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Family Offices

2010 Developments in Family Office Regulation under Dodd Frank: Part Two

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By

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This is part two of a three-part series that addresses the regulation of family offices under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),[1] signed into law by President Obama on July 21, 2010. The Dodd-Frank Act provides that family offices are to be exempt from the definition of "investment adviser"[2] in the Advisers Act, but left to the Securities and Exchange Commission ("SEC" or the "Commission") the definitional details, requiring only that the SEC's implementation of the new rule be consistent with its historic position as reflected in its exemptive orders. In proposing its definition of family office, the SEC focuses on single family offices which have assets in excess of $100 million. There are about 2,500 to 3,000 such family offices in the U.S. In the aggregate, these family offices manage more than $1.2 trillion in assets.

Part one of this series presented the current SEC position as reflected by the exemptive orders. See "Developments in Family Office Regulation: Part One," Hedge Fund Law Report, Vol. 3, No. 38 (Oct. 1, 2010). This part two discusses the proposed rules recently issued by the SEC. Unless extended by the SEC, the comment period with regard to the proposals ends on November 18, 2010. There will undoubtedly be comments for the SEC to consider and perhaps adopt. We expect that part three of this series will deal with the state of affairs as made final after the comment period ends and the SEC issues its final rules.

The SEC Proposals

On October 12, 2010, the SEC issued Release No. IA-3098[3] (the "Release"), containing proposed rule 202(a)(11)(G)-1 which defines "family offices" that would be excluded from the definition of "investment adviser" under the Advisers Act. While family offices generally meet the Advisers Act's definition of "investment adviser," they have historically avoided registration by availing themselves of the private adviser exemption found in Section 203(b)(3) of the Advisers Act or by seeking and obtaining exemptive relief from the Commission declaring particular family offices to be outside the intent of Section 202(a)(11) of the Advisers Act.[4] In the Release, the Commission reiterates Congress' view that the Advisers Act was not intended to regulate typical single family office arrangements. As cited by the SEC, the Senate committee report relating to the Dodd-Frank Act states that "family offices are not investment advisers intended to be subject to registration under the Advisers Act" and that "the Advisers Act is not designed to regulate the interactions of family members" in the management of their own wealth.[5]

As discussed in part one of this series, the Dodd-Frank Act eliminated the private adviser exemption and thus requires a number of previously exempt investment advisers – including family offices – to register with the SEC. Recognizing the potential impact this would have on family offices, Congress directed the Commission to adopt a definition of single family offices that would be "consistent with previous exemptive policy" and recognize "the range of organizational, management, and employment structures and arrangements employed by family offices."[6] Proposed rule 202(a)(11)(G)-1 excludes single family offices from the definition of investment adviser and thus from the provisions of the Advisers Act. This is of particular significance with respect to state registration as well: if a person is excepted from the definition of investment adviser under Advisers Act Section 202(a)(11), no state can require that person to register as an investment adviser at the state level.[7] In general terms, the proposed rule defines a family office as any company (including its directors, partners, trustees, and employees acting within the scope of their position or employment) that: provides investment advice about securities only to family clients; is wholly owned and controlled by the family members; and does not hold itself out to the public as an investment adviser.

Not surprisingly, the devil is in the details and in this case, it is in the definitions that are used in the proposed rule. The basic building block of the proposed rule is the definition of "family members": family members are comprised of "family clients" and family clients are part of the structure of "family offices." Each such term is defined and considered below.

Family Clients – Generally

Pursuant to the proposed rule, in order to be exempt from the Advisers Act, family offices are not permitted to provide investment advice to any clients other than "family clients."[8] "Family clients" generally include: (i) any family member; (ii) any key employee; (iii) any charitable foundation, charitable organization, or charitable trust, in each case established and funded exclusively by one or more family members or former family members; (iv) any trust or estate existing for the sole benefit of one or more family clients; (v) any entity wholly owned and controlled (directly or indirectly) exclusively by, and operated for the sole benefit of, family clients, provided that if such entity is a pooled investment vehicle it is excepted from the definition of an "investment company" under the Investment Company Act of 1940, as amended (the "Company Act"); (vi) any former family member, provided that after becoming a former family member no additional investments are permitted (other than additional investments the former family member is contractually obligated to make); and (vii) any former key employee, provided that upon the end of such individual's employment by the family office, no additional investments are permitted (other than additional investments the former family member is contractually obligated to make).[9]

