

P I M C O

April 9, 2021

Vanessa Countryman
Secretary, Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Staff Statement on Investment Company Cross Trading

Dear Secretary Countryman:

Pacific Investment Management Company LLC (“PIMCO”) appreciates the opportunity to respond to the U.S. Securities and Exchange Commission’s (“SEC” or “Commission”) statement and request for feedback (the “Staff Statement”) regarding investment company cross trading pursuant to Rule 17a-7 under the Investment Company Act of 1940, as amended (“1940 Act”).¹ PIMCO supports the Commission in its efforts to clarify and enhance the regulatory regime governing fund cross trading.

PIMCO is registered as an investment adviser with the SEC. As of December 31, 2020, PIMCO managed approximately \$2.21 trillion in assets on behalf of millions of individuals and thousands of institutions in the U.S. 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 open- and closed-end funds registered under the 1940 Act (collectively, “Funds”), separately managed accounts in accordance with specific investment guidelines and objectives specified by our clients, and private funds that are offered to institutional and individual investors, including funds that are Undertakings for Collective Investments in Transferable Securities.

I. Background

PIMCO is a leading provider of investment management services to fixed income Funds, as well as Funds investing in other asset classes such as equities and commodities, and employs a broad range of portfolio management tools in seeking to manage risk, capitalize on market inefficiencies and execute alpha-seeking strategies consistent with a fund’s investment objective. In particular, when in the best interests of its clients and consistent with Rule 17a-7 and applicable policies and procedures, PIMCO engages in cross-trading of Fund portfolio securities. As described below, “cross trades,” or trades between accounts with the same investment manager, are an important tool in the management of investment portfolios.

¹ Staff Statement on Investment Company Cross Trading, Division of Investment Management Staff (March 11, 2021), *available at* <https://www.sec.gov/news/public-statement/investment-management-statement-investment-company-cross-trading-031121>.



A. Benefits of Cross Trades

Cross trades provide significant benefits to the Funds and their shareholders, including allowing the Funds and their shareholders to avoid millions of dollars annually in transaction costs, and inefficiencies that would result if the same transactions were effected in the market through an intermediary. As discussed in more detail below, the new definition of “readily available market quotation” adopted under Rule 2a-5 will effectively prohibit the cross-trading of most fixed income securities. Prohibiting the cross trading of fixed income securities would create real and tangible costs for investors as a result of the imposition of spreads and dealer mark-ups by securities dealers on fixed-income trades effected in the market that are not incurred when securities are cross traded. In addition to the explicit costs, there would be potential harm done to shareholders as a result of the impact on investment opportunities and overall market liquidity. These negative impacts include the loss of investment opportunities for shareholders in a fund complex once a security is sold since there is no certainty that such security, once sold, will be available for purchase by another fund at a later date. In fact, it is our experience that often securities that are sold by a particular fund (e.g., to meet a redemption request or maintain guideline compliance) would be highly attractive to another fund and would not be available to such fund or its shareholders without the ability to cross trade. As a result, shareholders would lose a valuable investment opportunity. In addition, as the Commission is aware, the current market structure of fixed income trading remains largely intermediated. Funds, therefore, are dependent on banks’ (i.e., dealers’) availability, spread, inventory and willingness to make markets, which during market volatility can lead to reduced liquidity and increased costs in the marketplace for funds selling fixed income securities. Regulatory changes adopted over the past decade have further contributed to a reduction in banks’ trading balance sheets, which may lead banks to be more reluctant to make markets in various securities and increase total transaction costs in the future. Cross trades are therefore an important tool for managing liquidity in the Funds, particularly in volatile markets, such as the market environment that occurred in March and April 2020. During that period, elevated costs in the form of wide bid/ask spreads increased costs for Funds and their shareholders. Prohibiting cross trades of fixed income securities would take a valuable tool away from investment managers, and to the further detriment of shareholders.

In accordance with its fiduciary duties to its clients and with the requirements of Rule 17a-7, PIMCO only engages in cross trades on behalf of clients when such transactions are in the best interests of both the buying and selling parties. If it would be in the best interests of either party to the transaction to instead effect the trade in the market, PIMCO would do so.

