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SEC’s Proposed New Custody Rule Fails Industry Litmus Test

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Genna Garver

Genna Garver, a partner in Troutman Pepper’s Corporate Practice Group, was quoted in the July 24, 2023 *FinOps Report* article, “SEC’s Proposed New Custody Rule Fails Industry Litmus Test.”

“The new proposed rule is contrary to existing business practice and creates additional burdens for RIAs and custodians without a clear explanation for why changes are needed,” Genna Garver, a partner in the law firm of Troutman Pepper in New York tells FinOps Report. The SEC’s proposed amendments to its custody rule– Rule 206(4)-2– would effectively create new Rule 223-1. The original rule, adopted in 1962 as part of the Investment Advisers Act of 1940, was last changed in 2009. The SEC published its proposed new custody rule in the Federal Register on February 15 and comments were due by May 8, but there was plenty of feedback trickling into the regulatory agency in June and July. RIAs with at least US$1 billion in regulatory assets under management would have one year to get ready from the new rule’s effective date while smaller RIAs would have 18 months.

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Among the possible new burdens for RIAs would be the requirement for them to draft contracts with qualified custodians and to ensure that their service providers comply with new operational rules. Currently, the funds themselves handle any agreements with custodians. “The legal departments of RIAs would have to renegotiate the terms of dozens of agreements with custodians,” David Dickstein, a partner at the law firm of Kaufman Muchin and Rosenman LLC in New York tells FinOps Report. Why the change? Fund management firms and custodians believe the SEC’s new approach is a way of indirectly regulating the custody industry through RIAs. The problem with that idea, they assert, is that investors would pay the price because RIAs would have fewer custodian willing to take on their business with those remaining would be forced to increase their fees. “Custodians would be assessing their increased business risks associated with providing their services and assurances required under the rule, which would include the likelihood of any advisory client making the claim for indemnification,” says Garver.

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