THE SPECTER OF SEC REGULATION OF FAMILY OFFICES

By:

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EXECUTIVE SUMMARY:

Wealthy families form family offices to provide a variety of services that are customized to meet the administrative, financial, and wealth management needs of current and future generations. To date, most family offices have been able to operate in an environment relatively free of regulation of investment functions due to the private adviser exemption under the Investment Adviser Act of 1940. With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, many family offices may soon be subject to regulation by the SEC.

FACTS:

Dodd-Frank Wall Street Reform and Consumer Protection Act

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act, hereinafter referred to as the Act, was signed into law by President Obama. The 2,319 page Act contains provisions that can significantly impact family offices. Effective July 21, 2011, the Act repeals the private adviser exemption, which allows many family offices to provide investment management services without being subject to SEC registration.[1] The main requirements for the private adviser exemption are that a family office has fewer than fifteen (15) clients during the course of the preceding twelve (12) months, and that the family office does not hold itself out to the general public as an investment adviser.[2] The primary target of the repeal of the private adviser exemption was investment advisers to private funds such as hedge funds.[3] As acknowledgment that the repeal would require many family offices to register with the SEC, Congress amended the Investment Advisers Act of 1940 by creating a new exclusion from the definition of an investment adviser for a family office as subsequently defined by the SEC.[4] In defining a family office, the SEC is required to adopt a definition of a family office consistent with its previous exemptive orders, and one that also recognizes the range of organizational, management, and employment structures and arrangements employed by family offices.[5]

Proposed Rule Defining a Family Office

On October 12, 2010, the SEC issued Proposed Rule 202(a)(11)(G)-1, which defines a family office.[6] The proposed rule lays out the following conditions for a family office to be excluded from the definition of an investment adviser and avoid SEC registration:

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[1] H.R. 4173 § 403, 111th Cong. (2010) (Enacted).
[2] Investment Adviser Act of 1950, 15 U.S.C. § 80b-3(b)(3) (2010).
[3] S. Rep. No. 111-176, at 38-39 (2010) (Conf. Rep.).
[4] H.R. 4173 § 409(a), 111th Cong. (2010) (Enacted).
[5] *Id. at* § 409(b)(1) and (2).
[6] SEC Release No. IA-3098; File No. S7-25-10 (Oct. 12, 2010).

1. **The family office must not have any investment advisory clients other than family clients.**[7] Family clients include: (a) family members; (b) key employees defined as an executive officer, director, trustee, general partner, or person serving in a similar capacity, or any other employee of the family office, other than an employee performing clerical, secretarial, or administrative functions, who in connection with his or her regular duties has participated in the investment activities of the family office, or similar functions or duties for or on behalf of another company for a least twelve (12) months; (c) charitable foundations, charitable organizations, or charitable trusts established and funded exclusively by one or more family members or former family members; (d) limited liability companies, partnerships, corporations, or other entities wholly owned and controlled (directly or indirectly) exclusively by, and operated for the sole benefit of one or more family clients; (e) trusts and estates existing for the sole benefit of one or more family clients; (f) former family members which include spouses, spousal equivalents defined as cohabitants occupying a relationship generally equivalent to that of a spouse, and stepchildren; and (f) former key employees.[8]

   The proposed rule defines family members to encompass: (a) founders, their lineal descendants including adopted children and stepchildren, and such lineal descendants' spouses or spousal equivalents; (b) parents of the founders; and (c) siblings of the founders and such siblings' spouses or spousal equivalents and their lineal descendants including adopted children and stepchildren and such lineal descendants' spouses or spousal equivalents.[9]

   It should be noted that the investment advice that a family office can provide to former family members and former key employees is limited.[10] Absent a contractual obligation, former family members and former key employees cannot invest additional assets with the family office. In other words, the investment advice they receive from a family office is limited to the assets for which they were receiving, directly or indirectly, advice immediately prior to becoming a former family member or former key employee.

2. **The family office must be wholly owned and controlled, either directly or indirectly, by family members.**[11] The SEC points out that this "wholly owned and controlled" condition is not only consistent with its prior exemptive orders, but it assures that the family is in a position to protect its own interests and thus is less likely to need the

[7] *Id.* at 9.
[8] *Id.* at 38-39.
[9] *Id.* at 39.
[10] *Id. at 17 and 21.*
[11] *Id.* at 23.

protection afforded by federal securities laws.[12] The SEC adds that this condition helps to distinguish family offices from those that provide advice to non-family members and operate as a commercial investment adviser.[13] **Observation:** No guidance is provided on ownership, particularly in the context of the word "indirectly." However, control is defined as the power to exercise a controlling influence over management or policies of the company, unless such power is solely the result of being an officer of such company.[14]

3. **The family office must not hold itself out to the public as an investment adviser.**[15] This condition has been carried over from the private adviser exemption.

