By Rashad Wareh

Financial Reform Knocks on The Family Office Door

New law requires family offices to register as investment advisers—but the SEC still needs to define the law's terms and scope

On July 21, 2010, many single family offices watched President Obama sign into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act).[1] Title IV of the Act is the Private Fund Investment Advisers Registration Act of 2010, which imposes new regulatory oversight on investment fund managers, requiring them to register with the Securities and Exchange Commission (SEC) and to make significant changes to their operations. It also repeals the private adviser exemption to the registration requirement, which enabled many family offices to avoid registration with the SEC. Title IV takes effect immediately, although it includes a one-year transition period for the provisions relating to registration of family offices. Although the Act provides new ways to avoid registration, including one specifically for family offices, the SEC is empowered to define the scope and terms of the family office exclusion. Until the SEC acts, the true impact of the Act is unknown.

In light of the new law, family offices must immediately determine what to do. The SEC should hear the voice of family offices during the rulemaking process to ensure that the final regulations for the family office exclusion appropriately accommodate the full range of structures and approaches employed by family offices.

Those family offices that believe they may not qualify for the new family office exclusion should begin triage efforts, including consideration of whether non-family investors may continue to invest with the family (some may be grandfathered) and what restructuring will enable them to avoid registration (for example, by spinning off venture capital (VC) investments, redeeming certain non-family investors and providing alternative compensation for non-family investors).

Alternatively, families may consider transferring their investment management to a private family trust company, which will continue to be exempt from registration.

Private Adviser Exemption

Under the Investment Advisers Act of 1940 (the Advisers Act), any investment adviser is required to register with the SEC, unless the adviser qualifies for an exclusion from the definition or an exemption from registration, discussed below. The Advisers Act defines an "investment adviser" as:

> 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….[2]

The definition of investment adviser specifically excludes certain persons, including certain regulated trust companies.[3]

If an adviser meets the definition of an "investment adviser" and must register as such under the Advisers Act, the adviser must file Form ADV with the SEC and update the form annually. Form ADV includes information on the ownership of the adviser (if not an individual), the adviser's structure and the value of assets under management (AUM). A registered investment adviser also must, among other requirements, prepare annual disclosure documents

Rashad Wareh is a partner in the New York City office of Kozusko Harris Vetter Wareh LLP

for its clients, appoint a chief compliance officer, maintain SEC compliant books, records, and operating guidelines and procedures and undergo periodic examinations and audits by the SEC.

The Advisers Act also includes several exemptions from the requirement to register as an investment adviser.[4] In the past, investment advisers commonly avoided registration under Section 203(b)(3), which exempts from registration an investment adviser who has no more than 14 clients and doesn't hold himself out to the public as an investment adviser. This exemption, often referred to as the "private adviser exemption," enabled many family offices and other managers to avoid registration because a single investment fund was counted as a single client, as long as the manager's advice was provided to the investment fund alone and not to the fund owners.

Current Family Office Requirements

As considered here, a family office is an organization dedicated to managing the affairs of a single family, which typically either owns or controls the family office. Family offices provide a range of services, including investment and administrative services. Family office investment services range from oversight of third-party investment managers (that is, no direct investment management) to direct and active discretionary investment in stocks, bonds, exchange-traded funds, third-party investment funds (for example, hedge funds, VC funds, or private equity funds) and other investments.

Before the Act, a family office may have also avoided registration as an investment adviser because it was able to establish that it didn't meet the definition of "investment adviser," if, for instance, the family office (1) didn't receive compensation for providing investment advice; (2) wasn't "in the business of advising others" as to investments and didn't provide investment advice "as a part of a regular business;" (3) wasn't advising "others," as its investment advice was limited to advising one family who owns or controls the family office; or (4) was a regulated trust company and thus qualified for the bank and trust company exclusion from the definition of an investment adviser.

The private adviser exemption, however, has been the simplest and least-restrictive exemption from registration as an investment adviser, not dependent on a facts and circumstances analysis. As a result, it has been widely relied upon by family offices.

