Blogs
March 20, 2017
Asset Management ADVocate

Segregating Custody of Family Office Assets

Our previous post discussed how a family office registered as an investment adviser (RIA) under the Investment Advisers Act of 1940 (Advisers Act) might underestimate the scope of its custody of family assets for purposes of Rule 206(4)?2. The problem is that the rule's definition of custody extends to all funds and securities an RIA has the power to withdraw, even those not held for investment. This post considers how a family office with sufficient personnel to independently staff its RIA can limit the scope of funds and securities subject to Rule 206(4)?2.

Separating the RIA from the Rest of the Family Office

The problem stems from the SEC's failure to anticipate that an RIA might also provide non-advisory services to its clients. Thus, Rule 206(4)?2 applies to any funds or securities the RIA holds or has authority to obtain, even if such funds are used solely for administrative or operating purposes or the securities are issued by the family's operating subsidiaries. In addition, Rule 206(4)?2(d)(2) defines "custody" to include:

> Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your **supervised person** [our emphasis] legal ownership of or access to client funds or securities.

The first step in limiting the scope of custody is to house the RIA and the other family office services in separate entities. Moreover, the "supervised persons" of the RIA must not be given legal ownership or access to funds or securities held in the non-RIA entities. Section 202(a)(25) of the Advisers Act defines a "supervised person" to include:

> any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an [RIA], or other person who provides investment advice on behalf of the [RIA] and is subject to the supervision and control of the [RIA].

Ideally, the family's RIA should be staff and operated independently from the rest of the family office.

Keeping the Family Assets Separated

Rule 206(4)?2(d)(2) also deems an RIA to have custody "if a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them …." Rule 206(4)?2(d)(7) defines a "related person" as:

> any person, directly or indirectly, controlling or controlled by you, and any person that is under common control with you.

Unless the family's RIA and non-RIA entities are owned and controlled by different family members, the non-RIA entities will be related entities of the family's RIA. The SEC realized that a related person may hold assets that are unrelated to the RIA, so the deemed custody is limited to assets held by a related person "in connection with advisory services you [the RIA] provide to clients." Hence, if the family's RIA and its supervised persons do not manage assets held by non-RIA entities, these assets will not become subject to Rule 206(4)?2, even if the other entities are related persons. This can be accomplished by establishing separate investment accounts for the RIA to manage and scrupulously transferring funds or securities into these accounts before engaging the RIA. Otherwise, the family office may still run the risk of not properly identifying funds and securities when complying with Rule 206(4)?2.

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