COMMENTS:

Shortcomings of the Proposed Rule

The following are examples of some of the shortcomings of the proposed rule:

1. **Ownership of a Family Office.** As noted above, Section 409(b) of the Dodd-Frank Act instructs the SEC to adopt a definition of a family office consistent with its previous exemptive orders, and one that also recognizes the range of organizational, management, and employment structures and arrangements employed by family offices. Unfortunately, there is not much guidance in the proposed rule on what constitutes "wholly owned and controlled, either directly or indirectly, by family members." **Observation #1:** An irrevocable trust with an independent trustee for the benefit of family members and family owned holding companies such as corporations and limited liability companies are ownership structures frequently used for family offices. Yet, there is no mention whether or not such a trust and family owned holding companies meet the condition that the family office be "wholly owned and controlled, either directly or indirectly, by family members." In the spirit of the Congressional mandate in Section 409(b) of the Dodd-Frank Act, a family office wholly owned and controlled by an irrevocable trust with an independent trustee for the benefit of family members or a family owned holding company should be recognized as meeting this condition. **Observation #2:** One of the challenges for family offices is the ability to attract and retain professionals in the industry. To attract and retain talent, there may be instances when it will be necessary to offer an ownership interest in the family office as part of the overall compensation package. Consequently, the "wholly owned and

[12] *Id.*
[13] *Id.*
[14] *Id.* at 38.
[15] *Id.* at 24.

controlled, either directly or indirectly, by family members" condition should be flexible enough to allow key employees to own minority interests in a family office.

2. **Involuntary Transfers to Non-Family Clients**. Transfers occurring at death are the most common example of involuntary transfers. The proposed rule provides a four (4) month grace period for involuntary transfers to non-family members.[16] This grace period permits a family office to provide investment advice to non-family clients for four (4) months after the involuntary transfer of assets without forfeiting the family office exclusion. **Observation:** Depending on the particular situation involved, the four (4) month grace period may not be long enough to transfer the non-family member's assets to another investment advisor, seek exemptive relief, or otherwise structure the activities of the family office to comply with the Investment Advisers Act. As a result, a longer grace period should be considered.

3. **Definition of Family Members**. Although the proposed definition of family members appears to be broad, it might not be inclusive enough to cover the clients in many family offices. **Observation #1:** In many families, family members such as aunts, uncles, and cousins are active participants in family business activities and planning structures. Consideration should be given to including collateral kinship in the definition of family members in order to capture the breadth of family office clients. **Observation #2:** Using the founder as the yardstick for defining family members may be too restrictive and unrepresentative of the reality within many family offices. Families evolve and change over time. As a result, current and future generations of a family should be able to designate the individual to serve as the frame of reference for defining family members who best reflects the client makeup of a family office at any given point of time. Such an approach would add flexibility without violating the condition that a family office not hold itself out to the public as an investment adviser.

4. **Limited to Single Family Offices.** Under the proposed rule, only single family offices will be in a position to qualify for the family office exclusion. **Observation:** Consistent with the private adviser exemption, it makes sense to exclude multi-family offices that have non-family members as clients and are operating as a commercial business. However, there are numerous situations in which families with common goals and objectives have formed a family office to leverage the pooling of their resources and assets, while only providing services to members of the owners' families. There is no reason why existing multi-family offices of this nature should not be included in the new family office exclusion.

[16] *Id.* at 14-16.

5. **Limited Investment Advice to Former Family Members and Former Key Employees.** As mentioned earlier, family offices can only provide advice to former family members and former key employees as to their investments at the time that they became former family members and former key employees. **Observation:** This appears to be too restrictive. A reasonable alternative would be to grant a family office the authority and discretion to permit former family members and former key employees to invest additional assets with the family office.

Possible Impact on Private Trust Companies.

The private trust company, also known as a family trust company, an exempt trust company, or a family fiduciary services company, is a fast evolving and increasingly attractive tool for addressing the multi-faceted trust and wealth management needs of wealthy families. To that end, it is an entity authorized under state law to act as a fiduciary for a single family, and it is prohibited from soliciting business from the general public. **Observation:** The proposed definition of a family office should have no impact on a private trust company that is regulated or licensed under state law. That is because a trust company, which is supervised and examined by state or federal authorities, meets the definition of a bank and is not an investment adviser under the Investment Advisers Act.[17] On the other hand, certain states permit a private trust company to be unregulated or unlicensed. For instance, a private trust company in Nevada, referred to as a family trust company, is not required to be licensed.[18] Purportedly, Massachusetts, Pennsylvania, Virginia, and Wyoming also permit unregulated or unlicensed private trust companies.[19] Due to their unsupervised nature, unregulated or unlicensed private trust companies may fall within the definition of an investment adviser for purposes of SEC registration.[20] Consequently, similar to family offices, unregulated or unlicensed private trust companies may have to meet the SEC's definition of a family office in order to avoid the registration requirement.

CONCLUSION:

The SEC invited comments to the proposed rule, and the deadline for the comments was November 18, 2010. As of that date, seventy-six (76) comments had been submitted. The proposed rule and the comments can be viewed at www.sec.gov/rules/proposed.shtml.

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[17] 15 U.S.C. §§ 80b-2(a)(11)(A) and 80B-2(a)(2)(C) (2010).
[18] Nev. Rev. Stat. § 669A.110 (2010).
[19] Iris J. Goodwin, *How the Rich Stay Rich: Using a Family Trust Company to Secure a Family Fortune* (2009), http://works. bepress.com/iris_goodwin/1 at 10.
[20] 15 U.S.C. §§80b-2(a)(11)(A) and 80B-2(a)(2)(C) (2010).

In light of this extensive feedback from the professional community and family offices, it will be interesting to see what adjustments the SEC will make to the proposed rule. Regardless of the outcome, family offices that fall outside of the SEC's definition will still have options to avoid SEC registration. First, a family office can seek an exemptive order from the SEC.[21] Second, a family office can transfer its investment management to a regulated or licensed private trust company, which as noted above, is not an investment adviser under the Investment Advisers Act of 1940.[22]

[21] SEC Release No. IA-3098; File No. S7-25-10 (Oct. 12, 2010) at 8.
[22] Rashad Wareh, *Financial Reform Knocks on the Family Office Door,* Trusts & Estates, August 2010 at 48.