PIMCO

Via Electronic Submission

May 8, 2023

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

Re: Safeguarding Advisory Client Assets, File Number S7-04-23

Dear Secretary Countryman:

Pacific Investment Management Company LLC ("PIMCO") appreciates the opportunity to comment on the U.S. Securities and Exchange Commission's ("SEC" or "Commission") proposal regarding investment adviser safeguarding of client assets (the "Proposal").[1]

PIMCO is registered as an investment adviser with the SEC and as a commodity trading advisor and a commodity pool operator with the U.S. Commodity Futures Trading Commission ("CFTC"). As of March 31, 2023, PIMCO managed approximately $1.8 trillion in assets on behalf of millions of individuals and thousands of institutions in the United States and globally, including state retirement plans, unions, university endowments, corporate defined contribution and defined benefit plans, and pension plans for teachers, firefighters, and other government employees. PIMCO manages registered investment companies offered to institutional investors and individual savers and retirees, private funds, and thousands of separately managed accounts in accordance with specific investment guidelines and objectives specified by our clients.

I. Executive Summary

PIMCO appreciates the Commission's efforts to modernize the custody and safekeeping regime under the Investment Advisers Act of 1940, as amended ("Advisers Act"). However, the Proposal would vastly expand the reach of the custody rule by defining custody to encompass all investment positions in a client's account and, without an apparent historical basis justifying the change, all discretionary investment authority. We have significant concerns that, in doing so, the Proposal paints with too broad a brush. In particular, in taking a one-size-fits-all approach, the Proposal fails to account for important characteristics of various types of client relationships and investments that make the onerous new requirements of the Proposal unnecessary and unjustified in those contexts. To the extent the Commission has concerns about specific assets or financial instruments that carry heightened risk of loss or misappropriation, such as digital assets, we believe it should focus its rulemaking on such assets.

[1] *See* Safeguarding Advisory Client Assets, SEC Rel. No. IA-6240, 88 Fed. Reg. 14672 (proposed Feb. 15, 2023) ("Proposing Release").

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Nonetheless, if the Commission proceeds with the Proposal, we believe that, with respect to institutional separately managed account clients ("Institutional SMAs") specifically, the proposed requirements will prove impractical and costly while contributing little to investor protection. As an investment adviser to thousands of Institutional SMAs investing in a wide range of assets and asset types, we believe it is imperative that we share our insights and expertise as the SEC contemplates these changes.

While we focus here on how the Proposal would affect Institutional SMAs, the Proposal would raise many additional and varied concerns across client relationships, including with respect to private funds and retail separately managed accounts. We urge the Commission to consider other commenters' letters articulating these concerns and to more appropriately tailor any final rule to avoid costly and unproductive changes to the Advisers Act custody regime.

In summary, we recommend that, at a minimum, the Commission make the following revisions to any final rule:

- In place of disruptive and impractical requirements applied indiscriminately across asset classes, the final rule should focus on ensuring that advisers have reasonably designed policies, procedures and internal controls to address risks related to safeguarding client assets. Both the Commission and advisers have substantial experience with similar types of approaches in other contexts, which could be leveraged in administering the safeguarding rule, and it would be a more effective, tailored and scalable approach in general. In particular, the Commission should apply an approach that relies upon adviser's policies, procedures and internal controls for the following aspects of the Proposal:
    - With respect to Institutional SMA clients, in place of the proposed requirement that an adviser deemed to have custody of client assets enter into a written agreement with the client's qualified custodian and obtain certain written assurances from the qualified custodian complemented by the adviser's maintenance of an ongoing reasonable belief of compliance.
    - With respect to financial contracts, loan interests or similar non-traditional investments, in place of applying safeguarding requirements that are inapposite for these types of investments.[2]
    - With respect to the independent verification requirements, to expand the exception from independent verification to include assets that settle on a basis other than delivery-versus-payment where an adviser is deemed to have custody simply because it has discretionary authority to trade client assets.