As an alternative to the private adviser exemption, if a family office is expected to have more than 14 clients, it could request an exemption order from the SEC.[5] Since shortly after the enactment of the Advisers Act, the SEC has issued exemption orders to family offices despite their having more than 14 clients. Most recently, however, this path came to be regarded as slow and somewhat restrictive in practice, and the SEC only grants a limited number of applications.

> Without the exemption, family offices will be required to register as investment advisers unless they qualify for another traditional exclusion or for a new exemption.

New Ways to Avoid Registration

The Act flatly repeals the private adviser exemption.[6] Without this exemption, family offices will be required to register as investment advisers unless they qualify for another traditional exclusion from the definition of investment adviser (such as the bank and trust company exclusion) or for a new exclusion or exemption from registration created by the Act.

The Act provides three new avenues to avoid registration.

1. **VC fund adviser exemption.** The Act exempts advisers to VC funds from registration as an investment adviser.[7] Congress has directed the SEC to define "venture capital fund." The Report of the Senate Committee on Banking, Housing, and Urban Affairs to S.3217, the predecessor to the Act, provides some guidance.[8] VC funds are described as "a subset of private investment funds specializing in long-term equity investment in small or start-up businesses." This exemption is available to those advisers who

provide investment advice only to such funds.

2. **Private fund adviser exemption.** The Act exempts advisers to "private funds" from registration as an investment adviser, if the adviser provides advice only to one or more private funds and has less than $150 million in total AUM in the United States.[9] Congress also has directed the SEC to determine whether the size, governance or investment strategy of mid-sized private funds poses systemic risk and if so, to impose appropriate registration and examination procedures.[10] The Act defines a "private fund" as one that would be considered an investment company under the Investment Company Act of 1940 but for Section 3(c)(1) or 3(c)(7) of that Act (that is, referring to companies with fewer than 100 owners, or companies owned entirely by qualified purchasers).[11] A prior version of this exemption embodied in S.3217 and titled the "private equity fund adviser" exemption didn't impose a ceiling on AUM, but required the SEC to define "private equity fund." The S.3217 version would have been an attractive path for some family offices if it allowed a family office to spin out its VC investments and satisfy the VC fund adviser exemption, while fitting its remaining investments under the "private equity fund" exemption (with no limit as to AUM). By instead imposing the AUM ceiling for the private fund exemption, the Act limits its usefulness to families with greater than $150 million invested (other than in VC).

By imposing the assets under management ceiling for the private fund exemption, the Act limits its usefulness to families with greater than $150 million invested.

3. **Family office exclusion.** The Act excludes "any family office, as defined by rule, regulation, or order of the [SEC]" from the definition of an investment adviser under the Advisers Act.[12] It directs the SEC to provide rules of general applicability defining an excluded "family office" and requires the SEC to:

   "provide for an exemption that—(1) is consistent with the previous exemptive policy of the Commission, as reflected in exemptive orders for family offices in effect on the date of enactment of this Act and the grandfathering provisions in [the Act]; (2) recognizes the range of organizational, management, and employment structures and arrangements employed by family offices; and (3) does not exclude [certain grandfathered family offices] from the definition of "family office", solely because such [family office] provides investment advice to [certain persons]…."

Grandfathering provisions in the Act provide that a family office that was not required to register as an investment adviser before Jan. 1, 2010 shall not be excluded from the new family office exemption solely because it continues to provide investment advice to (1) individual officers, directors or employees of the family office, as long as such individuals had invested with the family office before Jan. 1, 2010 and were, at the time of investment, accredited investors; (2) any company exclusively owned by the family associated with the family office; or (3) certain registered investment advisers who co-invested limited amounts with the family office.[13]

In the Report of the Senate Committee on Banking, Housing, and Urban Affairs to S.3217 (the Report), in discussing the family office exclusion, the Committee noted the history of the SEC's exemption orders for family offices, and the Committee's belief:

> "that family offices are not investment advisers intended to be subject to registration under the Advisers Act. The Advisers Act is not designed to regulate the interactions of family members, and registration would unnecessarily intrude on the privacy of the family involved."

In the Report, the Committee recognized that many family offices have non-family members as officers, directors and employees, and that such persons (and other persons who may provide services

to the family) are at times permitted to co-invest with family members and specifically stated that such arrangements should not automatically exclude a family office from qualifying for the exclusion.

