October 30, 2023

Submitted electronically via SEC.gov
Ms. Vanessa A. Countryman
Secretary
US Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: **File Number S7-04-23; Release No. IA-6240; Safeguarding Advisory Client Assets (the "Proposal")[1]**

Dear Ms. Countryman:

The Securities Industry and Financial Markets Association ("SIFMA") and SIFMA's Asset Management Group ("SIFMA AMG")[2] appreciate the opportunity to provide further comments to the Securities and Exchange Commission (the "Commission") on the Proposal. This letter supplements the letters previously submitted by SIFMA and SIFMA AMG on May 8, 2023 (the "Initial Comment Letters").

As stated in the Initial Comment Letters, we support the Commission's principal aim of preventing loss, misuse, and misappropriation of client assets. However, the Proposal raises significant concerns, including with respect to the interaction between the Proposal and the multitude of other rulemakings, guidance, and interpretations. As discussed in detail below, SIFMA and SIFMA AMG draw from and expound upon certain points made in the Initial Comment Letters, as well as introduces new observations made in light of continued discussions with our members and industry participants, as well as conversations with the Commission.

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[1] Safeguarding Advisory Client Assets, SEC Release No. IA-6240 (Mar. 9, 2023) ("Proposal").

[2] SIFMA is the leading trade association for broker-dealers, investment banks, and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly one million employees, we advocate on legislation, regulation, and business policy affecting retail and institutional investors, equity and fixed income markets, and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (the "GFMA").

SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS, and private funds such as hedge funds and private equity funds. For more information, visit http://www.sifma.org/amg. SIFMA and SIFMA AMG appreciate the assistance of Jay Baris, Kenny Terrero, Chuck Daly, Victoria Anglin and Margaret Tomasik of Sidley Austin LLP in the preparation of this response.

Overview

The Proposal, if adopted, would amend and redesignate current Rule 206(4)-2 of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), to new Rule 223-1 entitled "safeguarding client assets" and impose a wide range of new requirements on registered investment advisers. In addition to the issues previously submitted for the Commission's consideration, we are concerned that critical aspects of the Proposal conflict with existing market structures and regulations, are inconsistent with the existing roles and responsibilities of market participants and would adversely impact investors.

Ultimately, if not significantly revised and subjected to additional review and comment, we believe that the Proposal likely would (i) significantly disrupt the operation of financial markets, (ii) restrict the ability of advisers to provide clients with investment advice for certain asset classes, (iii) limit the availability of custodial services, (iv) increase costs borne by investors, (v) result in fewer custodians for clients and advisers from which to choose, and (vi) negate the efforts and considerations taken in previous guidance issued by the Commission.

We believe that the Commission can accomplish its regulatory and policy objectives without the imposition of a one-size-fits-all rule that does not fully account for market realities. The Proposal should not be adopted as proposed.

Executive Summary

I. The Specific Problem the Proposal Attempts to Address and Solve For Remains Unclear.

The Proposal's purpose and intended application remain elusive. It conflicts with many existing market structures and well-functioning industry practices, and is a superfluous regulatory layering, considering existing Commission guidance.

II. The Proposal's Attempt to Reconceptualize Existing Terminology in the Advisers Act is Inconsistent with Existing Roles and Responsibilities of Market Participants.

The Proposal should not reconceptualize "maintain" in the context of the qualified custodian requirement. The Commission's efforts to reconceptualize "maintain" to mean "possession or control" is a material change with adverse consequences for market participants.

III. The Proposal Creates Custody Risk in its Failure to Adequately Distinguish Among Custody Risk, Counterparty Risk, and Investment Risk.

The Proposal does not adequately distinguish among custody risk, counterparty risk, and investment risk. The result would be a new regulation that will curb the ability of investors to

access investment advice for certain asset classes and either limit custody services offered by advisers or materially increase the cost of such services.

Discussion

I. The Specific Problem the Proposal Attempts to Address and Solve For Remains Unclear.

A. The Proposal's Overhaul of Adviser and Custodian Roles is Not Supported by a Compelling Demonstration of Benefits.

The Proposal, if adopted, would apply a new uniform overhauled custody rule to registered investment advisers of all types and – indirectly – custodians. It would prescribe, without clear justification or rationale, new responsibilities of advisers and custodians and redefine both the relationship between them and their relationships with clients while adding friction, time, cost and risk, all without providing corresponding benefits.