[2] For purposes of this letter, "financial contracts" refers to derivatives (futures contracts, options on futures contracts and swaps) and other similar contracts (*e.g.*, short sales, TBAs and other forward-settling securities transactions, and repurchase and reverse repurchase agreements, among others).

- The Commission should make the proposed privately offered securities exception more workable by:
    - Allowing an adviser to rely on its good faith judgment in determining whether an asset cannot be maintained with a qualified custodian.
    - Not adopting the proposed requirement for an accountant to verify promptly every transaction in a privately offered security, or at a minimum exempt an investment adviser from the requirement with respect to Institutional SMAs.
    - If the Commission determines to subject financial contracts, loan interests or similar non-traditional investments to the general scope of any final rule, excluding such instruments from the requirement for an accountant to verify promptly every transaction in those instruments.

Our recommendations arise from the following observations regarding the adverse impact of the Proposal in the Institutional SMA context, and how it can be better tailored to the characteristics of these clients:

- ***The Proposal fails to recognize and account for the degree and quality of engagement, diligence and oversight that Institutional SMA clients exercise with respect to their custodial arrangements.*** Inserting the investment adviser, through required contracts and assurances, into every relationship between sophisticated Institutional SMA clients and their custodians, without any evidence that such involvement is needed or welcome, would create costly and redundant requirements for little, if any, added protections for Institutional SMAs. We urge the Commission to exempt investment advisers from these requirements with respect to Institutional SMAs, subject to certain conditions discussed below.

- ***A more tailored approach to the Commission's concerns would be more effective and less disruptive, particularly with respect to Institutional SMAs. This alternative approach should be anchored on robust internal controls, with more prescriptive requirements only where necessary to target particular types of assets.*** The Proposal would impose, with respect to Institutional SMAs, a number of new requirements that would prove costly and also inhibit the kinds of investment activities in which Institutional SMA clients often seek to engage. These relationships, by their nature, already feature significant mitigants to the risks the Proposal seeks to address. Accordingly, we respectfully submit that, as an organizing principle, a more effective, tailored and scalable approach would leverage the Advisers Act's existing compliance rule requirements, with more prescriptive requirements limited to those assets with respect to which the Commission has specifically demonstrated a need. In particular, the Commission could address risks that it believes the current custody rule does not address, taking into account the nature of Institutional SMA relationships, by requiring reasonably designed policies and procedures for safeguarding client assets. Risk-based policies, procedures and internal controls offer a calibrated solution and would be implemented, maintained and monitored by experienced professionals and subject to

examination by Commission staff while avoiding redundant, ineffective, impractical and costly measures ill-suited to the Institutional SMA context.

- ***A broad-brush approach misses key distinctions across asset classes that account for critical differences in the potential for misappropriation and other safeguarding risks.*** We urge the Commission to reconsider the scope and application of the proposed rule. In particular, the Commission should configure the application of any final rule to recognize that the documentation, applicable regulatory framework, market practice and makeup of market participants with respect to certain investments, such as financial contracts and loan interests, result in a risk profile, from a safeguarding perspective, that is significantly different from other investments, such as widely-traded cash market instruments. If the Commission determines to subject investments like financial contracts and loan interests to the general scope of any final rule including the privately offered securities exception, we urge the Commission to exclude them from the requirement to verify promptly every transaction in a privately offered security in connection with the privately offered securities exception.

- ***The privately offered securities exception is essential to a workable rule, but the proposed approach would be impracticable in several respects.***

    - The Proposal would condition reliance on the privately offered securities exception on the adviser reasonably determining, and documenting in writing, that ownership of a privately offered security or physical asset cannot be recorded and maintained in a manner in which a qualified custodian can maintain possession or control of the asset (the "Reasonable Determination Requirement").[3] An adviser's obligation under the Reasonable Determination Requirement should be satisfied, and the adviser should be entitled to rely on the privately offered securities exception, where the adviser's determination is made in good faith. Absent such assurances that good faith determinations will not be second guessed, the exception risks being unworkable considering the broad range of asset classes for which determinations would be made.