Family Clients – Family Members

Family members are defined as including: (i) the founders, their lineal descendants (including by adoption and stepchildren), and such lineal descendants' spouses or spousal equivalents; (ii) the parents of the founders; and (iii) the siblings of the founders and such siblings' spouses or spousal equivalents and their lineal descendants (including by adoption and stepchildren) and such lineal descendants' spouses or spousal equivalents.[10] This definition of family members is generally consistent with the SEC exemptive orders, with certain notable additions. While adopted children were not always included in the definition of family member historically used

by the SEC, the proposed rule does categorically include adopted children in acknowledgment of the change in our definition of family. In a similar vein, although relief had not to date been requested, the proposed rules also include spousal equivalents in the definition of family members. The term "spousal equivalent," based on the definition in the auditor independence rules, means a cohabitant occupying a relationship generally equivalent to that of a spouse.[11] To the authors' knowledge, the spousal equivalent concept has not been used in Advisers Act regulation in the past or in any exemptive orders. Finally, given the emergence of young entrepreneurs, the proposed rule also includes the parents of the founders of a family office. In other words, the SEC is no longer looking at linear descendants of the founders of a family office exclusively, but is also looking upwards to the generation above the founders. Also consistent with prior exemptive relief and as discussed further herein, the definition of family office does not include firms that advise multiple families.

The definition of family member also contains a provision for involuntary transfers, whereby if a non-family member person or entity becomes a client of the family office as a result of the death of a family member or key employee (e.g., as a result of a bequest) or through another involuntary transfer, that person shall be deemed to be a family client for purposes of the definition for four months following the transfer of assets resulting from the involuntary event.[12] The SEC does not elaborate on what types of involuntary transfers are contemplated by the rule, other than resulting from the death of the family member. The four-month time period was intended by the SEC to allow the family office to orderly transition that client's assets to another investment adviser, seek exemptive relief, or otherwise restructure its activities to comply with the Advisers Act.[13] The SEC requests comments as to whether family clients should be permitted to transfer assets to non-family clients upon a death or other involuntary event without jeopardizing the ability of the family office to rely on the proposed rule, and if so, under what conditions and to what types of transferees. The SEC also requests comments as to whether a time period different than the four-month period should be used to allow the assets to be transferred to another investment adviser.

Certain former family members are permitted to remain clients of the family office, but only to the extent of their investments held through the family office at the time they became a former family member (i.e., no additional investments would be permitted, other than additional investments the former family member is contractually obligated to make).[14] The SEC crafted its proposed rule in this manner to account for the rise of divorce and potential changes in family membership, while preventing harmful investment or tax consequences for the former family member.[15]

Included in the proposed definition of family client is any charitable foundation, charitable organization, or charitable trust established and funded exclusively by one or more family members[16] and any trust or estate existing for the sole benefit of one or more family clients.[17] Entities wholly-owned and controlled by family members and operated for the sole benefit of family clients would also be included in the definition of family client.[18] Any pooled investment vehicles would have to be excepted from the definition of investment company under the Company Act.[19] Again, this is consistent with prior exemptive orders. See Woodcock Financial Management Company, LLC, Investment Advisers Act Release No. IA-2772 (August 26, 2008) (notice) and 2787 (order) (family office provided advisory services to trusts created exclusively for the benefit of family members and to limited liability companies, private foundations and other entities all owned exclusively by the family (or, in the case of private foundations, solely funded by the family) and operated exclusively for the benefit of the family and/or charitable organizations).