Business models and client relationships within the investment management industry vary widely and intentionally. We believe that the Proposal largely ignores this reality to the detriment of clients. Many institutional clients contract with preferred custodians, with little-to-no input from the adviser. By contrast, retail advisers may suggest clients open accounts with a certain custodian (typically an affiliated broker) and give the adviser authority to trade on that account. Both scenarios differ from dually registered adviser/broker-dealers that sponsor wrap fee programs which bring together advice, trading, and custody services in one arrangement. The Proposal's presumptive view of the adviser as a general contractor, responsible for every aspect of the client account, does not reflect market realities. We believe that the Proposal's assessment of market practice is incorrect and the resulting mislaid assumptions are likely to raise implementation issues and adversely impact clients in exchange for little to no safekeeping benefit.

As highlighted in the Initial Comment Letters, different asset classes have distinct timing, trading process, and risk regulation mechanisms. These inherent differences are not properly reflected in the Proposal's blanket approach to custody. Injecting a custodian into well-developed market structures that already incorporate investor protection measures is an ill-conceived one-size-fits-all solution. For example, the Proposal fails to take into account that in well-developed markets such as derivatives and bank loans, custodians may not be integral to a trade, but third parties, such as swap execution facilities and loan administrative agents, are involved and keenly interested in the related transfers of funds and ownership. As discussed in greater detail below, existing checks and balances within the operations of these markets protect investors, even though parties may not have a direct relationship with the advisory client.

The Proposal's requirement for a custodian to hold client cash off its balance sheet and redefine custody to include any adviser that trades with discretion would drastically alter custodians' responsibilities, necessarily regulating that which is beyond the Commission's remit and materially changing the role of the custodian. Moreover, the injection of the custodian into

transactions to, for example, conduct transaction-based verification, adds a layer of complexity that will frustrate timely and efficient transactions in exchange for minimal benefit, if any.

If adopted, the Proposal indirectly would regulate the business of bank custodians with advisers. We believe the Proposal's requirement to impose contractual terms, asset segregation, liability standards, and insurance requirements on custodians has nothing to do with the acts and advice of the adviser and are inappropriate and potentially harmful. The marginal benefits of an overhaul remain unclear at best and the Commission has not made a compelling demonstration of such benefits to customer asset protection. Despite its aim to further enhance the protection of client assets beyond funds and securities, the Commission's sweeping generalization that the Proposal is intended to address misappropriation wherever it may occur does not justify the detrimental effects on markets and certain asset classes that would become subject to new regulatory requirements under the Proposal.

B. The Proposal Does Not Adequately Consider Regulatory Developments and Industry Measures.

In recent years, the Commission has promulgated various rules and industry guidance designed to protect investors. One such example is in the area of private funds, and includes post-Madoff reforms, and enhancements of the Commission's examination program and Form PF reporting mechanisms.[3] Another is the evolution on measures to address "inadvertent custody."

In February 2017 and June 2018, the Commission issued guidance concerning the existing custody rule. Specifically, this guidance focused on helping advisers determine when they would have "inadvertent custody" of client assets in certain circumstances. Since the publication of this guidance, advisers have become significantly more attuned to the issue. Advisers have implemented policies and procedures to recognize situations where they have inadvertent custody of assets, as well as mitigating the risk of inadvertent custody. For example, advisers have implemented procedures requiring the segregation of duties, redundancies, and checks. Individually and collectively, these controls limit the opportunity for a single bad actor from controlling the entirety of a transaction. From our discussions with members, advisers can clearly designate who at the firm is authorized to issue asset and fund movement instructions. It is our understanding that custodians have implemented similar programs but tailored to their operations. In practice, policies and procedures implemented by both custodians and advisers prevent the misappropriation and loss of assets. We believe "inadvertent custody" should no longer be a justification for the Proposal.