    - The Proposal would require, in connection with the privately offered securities exception, notification from the adviser to an independent public accountant for each and every purchase, sale or other transfer of beneficial ownership of a privately offered security or physical asset within one business day followed by the independent public accountant promptly verifying each such transaction ("Notification and Verification Requirements").[4] The Notification and Verification Requirements would be impractical and costly. Although the Proposal appears to draw inspiration from audit concepts, the proposed approach incorporates no concept of materiality, imposing costly frictions on every single transaction in a privately offered security or physical asset that takes place in an advisory account. We urge the Commission not to adopt such a requirement as a condition to relying on the privately offered securities

[3] *See* proposed rule 223-1(b)(2)(i).
[4] *See* proposed rule 223-1(b)(2)(iii)-(iv).

exception. To the extent that the Commission deems it essential to include a form of the Notification and Verification requirement for at least certain client assets, the Commission should exempt an investment adviser from such requirements where the adviser adopts and implements reasonably designed policies and procedures and meets certain other conditions we describe below.

- ***The exception to the independent verification requirement for transactions that settle on a delivery versus payment basis ("DVP") is too narrowly drawn.*** While sweeping all discretionary investment authority into the scope of custody, the Proposal would provide an exception from the independent verification requirements for accounts where the adviser's trading authority is limited to assets that settle on a DVP basis ("Discretionary Authority Exception").[5] We believe that the Discretionary Authority Exception, as proposed, undervalues the safeguards inherent in many settlement processes (and related contractual arrangements) that settle on a basis other than DVP. The limitations on this exception also ignore the substantial client engagement, diligence, and oversight common among Institutional SMAs. We urge the Commission to permit reliance on the Discretionary Authority Exception with respect to client assets that settle on a non-DVP basis either where the adviser has adopted certain reasonably designed policies and procedures or where the account is an Institutional SMA and the client has provided certain representations to the adviser.

- ***Finally, the proposed compliance period is unrealistic in light of the complexity of the changes, the number of parties involved and the volume of Commission rulemaking that is likely to have overlapping compliance periods.*** The Commission should extend the implementation period for advisers with more than $1 billion in assets under management to at least three years following the rule's effective date.

While our discussion below focuses on key issues regarding how the Proposal would apply to Institutional SMAs and certain asset classes, the Proposal is sprawling and detailed in its reinvention of the custody rule. There are a number of other issues and points of concern that we do not take up here, but we encourage the Commission to carefully consider the letters of other commenters that have raised concerns. Among these issues are: the apparent exclusion from reliance on the privately offered securities exception for assets that are neither securities nor physical assets; continued limitations on the scope of client assets with respect to which a futures commission merchant ("FCM") may serve as a qualified custodian notwithstanding the proposed rule expansion and the acknowledged regulatory enhancements for FCMs;[6] the proposed limitations applicable to non-U.S. financial institutions that may serve as a qualified custodian; the impact of expanding the scope of custody to include discretionary investment authority on non-U.S. commingled investment vehicle clients, including those subject to substantial local regulation; and the misalignment of proposed client asset segregation requirements with bank custodial operating models.

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[5] *See* proposed rule 223-1(d)(3)(ii) and (b)(8).
[6] *See* Proposing Release at 14685-86.

II. Better Tailoring the Safeguarding Rule in the Institutional SMA Context

A. Agreement and Assurances Requirements

The Proposal would vastly expand the reach of the custody rule by replacing the long-standing and considered view that advisers do not have custody simply because of their ability to engage in authorized trading on behalf of a client with a position that extends the definition of custody to all discretionary investment authority. The impact of this change is compounded by the Proposal's expansion of the definition of assets to include all funds, securities, or other positions held in a client account. As a consequence, discretionary advisers to Institutional SMAs, which in many cases would not have custody under the current rule, would be newly deemed to have custody. This change alone is a radical shift in the application of the custody rule and one that the Proposal does little to justify with evidence that, under the current rule, Institutional SMAs have been exposed to the risks that the Proposal seeks to address.