B. PIMCO Cross-Trading Practices

i. Valuation of Instruments to be Cross Traded

PIMCO predominantly cross trades the following types of instruments: U.S. Treasury securities, corporate debt securities of U.S. and non-U.S. issuers, including investment grade and high yield fixed income instruments, and certain securitized products. For cross trades of fixed income

securities, including, but not limited to the types of securities listed above, PIMCO generally seeks to obtain bids and offers from independent dealers known to be familiar with the security in question. PIMCO takes reasonable measures to confirm that dealer quotes are reliable, generally based on the experience and knowledge of the PIMCO portfolio management team involved in executing the 17a-7 transaction. Cross trades of fixed income instruments are then typically effected at the average of the highest bid and the lowest independent offer received, in accordance with Rule 17a-7(b)(4) and applicable policies and procedures.

ii. Policies and Procedures Governing Cross Trades

The Funds have adopted procedures pursuant to Rule 17a-7 (“Fund Policy”) to ensure that purchase and sale transactions between a fund and eligible affiliates are effected in accordance with the requirements of Rule 17a-7. The Fund Policy sets forth the requirements of Rule 17a-7, including the requirements under Rule 17a-7(b) regarding what constitutes the “current market price” of an instrument and what is required in order to conduct a “reasonable inquiry” into the current market price. The Fund Policy also requires that PIMCO maintain records to support the inquiry conducted and to support the price used to effect the cross trade. Additionally, the Fund Policy requires that the cross trade be consistent with the parties’ respective investment policies and restrictions and be in the best interests of both the selling and buying parties, and that PIMCO maintain specific records regarding each cross trade. Finally, the procedures implementing the Fund Policy prohibit the cross-trading of certain securities, including fair valued securities and securities determined by PIMCO to be illiquid.

Pursuant to the Fund Policy, the Boards of Trustees of the Funds oversee the Funds’ compliance with Rule 17a-7 and, consistent with SEC no-action relief, receive a quarterly representation from the Funds’ Chief Compliance Officer that all Rule 17a-7 transactions were effected in compliance with the procedures. The Funds’ Chief Compliance Officer also reports to the Board on a quarterly basis regarding aggregate cross-trading activity and any compliance issues relating to Rule 17a-7 cross trades during the quarter. We believe that these protections protect shareholders from abuses while maintaining shareholder benefits of cross trades.

II. Expected Impact of Rule 2a-5 on Fixed Income Cross Trades

On December 3, 2020, the SEC adopted Rule 2a-5 under the 1940 Act, governing certain fund securities valuation practices.² Rule 2a-5 provides that, for purposes of Section 2(a)(41) of the 1940 Act, a market quotation is “readily available” only when that “quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable.”³ This language is consistent with language defining “level 1” inputs in the three-level fair value hierarchy of Financial Accounting Standards Board Accounting Standards Codification Topic

² 17 C.F.R. 270.2a-5. *See also* Good Faith Determinations of Fair Value, Investment Company Act Rel. No. 34128, 86 F.R. 748 (Jan. 6, 2021) (“Rule 2a-5 Adopting Release”).

³ 17 C.F.R. 270.2a-5(c); *see also* Rule 2a-5 Adopting Release at 790.

820. Furthermore, the discussion of the definition in the Rule 2a-5 Adopting Release (the “Rule 2a-5 Definition”) explicitly states that the SEC interprets the term “readily available market quotation” to encompass only securities whose values are determined solely by GAAP level 1 inputs.⁴ The Rule 2a-5 Adopting Release goes on to say, unequivocally, that the SEC “[does] not believe that securities valued with level 2 inputs are consistent with the definition of readily available market quotations.”⁵ To our knowledge, this is the first time the SEC or its Staff have advanced this position.