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[3] We also note the Commission's recent Private Fund Adviser amendments. Private Fund Advisers; Documentation of Registered Investment Adviser Compliance, SEC Release No. IA-6383 (Aug. 23, 2023) (Final). Significant concerns persist about the merits and legal foundation for the amendments, but the Commission stated that a goal of the quarterly statement requirement was to increase the likelihood that fraudulent activity would be uncovered and advisers would be deterred from engaging in fraudulent conduct. If the Proposal and the Private Fund Adviser amendments are effectively targeting the same objective, it remains unclear how they interrelate and avoid duplication.

C. Recent Market Events Do Not Justify the Proposal.

By definition, the Proposal cannot prevent all frauds committed by a dedicated bad actor nor is it the appropriate mechanism to mitigate the risk of underlying market failures. However, if the Proposal is the Commission's response to recent market events involving custodian stability, its efforts are misdirected. As drafted, the Commission's argument that client assets must be segregated because of the potential failure of a bank ignores the entirety of the regulatory regime dedicated exclusively to the objective of preventing bank failures. Bank failures and custodian business models are not market structure issues within the Commission's purview. Advisers Act amendments like the Proposal are ill-suited mechanisms to mitigate these issues.[4]

The Proposal also does not consider the vast operational implications of the intended changes and what this could mean for overall market risk. Particularly, a cash segregation requirement would likely require massive movements of overnight deposits between banks to avoid holding deposits in a custody account. The cash segregation requirement raises many questions as well: Does the associated volume and velocity of money have a cost? Does such a result have any implications for bank regulation? Would there be increased operational costs for clients? If the Commission believes further focus and attention is warranted on such matters, close coordination and collaboration with the banking agencies, accompanied by public transparency of any associated analysis, is essential.

Further, the Proposal would expose client assets to greater risk in times of bank crisis. The Proposal is widely expected to result in fewer available qualified custodians and protracted custody agreement negotiations. If a qualified custodian were to be weakened or suffer a failure, advisers and clients who used the failing custodian would face significant difficulty establishing and quickly transferring at-risk assets to a custodial account at a different financial institution and comply with the Proposal's requirements. In sum, in times of crisis, the Proposal would exacerbate the risk it purportedly seeks to mitigate.

II. The Proposal's Attempt to Reconceptualize Existing Terminology in the Investment Advisers Act is Inconsistent with Existing Roles and Responsibilities of Market Participants and Market Practices.

In contrast to the custody rule, the Proposal specifies that a qualified custodian does not "maintain" a client asset if it does not have "possession or control" of that asset. The Proposal

[4] For example, Silicon Valley Bank, an oft-cited example of investor assets at custodial-risk, did not put client assets at risk because of custody-related issues. The bank's vulnerability was the result of its failure to properly manage its deposit and interest rate risk in a rising interest rate environment. Counterparty risk of custodians in this form is already directly addressed and mitigated by banking and prudential regulators. For instance, FDIC insurance serves to protect certain custodial assets such as cash in custodial accounts. In addition, clients and customers of custodian banks can take counterparty risk into account by selecting their custodians and/or diversifying their business among custodians. Moreover, the Proposal could have the unintended effect of exacerbating times of banking stress by resulting in fewer qualified custodians. If one qualified custodian were to show signs of liquidity issues, the Proposal would make it even more difficult for advisers and their clients to quickly open suitable accounts with a more limited universe of available counterparties.

further defines "possession or control" to mean holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets. We disagree with the Commission's efforts to reconceptualize "maintain" in the context of the qualified custodian requirement. Reconceptualizing "maintain" to mean "possession or control" is a material change to the existing application of the maintain standard that cannot be applied uniformly to all asset classes and does not align with the well-established role and responsibilities of the custodian.

A. The Possession and Control Requirement Conflicts with the Expansion in Scope to Include All Assets.

The Proposal's "possession or control" requirement as a condition precedent to any change in the beneficial ownership of an asset is not the appropriate role for a custodian in many widely traded assets, including loan documents, swap contracts, and ISDAs, among others. The role of a custodian, in these instances, should continue to be a tracking mechanism – to "maintain" a record of the asset based on the information available to the custodian, as such term is used and understood in the current rule.