Alongside this significant expansion in scope, however, the Proposal would also require each adviser to insert itself into the contractual arrangement between the client and the service provider selected by each client to serve as custodian. In particular, the Proposal would require a written agreement between each investment adviser deemed to have custody of client assets and the client's qualified custodian and for written assurances complemented by the adviser's maintenance of an ongoing reasonable belief of compliance (collectively, the "Agreement and Assurances Requirements"). The SEC acknowledges that the proposed requirements would substantially depart from current practices.[7] The Proposal asserts that this departure is necessary in order to help protect client assets and ensure standard custodial protections.[8]

However, we believe the proposed Agreement and Assurances Requirements would be significantly misaligned with the realities of advisers' business relationships with Institutional SMAs and their custodians and, while imposing significant new burdens, would not meaningfully enhance current investor protection. Institutional investors are sophisticated consumers of advisory and related services, including custody. They typically employ staff and other outside advisers, including investment consultants and legal counsel, that work with multiple investment advisers and select and oversee a number of custody accounts. In addition to periodic reporting provided by their investment advisers as well as other third-party reporting and portfolio analysis, institutional investors request and obtain detailed and regular reporting and data feeds from the custodian that they believe best protect their interests.

Institutional investors are, thus, well-situated to determine and obtain the information and contractual protections they deem necessary and appropriate to their oversight. Inserting the adviser into these arrangements is impractical and would impose significant upfront and ongoing expense for little, if any, added protections for these institutional clients. For example, the judgment and contractual leverage of well-resourced institutional investors concerning due care and indemnification protections from their custodians would be little served by redundant

[7] *See* proposed rule 223-1(a)(1)(i), (ii); Proposing Release at 14691.
[8] *See* Proposing Release at 14691.

assurances provided by the custodian to the adviser, a party that may not be in a position to enforce such protections in any case.[9]

Moreover, qualified custodians have little incentive to accede to the Agreement and Assurances Requirements. The custodial business is designed around scale, relying on standardized terms that allow custodians to routinize operations and manage their potential liabilities. The Agreement and Assurances Requirements up-end this business model, insisting that qualified custodians take on new responsibilities and negotiate customized contracts. Even assuming that qualified custodians could or would accommodate these changes, they are likely to come at significant costs to compensate the custodians both for the expanded legal review and operational demands as well as any potential increase in liability, which costs are likely ultimately to be borne by clients. In the case of Institutional SMAs, where the clients have a long history contracting with and monitoring custodians, these added costs come with little in the way of potential new benefits.

We appreciate that the SEC, in proposing these changes, is seeking to mitigate a perceived risk of loss, misuse, misappropriation, theft or exposure to the adviser's financial reverses. However, we believe that the SEC could more effectively accomplish these goals with a different approach that is also less costly and impractical. Specifically, if the SEC adopts the Agreement and Assurances Requirements, the SEC should take an approach with respect to Institutional SMAs that recognizes the existing risk mitigants in these advisory relationships and focus instead on the adviser's policies, procedures and internal controls.[10] By leveraging the Advisers Act's existing compliance rule, the SEC could draw on advisers' decades of experience with developing, implementing and overseeing compliance processes and structures, as well as the SEC staff's decades of experience with examining advisers' compliance programs, and avoid creating redundant, ineffective and costly new requirements for the relationship between an adviser and each of its Institutional SMA clients' custodians.

The Proposal already recognizes the value of this approach in requiring that an adviser relying on the privately offered securities exception reasonably safeguard client assets. In this context, we believe the SEC could create a general requirement for reasonably designed policies, procedures and internal controls and provide guidance regarding potential approaches, which advisers could adopt and implement as appropriate based on their particular risks and characteristics. Reasonably designed policies, procedures and internal controls concerning custody of Institutional SMA assets could include, for example, segregation of duties (e.g., operational duties from investment decision-making), controls for onboarding brokers and counterparties, and periodic review and reconciliation of client accounts coupled with periodic checks to confirm internal compliance with such policies, procedures and controls.

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[9] *See* Proposing Release at 14692 ("[W]e view the safekeeping protections in the proposed reasonable assurances requirements to be duties owed primarily to the client.").

