level Requirements, 78 Fed. Reg. 78899 (Dec. 27, 2013); Comparability Determination for Canada: Certain Entity-Level Requirements, 78 Fed. Reg. 78839 (Dec. 27, 2013);, Comparability Determination for the European Union: Certain Entity-Level Requirements 78 Fed. Reg. 78923 (Dec. 27, 2013); Comparability Determination for the European Union: Certain Transaction-Level Requirements 78 Fed. Reg. 78878 (Dec. 27, 2013), each available at http://www.cftc.gov/LawRegulation/DoddFrankAct/CDSCP/index.htm.

[5] *See* Swap Data Recordkeeping and Reporting Requirements, 17 C.F.R. § 45.

sufficiently mitigate any perceived systemic risks and to avoid redundant, superfluous, and possibly conflicting regulation by multiple regulators. The FSB also should avoid encroaching on an investment fund's home regulator if that regulator has a history of effectively regulating the industry and has an expertise beyond that of other regulators.