

## Custody Pitfalls for Family Offices

The staff of the Division of Investment Management (IM) recently issued a flurry of interpretive guidance regarding when advisers are deemed to have custody of their clients' funds and securities. The guidance covers [transfers among a client's custodial accounts](#), [standing letters of instruction to a custodian](#), and [inadvertent custody under the client's custodial agreement](#). The guidance does not affect family offices exempted from the Investment Advisers Act of 1940 (Advisers Act) by [Rule 202\(a\)\(11\)\(G\)?1](#). The guidance also does not address issues commonly faced by family offices that must register under the Advisers Act.

## Exempt Family Offices

[Rule 206\(4\)?2](#) regulates the custody of client funds and securities by investment advisers "registered or required to be registered under" the Advisers Act. A single family office that complies with Rule 202(a)(11)(G)?1 "shall not be considered to be an investment adviser for purpose of the [Advisers] Act" and, therefore, is not subject to Rule 206(4)?2. Exempt family offices may nevertheless want to consider following certain aspects of Rule 206(4)?2, such as:

- Identifying the family office as agent or trustee for family office accounts;
- Providing periodic account statements to family members, indicating where their assets are held;
- Obtaining an internal control report to assure there are adequate controls for accessing funds, securities and other investments; and
- If the family office does not produce audited financials, having an accountant periodically test and verify holdings in custody accounts and compliance with controls.

Family office employees are less likely to succumb to temptation if they know the family's assets are independently monitored.

## Registered Family Offices

The new guidance is aimed at registered investment advisers (RIAs) who do not have "custody" for purposes of Rule 206(4)?2. According to IM:

[An adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades does not constitute "custody."](#)

Most family offices registered as RIAs cannot limit their authority to sending trade instructions to the custodian. Family offices often maintain accounts for paying taxes and other expenses, managing real property or family businesses and other non-investment purposes. Even if investment funds are maintained in segregated accounts, the family office needs to withdraw funds from these accounts to provide income to family members or to cover expenditures. Rule 206(4)?2(d)(2)(ii) defines "custody" to include:

Any arrangement ... under which you [the RIA] are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian[.]

Thus, if a family office registers with the SEC, it will typically be treated as having custody of the family's funds

and securities and must hold these funds and securities in compliance with Rule 204(6)?2. The potential pitfall is that Rule 204(6)?2 applies to all funds or securities over which a registered family office has custody, even if they are not involved in the investment management side of the office. For example, an account used primarily to pay taxes on behalf of family members would be subject to paragraph (a)(1) of the rule. See, *Piedmont Financial Co.*, 1990 WL 286501 SEC No-Action Letter (pub. avail. May 30, 1990). Similarly, interests in an LLC used by the family office to manage real estate holdings would be "privately offered securities" subject to paragraph (b)(2) of the rule. A family office that is an RIA must therefore take care to identify all bank and security accounts maintained by the office, and all business entities established by the office, in response to the periodic surprise examination required by paragraph (a)(4) of the rule, even if the accounts or entities have nothing to do with the office's investment activities. Omission of any accounts or entities could lead to an inadvertent violation of Rule 204(6)?2. In a subsequent blog, we will consider whether it is possible for a large family office to separate its RIA from its other functions for purposes of Rule 204(6)?2.

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