[10] The SEC has recently made a similar adjustment to a proposed rule, recognizing the challenges associated with requiring certain written agreements and adopting a policies and procedures alternative. *See* Shortening the Securities Transaction Settlement Cycle, SEC Rel. No. 34-96930, 88 Fed. Reg. 13872 (adopted Feb. 15, 2023) at sections III.B.5 ("Challenges Associated With Requiring Written Agreements in Support of Increasing Same-Day Affirmations") and III.C.2 ("New Policies and Procedures Alternative to Written Agreements Requirement").

Accordingly, we believe that any adoption should (at a minimum) exempt an investment adviser from the Agreement and Assurances Requirements, and instead permit the adviser to rely on the policies, procedures and internal controls described above, with respect to any client the assets of which the adviser is deemed to have custody, where such client:

1. Is a "qualified purchaser" under the Investment Company Act of 1940 (the "1940 Act") and is not a commingled investment vehicle that the adviser manages; and

2. Provides a written representation to the adviser that the client has entered into a written agreement with one or more qualified custodian(s) for the maintenance of the relevant client assets, which requires the qualified custodian to send account statements, at least quarterly, to the client, or its independent representative, identifying the amount of each client asset in the account at the end of the period and setting forth all transactions in the account during that period, including investment advisory fees.

If the SEC believes additional safeguards are necessary, it could accompany this proposed exception with requirements that: (i) the adviser has a reasonable basis for believing that the client entered into such arrangement(s) of its own accord and without the recommendation or involvement of the adviser; and (ii) the client has represented to the adviser that the client: (a) has such knowledge and experience in financial and business matters, or employs or is represented by others who have such knowledge and experience in financial and business matters, as may be appropriate to select and contract with a qualified custodian; and (b) will inform the adviser of material changes impacting these representations.

B. Safeguarding Rule and Certain Non-Traditional Investments

PIMCO frequently has authority to transact in various non-traditional investments, such as financial contracts and loan interests, on behalf of its Institutional SMA clients. Although the Proposal's broad sweep likely would capture such investments,[11] we believe that applying the substantial new requirements to advisers managing such assets is unnecessary and will afford little, if any, added protection. We urge the Commission to reconsider the scope and application of the proposed rule and configure the application of any final rule to recognize that the documentation, applicable regulatory framework, market practice and makeup of market participants with respect to financial contracts and loan interests, for example, result in a risk profile, from a safeguarding perspective, that is significantly different from other investments, such as widely-traded cash market instruments.

The Commission's "overarching principle" for applying the proposed rule is that it should be applied "when an adviser has the ability or authority to effect a change in beneficial ownership of a client's assets," *i.e.*, when the adviser "can subject a client's assets to the risks of loss, misuse, misappropriation, theft, or financial reverses of the adviser."[12] This is precisely the point of departure for non-traditional investments like financial contracts and loan interests. For example, clearinghouse rules prevent the transfer of futures, options on futures and cleared swaps, and

[11] *See, e.g.*, Proposing Release at text accompanying n.59 ("Assets under the rule also would include financial contracts held for investment purposes . . . and other assets that may not be clearly funds or securities covered by the current rule.").

[12] Proposing Release at 14679.

exiting such a contract on a client's behalf would require a separate transaction.[13] Counterparty consent would be needed for the transfer of an over-the-counter ("OTC") swap, and the extensive steps involved in trading OTC derivatives (*e.g.*, counterparty credit analysis and negotiation of documentation) virtually eliminate the ability of an adviser (or any other party) to misappropriate an OTC swap. Likewise, we agree with previous commentary on the custody rule that, "the settlement process for the transfer of [bank loan interests] includes extensive documentation and the involvement of several [third] parties, [such as an independent administrative agent,] all of which serve to limit the adviser's role and mitigate the risk of an adviser's misappropriation or self-dealing."[14] Moreover, possession or control of the documentation related to such instruments (*e.g.*, the statement delivered to the counterparty concerning a cleared swap, or the confirmation between the parties in an OTC swap transaction) provides no "ability or authority to effect a change in beneficial ownership of a client's assets."

