SEC's New Custody Rule Threatens to Increase Investment Costs, Reduce Returns

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The SEC is proposing major policy changes that will increase investment fees and lower returns on retirement accounts and other investments. It's doing so by dramatically altering its rules for how registered investment advisors handle clients' assets, known as the "Custody Rule." These costs won't just affect institutional investors. If you've ever worked with a financial advisor or invested money through a 401(k) account or pension fund, you've probably benefited from bank custody services.

These changes were reputedly spurred by concerns about crypto and other digital assets; however, the SEC overshot its objective and is rushing through a massive overhaul that will fundamentally interfere with banks' existing business practices by restricting deposits, increasing custodian liability and forcing banks into a supervisory role over investment advisors. These added costs will increase administrative expenses on investments and may significantly reduce 401(k) and other investment returns. For perspective on how administrative costs affect returns, $100,000 invested over 20 years would earn $10,000 less for every 25-basis-point increase in administrative fees, as estimated by the SEC.

How do banks support investment activities?

Banks generally take deposits and make loans, but they have also traditionally served as safe keepers of assets (for example, providing safety deposit boxes to protect family heirlooms). As household assets and investments have evolved, so too have banks' custody services. Pension funds, mutual funds, insurance companies and other institutional investors all rely on custody banks to safeguard your investments and, as of the end of FQ4 2022, approximately $250 trillion was held in custody by the 12 largest custodians. These services provide valuable administrative benefits, such as consolidated access to investment performance across accounts, streamlined order execution and settlement and tax support.

The proposal would drive significant cost increases because of several factors:

1. ***The proposal would severely restrict bank deposits*.** Deposits are a core banking activity and, as such, are carefully supervised by the banking agencies. This proposal reflects an extraordinary attempt by the SEC to dictate how banks handle cash. Under the proposal, all custody assets would need to be segregated — practically speaking, the only way to do this would be for the custody bank to deposit the custody cash in another bank, creating administrative inefficiencies, operational risk and higher fees to offset the costs of providing these services.

2. ***Custody banks would become liable for events outside of their control.*** Custody banks would be forced to assume greater liability for the actions of third-party intermediaries and market utilities. This requirement would not only require bank custodians to increase their fees to cover this additional liability but would also disrupt domestic and international market practices by requiring banks to undertake the herculean task of renegotiating bespoke service agreements for clients across the globe.

3. ***Custodians would be forced to interfere in client-registered investment advisor relationships.*** Registered investment advisors would no longer be able to exercise investment decisions on behalf of their clients without banks being legally required to monitor and second-guess those actions. This would slow down transactions, reduce market efficiencies and effectively force banks to take on a supervisory role over investment advisors.

The SEC failed to consider these costs.

The SEC failed to consider these cost factors as part of its economic analysis, despite the potential consequences to investors and others. Many commenters, including the U.S. Small Business Administration's Office of Advocacy, have pointed out the costs and challenges the rule would present for investors, small registered investment advisors and public accountants, in addition to bank custodians. The SEC's failure to properly address these costs is inconsistent with its obligations under the Administrative Procedure Act.

The rule represents yet another overreach by the SEC into bank regulation.

Banks are a trusted choice to custody customers' assets, in part because of the strict regulations and supervision in place for banks. In recognition of this, the SEC has always considered banks to be "qualified custodians" under the Custody Rule. While the SEC has the authority to regulate registered investment advisors, this proposal is an attempt to regulate bank deposits, which rests under the authority of the banking agencies. The SEC's effort to fundamentally alter the way banks perform traditional bank custody and deposit-taking activity exceeds its scope of authority and interferes with the robust prudential rules already enforced by the federal banking agencies.

The Bottom Line.

The SEC should withdraw the current rule and reintroduce a proposal aligned with its original objective. Moving forward with the existing proposal will increase costs and ultimately harm investors.