The text of the family office exclusion and the earlier Report on S.3217 indicate that, in defining the family office exclusion, Congress intended that the SEC not be limited to replicating the criteria for its past exemption orders and that it must take into account the fact that family offices vary widely in their organization, management and employment structures. The grandfathering provision is an interesting addition to this process because it appears to suggest that Congress wants the SEC to avoid disrupting certain existing family office structures and common arrangements, in the SEC's determination of what type of family office will avoid being considered an investment adviser.

The Act also expands state regulatory oversight of investment advisers by raising the threshold for federal oversight of most investment advisers to $100 million. The Act provides, with some exceptions, that no investment adviser with AUM of between $25 million to $100 million shall be permitted to register as an investment adviser under the Advisers Act, unless as a result of this provision the adviser would be required to register with 15 or more states.[14] Due to this change, state regulatory authorities will be responsible for oversight of most investment advisers with less than $100 million AUM. This increased state oversight doesn't apply to investment advisers who are excluded from the definition of investment adviser under Section 202(a)(11) of the Advisers Act (for example, an adviser excluded from the definition under the bank and trust company exclusion or the new family office exclusion), but does apply to advisers who would otherwise be exempt under section 203 of the Advisers Act (for example, VC fund advisers or private fund advisers).

Open Issues

Because the Act provides enabling legislation, rather than actively defining the new family office exclusion from the definition of investment adviser and the new exemptions from registration as an investment adviser, a number of issues remain uncertain.

- What is a "VC fund?"

- What size, governance or investment strategy or private fund will result, in the SEC's view, in "systemic risk?" When a private fund does cause systemic risk, what registration and examination procedures will the SEC impose on the adviser to such a fund?

- Will a family office be unable to qualify for the family office exclusion if (1) it operates for a profit, (2) individual family members control the board but don't hold a majority of officer (or equivalent) positions, or (3) it's not controlled by a family, although it only serves one family?

- Will the definition of "family" incorporate stepchildren, in-laws, former spouses, nonprofits established by the family, partners in civil unions, ERISA-regulated plans and other employee compensation arrangements, etc.?

- Previous definitions of "family" imposed by the SEC in the context of the Advisers Act and the Investment Company Act of 1940 have been fairly narrow. Practitioners must comment to the SEC, in the rulemaking process, to ensure that it uses a reasonably broad definition of "family" for the family office exclusion.

- The grandfathering provision appears to permit a family office to qualify for the family office exclusion despite non-family directors, officers and employees having co-invested with the family, if such investment occurred before Jan. 1, 2010. Will non-family members who are closely connected with the family office be permitted to invest with the family going forward and still permit the family office to qualify for the exclusion? A practical rule for the SEC to consider would be to provide that a family office advised family investment fund with a de minimis level (for example, 5 percent) of non-family ownership could still qualify for the family office exclusion, assuming the exemption would otherwise be available. This would also take some pressure off of the definition of who is "family."

- What reporting requirements will the SEC impose on VC fund advisers and private fund advisers? Under the Act, advisers who qualify for one of those

exemptions must comply with recordkeeping and reporting requirements that the SEC "determines necessary or appropriate in the public interest or for the protection of investors."[15]

Under current law, federal registration rules control if an investment manager has more than $25 million AUM and state registration rules apply otherwise. Under the Act, federal registration rules will control if (1) a family office qualifies for the family office exclusion (in which case neither federal nor state registration is required), (2) an investment manager has more than $100 million AUM, or (3) an investment manager has between $25 million and $100 million AUM and, either (a) the regulators in the manager's home state wouldn't subject the manager to examination, or (b) the manager would be required to register in 15 or more states if subject to state registration rules.[16] Family offices that don't qualify for the new law's family office exclusion must determine in which states they must register and if under state law they qualify for an exemption from registration.

Restructuring During the Transition

The Act provides a transition rule that delays for one year its provisions as to the termination of the private adviser exemption and the creation of the new family office exclusion and the new exemptions from registration.[17]

Family offices and other managers of private family investment funds should now consider how the Act might affect their structure and operations, and, if they wish to avoid registration as an investment adviser, what changes may be necessary. All family offices—and any family funds that relied on the private adviser exemption in the past—should be evaluating their structure, the persons connected to the structure (directors, officers, employees and investors) and the economic interests they hold. If a family office has informal relationships with its funds or clients, it should consider formalizing those to assess where they fit under the new law.