Because these features of non-traditional investments already afford significant protections against the risk of loss, misuse, misappropriation, theft or exposure to the adviser's financial reverses in such instruments, we believe that the Commission should not subject these instruments to the requirements of the Proposed Rule. The Commission should, instead, address any residual concerns through a focus on the adviser's policies, procedures and internal controls. Based on the adviser's reasonable and good faith assessment of such residual risk, the adviser could be required to adopt and implement reasonably designed policies, procedures and internal controls with the features described above. In light of the existing protections for the underlying instruments in non-traditional investments discussed above, an appropriate focus of such policies, procedures and internal controls could involve reasonable steps to safeguard client assets maintained as margin, collateral or otherwise in connection with non-traditional investments.

If the Commission determines to subject such non-traditional investments to the general scope of any final rule, the Commission must address the limitations of the exceptions in the Proposal – in particular the privately offered securities exception – applicable to such instruments, and we urge it to exclude them from the Notification and Verification Requirements in connection with the privately offered securities exception for the reasons described below.[15]

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[13] The CFTC and U.S. futures exchanges have a number of relevant rules, reporting regimes and procedures. *See, e.g.*, CFTC Part 17 (addressing FCM daily reporting of client positions), CFTC Part 38 (addressing designated contract market surveillance of trading), CFTC Part 18 (addressing periodic filing of certain trader ownership and control information for futures, options on futures and swaps trades), CFTC Part 45 (addressing swap data repository reporting, which includes the legal entity identifiers for the parties to the reported swap), CME Group Rule 576 (requiring use of individual user Tag 50 IDs when trading on a Globex terminal), and ICE US Rule 4.13 (requiring use of eBadges for direct trading access).

[14] Letter to Paul Cellupica, Custody Rule and Trading Controls Relating to Bank Loans, from the Loan Syndications and Trading Association (July 22, 2019), https://www.sec.gov/files/loan-syndications-and-trading-association-072219.pdf at 2-3.

[15] *See, e.g.*, Privately Offered Securities under the Investment Advisers Act Custody Rule, SEC Staff, IM Guidance Update No. 2013-04 (Aug. 2013), *available at* https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf, at n.2 ("[T]he Division considers securities that are evidenced by ISDA master agreements that cannot be assigned or transferred without the consent of the counterparty to be privately offered securities under Rule 206(4)-2(b)(2).").

C. Privately Offered Securities Exception

1. Safe Harbor for Good Faith Determinations

The SEC states that, in addressing the Reasonable Determination Requirement, an adviser should generally consider "the asset and the available custodial market" and need not "identif[y] . . . every conceivable qualified custodian and . . . evaluat[e] . . . its custodial services."[16] The frequency for this determination that would be reasonable is likewise a facts and circumstances determination, according to the SEC, and would depend in part on whether there are "indicators of a developing custodial market."[17]

While flexibility in the Reasonable Determination Requirement is a welcome approach, we are also concerned that there may be an unhelpful degree of ambiguity and risk of second-guessing advisers' determinations. This concern is particularly acute where an adviser transacts on behalf of clients in a broad range of asset classes for which determinations would be made.

An adviser's obligation under the Reasonable Determination Requirement should be satisfied, and the adviser should be entitled to rely on the privately offered securities exception, where the adviser's determination is made in good faith. Absent such assurances that good faith determinations will not be second guessed, the exception risks being unworkable.

We also believe that the SEC should recognize that in making this determination regarding whether a privately offered security can be custodied with a qualified custodian, advisers are permitted to consider the competitiveness, comprehensiveness, investment and operational risk, and cost of available custodial solutions, as well as their own vendor-diligence standards. In other words, the SEC should not formulate the Reasonable Determination Requirement in such a way as to effectively require that an adviser entrust client assets to a qualified custodian simply because it is the only, or one of few, custodians that offer to custody an asset, regardless of cost, operational concerns, and other factors.