The Proposal's attempt to apply a one-size-fits-all solution is precluded by market practice as the requirement for a custodian to exercise "possession or control" does not align with a wide range of instruments commonly traded by registered investment advisers. For example, traditional stocks and bonds are subject to a complex infrastructure of street name, book entry, and parties (see, DTC and Cede & Co.) that would prevent such exclusive "possession or control" of assets. With respect to derivatives contracts, it would be inconsistent with the operation of futures markets to expect a qualified custodian to possess an exchange-traded futures contract. Although physical certificates exist, the concept of holding bearer bonds or stock certificates held in a vault is outdated and unlikely to be implemented broadly. Requiring a custodian to become involved in every trade would add friction and duplication to many already highly regulated markets.

In particular, the inherent nature of real estate assets does not fit well within the proposed "possession or control" approach. By way of illustration, injecting a custodian into real estate transactions or natural resources and related infrastructure would be inconsistent and duplicative with market practice as transfer of ownership is onerous and well documented.[5] The transaction verification requirement also poses great difficulty as public accountants are not typically trained in the idiosyncrasies of property law. We are skeptical that the challenges are solvable in light of the Proposal's regulatory parameters.

Further, the requirement for a custodian to exercise "possession or control" does not fit within the private market context. The nature of assets in this context are inherently at low risk of misappropriation as they are effectively self-custodied, resulting in little to no benefit to investors by inserting a custodian.

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[5] Real estate transactions usually involve not only the parties buying and selling, but also licensed professionals including attorneys, real estate agents, and notary publics. Generally, a deed and mortgage must be filed with a local, county, or state office. Given that local authorities already possess and control the documents relevant to a subsequent transfer, requiring a custodian to also possess and control is unworkable.

In addition, the Proposal's requirement to have a qualified custodian involved in any change of beneficial ownership has expansive market implications that have not been sufficiently analyzed or addressed by the Commission. As described above, having a qualified custodian maintain "possession or control" of certain client assets is inconsistent with and would significantly disrupt the operation of markets. The expansion of the Proposal's asset base to apply to all client assets held in advisory accounts requires extensive examination of the implications on these new asset classes as different markets present unique challenges to implementation. In order to conduct an effective analysis, the Commission must engage and coordinate with other regulators and market participants. The present analysis of costs and benefits is inconsistent with the Proposal's breadth of implications.

An effective analysis would also take into account the inherent checks and balances prompted by market interests. Advisers do not operate in a vacuum, but in the market with numerous third-party service providers, including brokers and custodians, necessitating the maintenance of formal and informal relationships amongst these parties. Third parties are involved in many parts of the financial system. Not only are they incentivized to maintain positive business relationships with advisers, but they also provide natural "maker/checker" functions due to their own market interests. By way of example, when an adviser instructs a broker to execute a trade, that broker has a commercial and legal interest in ensuring the transfer of ownership regarding the security and payment for their services. The present trade validation process, in many instances, already provides for validation, making validation by a qualified custodian repetitive and unnecessary. A qualified custodian could reference those brokers or third parties for validation of trades in lieu of having the responsibility to validate such trades themselves.

We believe that it will be infeasible for the Commission to modify the Proposal by attempting to carve in and out specific asset classes or parts of the financial market on the basis of existing or inherent mechanics or investor protections. Such an approach would likely result in an extremely complex rule dominated by exceptions. The task of assembling a definitive and comprehensive inventory is made more difficult due to the Proposal's expanded scope to include all assets (including those issued and traded in non-US markets). The gravity of the implications would also place a high priority on specific drafting decisions. Rule text could create market distortions or implementation problems that would require further Commission rule amendments or guidance to resolve. It would also result in a static rule that would struggle to adapt and adjust as markets, controls, assets, infrastructure, and other regulatory developments evolve. While we generally believe this Proposal warrants reconsideration, we particularly emphasize reconsideration if the Commission believes this type of carve in/carve out approach is the way forward from the Proposal.

B. The Proposal Imposes US Regulation in Non-US Jurisdictions Yielding Unworkable Results.

The implications of reframing “maintain” extend beyond the borders of the US. The concept of “maintain” applies to non-US private funds and with respect to non-US funds managed by US advisers even though they are subject to very different home custodial regulatory regimes.

