Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: February 27, 2023

As we finalized our new in-depth analysis of the SEC's rewrite of the nation's custody rules, I asked some of the best-informed people I know if they had ever heard of a financial custodian. All they could come up with is the name of their elementary-school custodian and, in some ways, this is apt. Custody is among the services often called market "plumbing" because one only notices its importance when something goes wrong or realizes how risky poor maintenance is when everything gets wet. The SEC is right to retool custody services – their abuse was all too evident in the Madoff affair and even more costly to hapless investors in the course of crypto chaos. However, as seems often the case with the Commission, it has taken a righteous cause and turned it into a jihad.

When my question about custody services doesn't outright kill conversation, I often explain the importance of this obscure financial service as follows: when you give an investment adviser your money to buy stock or other assets, he or she does so on your behalf. The adviser takes a bit – okay, maybe a big bit – for his or her trouble, but the assets purchased are yours, not the adviser's. If the investment is poor because the asset loses value, that's your bad. But, if the asset loses value or, worse, disappears due to malfeasance or insolvency on the part of the adviser, you've quite literally been robbed. To prevent this, custodial requirements were imposed decades ago to ensure that the entity that holds your assets acts in your interest, not in its own when the coast is clear.

With trillions of assets now housed in custodians, it's readily apparent why robust custody that safeguards investor assets is so critical to sound financial systems as well as to social welfare. But, as is all too often the case, the SEC takes a good idea and then magnifies it into an ideology of federal regulatory policy. In the custody rule, the Commission sets forth a 434-page proposal stipulating behavior down to the millimeter that still fails to recognize that SEC rules are not the only mighty force stipulating financial-institution behavior. In financial regulation, there's no one true way – SEC standards are in fact only a part of the framework dictating how bank custodians set their course. More important to banks than even the mightiest SEC rule is what bank regulators tell them because the banking agencies hold the trump card: capital rules. If these make a business line uncompetitive or unprofitable, then banks exit said business.

Where do capital rules come in for custody? The SEC is absolutely right that promises to put someone else's money under one's own pillow more often than not end badly for the ripped-up pillow and the money beneath it. The rule thus would mandate that custodians of whatever charter be subject to regulation, supervision, and third-party audits and so it certainly should be.

However, the proposal doesn't say what these rules or oversight must entail and it thus gets problematic when it requires that custodians indemnify investors for losses. If the custodian does its job, then there is no need for indemnification because assets are held so securely that the adviser can't abscond with them. It is of course possible that a custodian itself could falter either via operational errors or flat-out insolvency, but assets held in the figurative vaults the proposal rightly also prescribes should be well insulated from fragility at the custodial institution is required also to be well protected from its parent company and affiliates. When the investment adviser is also the custodian, this can get tricky and the SEC is right to be wary. But, when the custodian is a bank, then these indemnification requirements create a contingent obligation on the part of the bank that will surely be captured in the organization's regulatory capital at considerable cost.

It's hard to know if the SEC knows about bank capital requirements, but it's clear that it doesn't much care. The rule is based in part on the Commission's view that banks will regain custodial competitive clout once the riff-raff are cleared away by force of this new rule. That might be true, but banks still need to recoup the cost of doing business. If capital costs go up, then the price of custodial services will also go up. If the market is inelastic, then maybe custodial services will remain on offer. However, the cost might well go up and maybe go up a lot, likely most harming the retail investors the Commission hopes to protect.

Or maybe banks don't have quite the clout the SEC contemplates. Bank regulators thought capital costs could go up exponentially and borrowers would just grin and bear it, but of course "shadow" markets sprung up in their stead. The SEC may think that all its standards ensure that nonbank custodians will be as good as bank custodians and maybe that's true. But nonbank custodians without the capital to honor indemnification calls will outclass banks every moment on each pricing decision. Maybe these custodians won't be shadowy because they are governed by the Commission's rules, but they certainly may come in the form of entities with parent or affiliate companies outside the reach of safety-and-soundness and resolution standards.

Been there, done that with the "nonbank financial intermediation" that has FSOC all a flutter. If the Commission isn't careful, its zeal to recast custody could either hike the cost of custody at peril to retail investors or send this essential service skittering outside the regulatory perimeter in the wake of so many other systemic-critical activities.