2. Transaction-by-Transaction Notification and Verification Requirements

The Proposal acknowledges that advisory clients increasingly hold privately offered securities in their portfolio[18] and concludes that, as a consequence, significant new verification requirements are needed in the form of the Notification and Verification Requirements. We believe the Notification and Verification Requirements are impractical, would prove to be particularly costly and do not reasonably reflect the existing safeguards for such transactions. In addition, the Proposal appears to assume that such transactions are infrequent, significantly underplaying the

[16] *See* Proposing Release at 14707.

[17] *See id.*

[18] *See* Proposing Release at 14704 ("[I]t is increasingly common for advisory clients to have privately offered securities in their portfolio") and 14705 ("When this [privately offered securities] exception was adopted, the size of the privately held securities market was much smaller than it is now on an absolute basis as well as in relation to the size of the publicly traded securities market. In addition, the type, nature, structure, and prevalence of private issues have also changed and expanded in recent years. . . .").

burden of these requirements as they would apply in the Institutional SMA context, where transactions may occur regularly.

Moreover, the Notification and Verification Requirements are unnecessary because transactions in many such assets, such as financial contracts and loan interests as described above, commonly involve standardized trading and settlement processes and documentation that have evolved over many years and provide significant protections against loss and misappropriation. In some cases, such transactions require the involvement of the counterparties or independent third parties to effectuate a change in beneficial ownership. In addition, the degree and quality of engagement, diligence, and oversight common among Institutional SMAs provides substantial additional protections from loss and misappropriation. When considering these existing protections, together with an adviser's policies and procedures reasonably designed to mitigate the risk of loss, misuse, misappropriation, theft or the adviser's financial reverses, the costs and burdens associated with the Notification and Verification Requirements are unwarranted. This is particularly true in view of the wide range of assets and asset classes potentially in scope, as discussed above, and where an adviser may transact in privately offered securities on behalf of thousands of Institutional SMAs. For instance, PIMCO has authority to transact broadly in one or more types of financial contracts for a large majority of its Institutional SMA clients. During the calendar year ended April 28, 2023, PIMCO engaged in tens of thousands of transactions on behalf of Institutional SMA clients that would be subject to the Notification and Verification Requirements under the Proposal if financial contracts and loan interests are deemed to be privately offered securities necessitating utilization of the privately offered securities exception.

In view of the existing safeguards for such transactions, as well as the severe operational burden that would be introduced by the Notification and Verification Requirements, we urge the SEC not to adopt such a requirement as a condition to relying on the privately offered securities exception. However, to the extent that the SEC deems it essential to include a form of the Notification and Verification requirement for at least certain client assets, the SEC should exempt an investment adviser from the Notification and Verification Requirements with respect to any client assets of which the adviser is deemed to have custody, where:

1. The adviser adopts and implements reasonably designed policies and procedures to periodically review and assess the trading and settlement processes and documentation for such excluded asset classes;

2. The adviser has determined in good faith that the privately offered securities are of a type with respect to which there exist commonly accepted forms of documentation and trading and settlement processes that provide reasonable protections against loss and misappropriation of client assets; and

3. The adviser has a reasonable basis for believing that such client exercises due diligence and oversight of its account that is reasonably designed to identify material discrepancies in the transacting of instruments in such asset class.

D. Discretionary Authority Exception; Audit Provision

We believe that the Discretionary Authority Exception is too narrowly drawn and undervalues the safeguards inherent in many settlement processes (and related contractual arrangements) other than DVP arrangements.[19] The limitations on this exception also ignore the substantial engagement, diligence, and oversight common among Institutional SMA clients.[20]

The SEC should permit an investment adviser to rely on the Discretionary Authority Exception with respect to any client the assets of which the adviser is deemed to have custody, even if they settle on a non-DVP basis, where either:

1. The adviser adopts and implements policies and procedures reasonably designed to mitigate the risk of misappropriation in connection with discretionary authority exercised over assets that settle on a non-DVP basis;[21] or

2. Such client is a "qualified purchaser" under the 1940 Act and the adviser has received from such client a representation that the client obtains an independent verification or audit, on at least an annual basis and pursuant to standards determined to be sufficient by such client; provided that such client is not a commingled investment vehicle that the adviser manages.