Family Clients – Key Employees

The proposed rule codifies the historic treatment of certain key employees of a family office as family by including any key employee in the definition of family client. "Key employee" is generally defined in proposed rule 202(a)(11)(G)-1(d)(6) as any natural person who is an executive officer, director, trustee, general partner, or person serving in a similar capacity of the family office or any employee of the family office (other than an employee performing solely clerical, secretarial, or administrative functions with regard to the family office) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office, provided that such employee has been performing such functions and duties for or on behalf of the family office or substantially similar functions or duties for or on behalf of another company, for at least 12 months. This is consistent with prior exemptive orders. See WLD Enterprises, Inc., Investment Advisers Act Release No. IA-2804 (October 17, 2008) (notice) (family office provided investment advisory services to pooled investment vehicles created exclusively for the benefit of, and that were wholly owned by, family members, family trusts, or private foundations, where certain key employees having significant involvement with the investment advisory process or revocable trusts established for the benefit of such key employees also invested in the family investment entities); see also Adler Management, L.L.C., Investment Advisers Act Release No. IA-2500 (March 21, 2006) (notice) (family office provided investment advisory services to entities beneficially and solely owned by or solely for the benefit of family members, except that one long-standing family employee also held a beneficial interest in such entities). The SEC requests comment on its treatment of key employees under the proposed rules.

In fact, the proposed rule relating to key employees is broader in scope than many prior exemptive orders as in such orders the key employees typically had their investments frozen or were permitted to continue their investments through the family office, but upon termination of employment were limited to investments at the time of termination along with reinvestment of accretions or distributions on the investment.[20] In its Release, the SEC cited the Senate Committee Report explaining that some family offices have non-family member directors, officers and employees that co-invest alongside the family as a means of aligning the interests of such persons with those of the family members served by the family office.[21]

The key employee definition is based on the knowledgeable employee standard contained in Advisers Act Rule 205-3(d)(iii), which sets forth the types of clients who can be charged performance fees by registered investment advisers. The knowledgeable employee standard found in Advisers Act Rule 205-3(d)(iii) was itself based on a similar standard found in Company Act Rule 3c-5(b)(1) which provides that a person who qualifies as a "knowledgeable employee" is not counted for purposes of determining the number of beneficial owners of private investment fund relying on the Section 3(c)(1) exception and may participate in a private investment fund relying on the Section 3(c)(7) exception without having to qualify as a qualified purchaser. In proposing the "key employee" definition, the SEC is imputing the policy conclusions used for the aforementioned "knowledgeable employee" standards – that these types of employees are likely to be sophisticated financially and be in a position or have a level of knowledge sufficient to evaluate the risks involved.[22]

Under proposed rule 202(a)(11)(G)-1(d)(2)(vii), upon the end of key employee's employment by the family office, key employees would be permitted to remain clients of the family office, but only to the extent of their investments held through the family office at the time they became a former key employee (i.e., no additional investments would be permitted, other than additional investments the former key employee is contractually obligated to make).

Ownership and Control

Another component to the definition of family office under the proposed rule is that it must be wholly owned and controlled (directly or indirectly) by family members (as defined above).[23] "Control" means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely as a result of being an officer of such company.[24] This requirement is generally consistent with prior exemptive relief. See WLD (majority of board of directors of family office comprised of family members and family office wholly owned by family members); see also Slick Enterprises, Inc., Investment Advisers Act Release No. IA-2736 (May 22, 2008) (notice) (majority of board of directors of family office comprised of family members and family office owned exclusively by family members). The SEC cited two examples in which it granted exemptive orders to family offices which were not wholly owned by family members. See In the Matter of the Pitcairn Company, Investment Advisers Act Release No. 52 (Mar. 2, 1949); see also Investment Advisers Act Release No. 1700 (Feb. 12, 1998) (notice). The Commission seeks comments on whether the non-family members should be permitted to have ownership of the family office and what, if any, additional safeguards should be imposed on such an arrangement to ensure that such family office is not operating as a commercial investment adviser.[25]

Holding Out

Pursuant to the final prong of the proposed rule, the family office cannot hold itself out to the public as an investment adviser. In the Release, the SEC provides that a family office that holds itself out to the public as an investment adviser suggests that it is seeking to enter into a typical advisory relationship with non-family clients and is thus inconsistent with prior exemptive relief.[26] The prohibition against "holding out" to the public as an investment adviser is also contained in the private adviser exemption housed in section 203(b)(3) of the Advisers Act.