Most fixed income securities are classified as level 2 or level 3 securities for U.S. GAAP purposes, meaning they do not necessarily have daily market pricing data (quoted prices) available and are priced for net asset value purposes using models that incorporate other observable data (in the case of level 2 securities) or are priced based on an estimation process (in the case of level 3 securities). The language in the Rule 2a-5 Adopting Release and the application of the Rule 2a-5 Definition for purposes of Rule 17a-7 would therefore preclude funds from engaging in cross trades of most fixed income securities, because under the Rule 2a-5 Definition, such securities would not have a “readily available market quotation.”

A. Expected Impact of the Rule 2a-5 Definition on the Funds

At any given time, all or substantially all of the fixed income securities held by the Funds are classified as level 2 or level 3 securities for U.S. GAAP purposes. Accordingly, the application of the Rule 2a-5 Definition for all purposes under the 1940 Act, including Rule 17a-7, would negatively impact a common trading mechanism used by the Funds (and in the industry) by eliminating their ability to cross-trade all or substantially all fixed income portfolio holdings using independent bid and offer prices. We believe that this would result in substantial costs and potential negative market effects for the Funds and their shareholders. As discussed above, these costs and impacts include: the imposition of spreads by securities dealers on fixed income trades that are not incurred when securities are cross-traded; the market impact of having to sell securities in the market; the liquidity impact to the market and to individual funds of having to sell securities in the market; and, the loss of investment opportunities for shareholders in a fund complex once securities are sold in the market.

III. Conclusion and Recommendations

We believe the best course of action for the SEC and the Staff would be to permit funds to continue to cross trade fixed income instruments in a manner consistent with the terms of Rule 17a-7(b)(4) and with longstanding industry practice. Consistent with the U.S. SEC Fixed Income

⁴ Rule 2a-5 Adopting Release at 771-72 (noting that the definition of readily available market quotation “is consistent with the definition of a level 1 input in the fair value hierarchy outlined in U.S. GAAP” and that “under the final definition, a security will be considered to have readily available market quotations if its value is determined solely by reference to these level 1 inputs”).

⁵ *Id.* at 772.

Market Structure Advisory Committee recommendation, we believe such instruments should be limited to those classified as level 2 securities for U.S. GAAP purposes.⁶

The current criteria sufficiently and appropriately protect against conflicts of interest that may arise in the execution of cross trades. Advisers are subject to a fiduciary duty and fund board oversight, as well as explicit provisions of Rule 17a-7, to only execute cross trades that are in the best interests of both the buying and selling clients and that are in accordance with the clients' investment policies. Furthermore, the specific valuation guidelines provided in Rule 17a-7 ensure that the buying or selling client is not paying too much or receiving too little, respectively, for the security being crossed. Additionally, funds are subject to existing guidance limiting quotes utilized for cross trades to those that are actionable,⁷ which protects shareholders when funds utilize cross trades. In addition, as described in more detail above, the Funds have adopted policies and procedures that are designed to protect shareholders from abuses while maintaining shareholder benefits of cross trades.

To the extent the SEC and Staff determine to pursue a rulemaking process to amend the requirements of Rule 17a-7 to address these issues, we generally support the recommendations set forth by the Investment Company Institute and the Securities Industry and Financial Markets Association in their comment letters in response to the Staff Statement.

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We thank the SEC for allowing us to comment on the Staff Statement and appreciate in advance the SEC'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,



Emmanuel Roman
Chief Executive Officer

⁶ Recommendation Regarding Modernizing Rule 17a-7 under the 1940 Act, U.S. SEC Fixed Income Market Structure Advisory Committee (June 1, 2020).

⁷ The adopting release for Rule 22e-4 under the 1940 Act ("Rule 22e-4 Adopting Release") states that "indications of interest" or "accommodation quotes" may not reflect current market values of the securities and thus are not "market quotations or market values for the purposes of Rule 17a-7." The Rule 22e-4 Adopting Release continues by noting certain safeguard which may be used to assess the quality of a quotation provided by a dealer, such as the activity of the dealer in the relevant market and subjecting less liquid assets to careful (and potentially heightened) review by the adviser. Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315, 81 F.R. 82142 (Nov. 18, 2016).