The Commission also should clarify that reliance on the exception for entities subject to audit (the "Audit Provision")[22] is available with respect to the account of an Institutional SMA client. We applaud the Commission's recognition of the utility and benefits of audits and the Audit Provision,[23] and we believe that the same benefits and protections should be extended to all Institutional SMA clients (many of which include the types of investors – pension plans, retirement plans, college saving plans, and others – noted by the Commission as within the scope of the Proposal). Where the Institutional SMA client obtains an annual audit for its own purposes, it should be able to determine the conditions of that audit and should not be subjected to the requirements of proposed rule 223-1(b)(4)(i) – (v) or a liquidation audit.

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[19] For example, see the discussion of non-traditional investments in section II.B.

[20] *See* proposed rule 223-1(b)(8); Proposing Release at 14724 (discussing the DVP / non-DVP distinction in the exception, and noting, "We believe this exception will focus the requirement to obtain a surprise examination where the risk of misappropriation is greatest"); *see generally* Comment Letter, Engaging on Non-DVP Custodial Practices, from the Investment Adviser Association, the Asset Management Group of the Securities Industry and Financial Markets Association, and the Loan Syndications and Trading Association (May 13, 2021) at section II, https://www.sec.gov/files/iaa-sifma-lsta-051321.pdf.

[21] Advisers should be permitted to design policies and procedures that are reasonable for their businesses, but examples may include policies and procedures for position quantity reconciliations and/or policies and procedures to review the settlement process for the relevant asset, assess whether that settlement process presents opportunities for misappropriation and provide for controls with respect to such risks.

[22] *See* proposed rule 223-1(b)(4).

[23] *See* Proposing Release at 14718 – 19.

III. Other Recommendations

A. Business Development Companies; Wholly-Owned Subsidiaries of Registered Investment Companies and Business Development Companies

Under the Proposal, Form ADV Part 1A Item 9 would be amended to incorporate an exclusion for clients that are business development companies ("BDCs") that elect to be regulated as such. Consistent with that disclosure approach, the Commission should clarify that the exception at paragraph (b)(5) is also available to BDCs. This would align the rule text with the common understanding that BDCs, which are subject to section 17(f) of the 1940 Act, are not subject to the current Custody Rule.

In the same vein, the Commission should clarify that the exception at paragraph (b)(5) is also available to wholly-owned subsidiaries of registered investment companies and BDCs.

B. Shares of Interval Funds, Other Closed-End Funds and BDCs Held at Transfer Agent

The Commission should include within the exception at paragraph (b)(1) shares of closed-end investment companies operated as "interval funds" under Rule 23c-3 under the 1940 Act, any other registered closed-end investment company and any BDCs that elect to be regulated as such, held at a transfer agent. Where a transfer agent "fulfill[s] all of the obligations assigned to a qualified custodian under the rule"[24] with respect to shares of registered investment companies or BDCs, such holdings should be treated equivalently to registered open-end investment companies under this exception.

C. Implementation Period

The Proposal calls for implementation of the final rule, including its vastly expanded scope, expansive requirements for new contractual arrangements and assurances and extensive new notification and verification arrangements with independent public accountants, within one year following the effective date for advisers with more than $1 billion in regulatory assets under management ("RAUM").[25] Larger advisers would be particularly heavily impacted by the Proposal, as, for example, the number of custodial counterparties implicated by the Agreement and Assurances Requirements and volume of transactions that would be subject to the Notification and Verification Requirements are likely to be significantly greater than for smaller advisers. Advisers have less control over these areas, as they rely on the cooperation and actions of third parties. Accordingly, we urge the Commission to extend the implementation period for advisers with more than $1 billion in RAUM to at least three years following the rule's effective date.

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[24] *See* Proposing Release at 14675.

[25] *See* Proposing Release at 14732.

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

Sincerely,

Sung-Hee Suh
Managing Director
General Counsel for Global Regulatory and Litigation