While the US’s capital markets are the most developed in the world and set the standard for thoughtful practices, they do not operate alone and the Commission should not assume that non-US markets can or should always adapt to accommodate. If the Commission believes that market practices outside the US warrant attention and have opportunities for improvement, it should directly work with the local regulators of the relevant jurisdiction.

The Proposal raises conflicts as it indirectly attempts to impose US regulation in non-US jurisdictions. At best, non-US funds would be reluctant and, at worst, unable to contract with US managers because US advisers would bring with them US-centric and US-specific custody regulations. For example, an investment adviser retained by and granted discretion to trade on behalf of a UCITS fund would be deemed to have custody under the Proposal; however, the UCITS regime is subject to its own custody requirements. These requirements may be incompatible with non-US funds to retain US advisers. Any credible assessment of the Proposal must attempt to identify and quantify the loss of this business for US advisers and the loss of access to US managers for non-US funds and managers. Given the magnitude of assets potentially impacted, the costs would be significant and the Commission would be challenged to demonstrate why the existing UCITS regulatory framework is inadequate.

C. Reconceptualizing “Maintain” Inappropriately Changes Existing Roles and Responsibilities of Market Participants.

The Proposal’s reconceptualizing “maintain” to require “possession or control” of an asset effectively requires a custodian to act as guarantor. However, the Proposal does not account for custodians who maintain reasonable controls and processes not being willing nor able to act as a guarantor. In the case of asset classes that cannot be held in custody via “possession or control,” the custodian plays a recordkeeping function; it will not willingly accept liability over assets that it does not or cannot control. Rather, such custodian tracks activity in a client’s account and is careful to disclose to clients when it has less information, and therefore less ability to represent facts with greater confidence.

We respectfully submit that the Commission should not reframe the term “maintain.” Rather, the term ought to be read in its common usage, that is, how the market has interpreted the term under the existing custody rule as well as how custodians have historically operated. The Commission should refer to the relative paucity of account statement integrity issues where a qualified custodian is involved as testament of existing robust processes. Idiosyncratic issues where an adviser falsifies account statements will not be prevented by a rule, as bad actors are not typically concerned about rule compliance.

As noted above, the Proposal must recognize common instances where the client selects and retains the custodian. In such a case, the adviser has no control over the selection of the custodian and no privity of contract to force a different result. At most, the adviser can decline the business or withdraw if the custodian selected by the client is suspect for business or operational reasons, or otherwise does not meet minimum standards of a qualified custodian promulgated by the Commission.

We believe the adviser and custodian each have a unique role to play in protecting client assets. Neither is a supervisor of the other, but both parties are committed to acting in the service of their mutual client. Thus, deputizing one to be legally responsible for the other is inappropriate. This is especially the case when neither has selected the other as a business partner. An adviser and custodian frequently work together even in the absence of a contract between them and coordinate for the benefit of their mutual client. Despite each party having their own set of internal controls designed for their particular organization, technology, and workflow, they coordinate closely to ensure trade instructions are processed efficiently and accurately. Processes for identifying outliers, comparing and reconciling holdings, and validating instructions are common. Larger organizations often arrange for independent controls reports such as SOC-1 reports. Onboarding processes become familiar and standardized for advisers and custodians that work with each other frequently, but take more time and attention when neither is familiar with nor works frequently with the other.

III. The Proposal Creates Custody Risk in Its Failure to Adequately Distinguish Among Custody Risk, Counterparty Risk, and Investment Risk.

As discussed in greater detail in the Initial Comment Letters, the Proposal would upend the existing custody system that utilizes foreign financial institutions ("FFIs") custodian and sub-custodian arrangements to access non-US markets. The Proposal imposes requirements that custodians must (i) be subject to judgments that originate in the United States, (ii) operate within a country that has similar anti-money laundering laws as the United States, and (iii) keep client assets segregated. While the Commission's rationale for these requirements is purportedly grounded in custody risk, it has inappropriately conflated custody risk and investment risk, resulting in the promulgation of proposed requirements that exceed its authority, limiting in the process investors' options to invest beyond US markets.