Grandfathering

The Dodd-Frank Act required the SEC's proposed rules to contain a grandfather provision that does not exclude from the definition of "family office" any person or entity that was not registered or required to be registered as an investment adviser under the Advisers Act on January 1, 2010 solely because the person provides investment advice (or was so engaged before January 1, 2010) to natural persons who are officers, directors or employees of the family office who have invested with the family office before January 1, 2010, and are "accredited investors" under Regulation D; any company owned exclusively and controlled by members of the family of the family office; and any SEC-registered investment adviser that provides advice and identifies investment opportunities for the family office, invests in these opportunities on the same terms as the family office and whose assets as to which the family office directly or indirectly provides investment advice represent no more than five percent of the value of the total assets as to which the family office provides investment advice.[27] The SEC incorporated the grandfathering provision in its proposed rules in the same form provided in Section 409(b)(3) of the Dodd-Frank Act.

Family Offices versus Family-Run Offices

The SEC distinguishes between family offices and family-run offices. Family offices, assuming Section 202(a)(11)(G) applies, fall outside all of the provisions of the Advisers Act, not merely the registration provisions. Family-run offices on the other hand – i.e., those that render services to a variety of clients – although owned and controlled by a single family, are not excluded from the definition of investment adviser. The theory for this distinction seems sound; an organization that serves clients as an investment adviser is no less so just because it is owned by a single family. The focus is as much on the clients being served as on the ownership of the family office.

Multiple Family Offices

As proposed, the rule does not extend to multi-family office structures, but in the preamble to its proposals the SEC recognizes and seems to acknowledge that families do pool operations to achieve economies of scale and benefit by saving overhead and operational expense. The SEC notes in the Release that entities providing advice to multiple families are more akin to typical commercial investment advisers appropriately subject to the Advisers Act.[28] To its credit, the SEC has requested comments about this very matter and there will certainly be commenters that will support this view, as we do. Hopefully some recognition of these arrangements will end up in the final rule.

Conclusion

As discussed herein, the SEC includes specific as well as general requests for comment from all members of the public on all aspects of the proposed definition of "family office." Any comments must be received by November 18, 2010. Readers that have comments should feel free to submit them to the SEC directly or to us to organize and submit them in a timely manner. While the SEC considers any comments it receives, family offices should begin considering the implications of the proposed rules for their structures and business practices.

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] "Investment adviser" is defined in Section 202(a)(11) of the Advisers Act to mean "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."

[3] *See* Investment Advisers Act Release No. 3098 (Oct. 12, 2010) (17 CFR Part 275).

[4] The definition of "investment adviser" specifically carves out certain persons and includes a "catchall" carve-out in subsection 202(a)(11)(G) for "such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order."

[5] S. Conf. Rep. No. 111-176, at 75 (2010) (the "Senate Committee Report").

[6] Section 409(b) of the Dodd-Frank Act.

[7] *See* Section 203A(b)(1) of the Advisers Act.

[8] Proposed rule 202(a)(11)(G)-1(b)(1).

[9] Proposed rule 202(a)(11)(G)-1(d)(2).

[10] Proposed rule 202(a)(11)(G)-1(d)(3).

[11] *See* 17 CFR 210.2-01(f)(9) and (13); Final Rule: Revision of the Commission's Auditor Independence Requirements, Securities Act Release No. 7919 (Nov. 21, 2000) (Dec. 5, 2000), at IV.H.8 and Proposed rule 202(a)(11)(G)-1(d)(7).

[12] Proposed rule 202(a)(11)(G)-1(b)(1).

[13] *See* Release at 63757.

[14] Proposed rule 202(a)(11)(G)-1(d)(2)(vi) and (d)(4).

[15] *See* Release at 63757.

[16] Proposed rule 202(a)(11)(G)-1(d)(2)(iii).

[17] Proposed rule 202(a)(11)(G)-1(d)(2)(iv).

[18] Proposed rule 202(a)(11)(G)-1(d)(2)(v). "Control" is defined in proposed rule 202(a)(11)(G)-1(d)(1) as the power to exercise a controlling influence over the management or policies of an entity, unless such power is solely the result of being an officer of such entity.

[19] For example, pursuant to Sections 3(c)(1) or 3(c)(7) of the Company Act.

[20] *See* Release at 63758.

[21] *See* Release at 63758; *see also* Senate Committee Report at 76.

[22] *See* Release at 63758.

[23] Proposed rule 202(a)(11)(G)-1(b)(2).

[24] Proposed rule 202(a)(11)(G)-1(d)(1).

[25] *See* Release at 63759.

[26] *Id.*

[27] Proposed rule 202(a)(11)(G)-1(c).

[28] *See* Release at 63756.

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