While related, custody risk and investment risk are distinct. Custody risk includes the risk for error presented in processing transactions, as well as maintaining records of securities ownership and cash balances. Investment risk involves risks associated with the merits of the investment and the value of the asset. Different still is counterparty risk that includes the risks associated with effecting a trade made with a financial institution or other assets held on deposit. By failing to adequately distinguish among these categories of risk, the Proposal's requirements extend beyond addressing investor transparency and adviser accountability, and ultimately limit the number of FFIs, custodians and sub-custodians available to advisers and their investors.

When investing in foreign markets, investment risk includes geopolitical risk. An illustration is the case of nationalization or freezing of assets by a local government in an emerging market country. While one might generically call this "misappropriation," it is not a risk a custody rule can guard against. These events are political in nature and, rightfully, neither custodians nor advisers have the ability to influence the compensation for or release of assets. This is the remit of elected officials and diplomats. When making an investment decision, the adviser considers this risk as part of its investment thesis and discloses this risk. Custody banks will not, and should not, accept liability for investment risk for investing in a particular country. If custodians are forced to do so, it is likely they will cease operating in risky markets. Without an FFI, advisers would no longer be able to advise their clients in that country, leaving those who wish to stay in that market on their own without professional advice. We believe that this would expose investors to unnecessary risk. Further, FFIs and sub-custodians outside the US are even less likely than custody banks to accept liability for this risk as they are not required to do so under their local regulations and are not subject to the Commission's rules.

The implications for holding custody banks liable for investment losses extend well beyond emerging markets. If the custody rule considers custodians to be strictly liable in practice for the Commission's conflation of investment risk and custody risk, custodians and FFIs will likely refuse to service some markets and re-price their services in other markets accordingly. These costs should be fully identified, assessed and considered by the Commission.

The Proposal's treatment of sub-custodians potentially places the adviser at odds with their client. If a foreign sub-custodian does not meet the Proposal's minimum requirements or the adviser believes it may not meet the Commission's expectations for ongoing service, the only response available to the adviser to avoid a regulatory violation will be to cease advising clients invested in that foreign market. This is the case even if an investor is fully aware and willing to accept the risk or is willing to rely on their investment adviser to make such assessments on their behalf.

Ultimately, the implications for custodians, sub-custodians and advisers will result in clients losing access to the returns and diversification that those markets provide or bearing increased costs to retain access to such markets.

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As noted in the Initial Comment Letters and at the outset of these comments, SIFMA and SIFMA AMG support the Commission's principal aim of preventing loss, misuse, and misappropriation of client assets. SIFMA and SIFMA AMG also support revisiting, re-assessing, and updating investment adviser regulatory requirements for custody and safeguarding. As fiduciaries, our members share the Commission's mission to ensure that client assets are protected from misappropriation and misuse.

However, our and our members' experience with markets and operational logistics informs our perspectives on the Proposal. We have serious concerns about the breadth and consequences of the Proposal and urge the Commission not to adopt the Proposal in its current form. As stated

in the Initial Comment Letters, the Commission should consider withdrawing the Proposal and engaging in a market-wide analysis and discourse that is otherwise infeasible in the constraints of the Proposal and comment period.

SIFMA and SIFMA AMG appreciate the opportunity to comment on the proposed rules. If you have any questions or would like to discuss anything in this letter further, we welcome the opportunity to engage with you. Please feel free to contact Kevin Carroll (kcarroll@sifma.org), Kevin Ehrlich (kehrlich@sifma.org) or our counsel at Sidley Austin LLP.

Respectfully Submitted,

Kevin Carroll
Deputy General Counsel
SIFMA

Kevin Ehrlich
Managing Director and Associate General Counsel
SIFMA AMG

cc: Honorable Gary Gensler, Chair, US Securities and Exchange Commission
Honorable Hester M. Peirce, Commissioner, US Securities and Exchange Commission
Honorable Caroline A. Crenshaw, Commissioner, US Securities and Exchange Commission
Honorable Jaime Lizárraga, Commissioner, US Securities and Exchange Commission
Honorable Mark T. Uyeda, Commissioner, US Securities and Exchange Commission
William Birdthistle, Director, US Securities and Exchange Commission, Division of Investment Management