In addition, family offices should determine what effect registration as an investment adviser will have on their ability to keep the family's financial affairs confidential, and, if the family office serves more than one branch of the family, what effect registration has on intra-branch confidentiality. It's also fair to assume that the associated regulatory burden will grow, not shrink, as a result of the Act.

Here are some alternative approaches for family offices to consider.

- **All family offices:** Consider other exclusions from being considered an investment adviser or exemptions from registration: (1) Form a regulated trust company and offer family investment advisory services through it, thus qualifying for the bank and trust company exemption to registration;[18] (2) register as an investment adviser; (3) outsource investment advice to third-party registered investment advisers and ensure that such advisers have the direct investment advisory relationship with the family investment funds and other family persons so that the family office then ceases to render investment advice; or (4) close the family office and transition all of its services, including investment management, to a multi-family office that's a registered investment adviser.

- **Family offices with no non-family investors:** Qualify under the family office exemption. Possible problems include: (1) What is the meaning of "family"? (2) If the family office is operated for profit, does that render it ineligible, and how is "profit" measured? (3) Does the family office's management structure render it ineligible? and (4) What qualification criteria will result from the SEC rulemaking process?

- **Family offices with non-family investors or those that otherwise don't qualify for the family office exclusion as currently structured:**

  —Consider alternative means to compensate non-family investors, other than through co-investment in family investment funds. Until the SEC completes the rulemaking process, what alternatives are feasible is uncertain.

  —If existing non-family investors will render the family office ineligible for the family office exclusion,

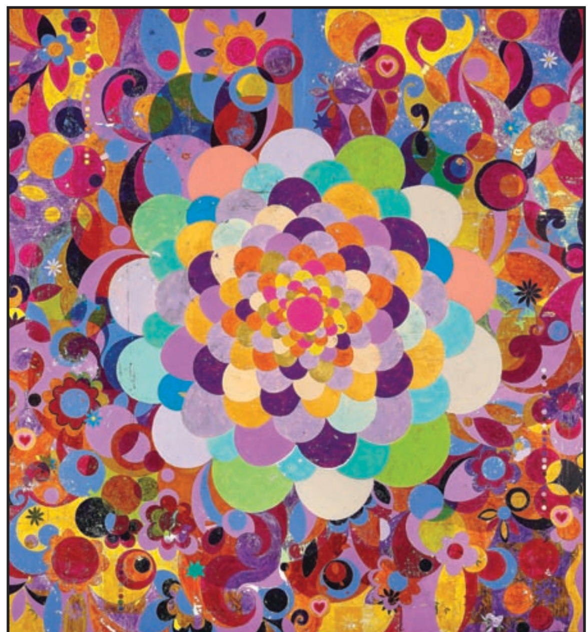
despite the grandfathering provisions, begin the process to spinout those investors as soon as possible. Depending on the nature of the investments, the spin-out process may be a lengthy one.

—Restructure the family office so that (1) the family office handles only administrative and non-investment functions; (2) affiliated companies (possibly subsidiaries) provide all investment advice; and (3) the VC investments are separated from the family's other investments. To separate out the VC investments, spin out VC investments into one or more separate VC funds; ensure that investment advice to such VC funds is given by an entity whose only advisory clients are VC funds (to qualify for the VC fund adviser exemption, the adviser may only advise VC funds); keep remaining, non-VC investments in separate private funds; and ensure that investment advice to such separate private funds is given by an entity whose only advisory clients are private funds (to qualify for the private fund adviser exemption, the adviser may only advise private funds). If total AUM in the private funds advised by any one adviser entity are likely to exceed $150 million, consider whether additional advisory entities would permit separate qualification of each under the private fund adviser exemption (the SEC rules likely will include an anti-abuse/avoidance provision that will restrict this path).

Practitioners' concern as to the impact of the Act on family offices and family investment funds is understandable—but the exclusion of a family office as an investment adviser, as well as the VC fund and private fund exemptions, also represent a welcome opportunity for the SEC to provide clear and reasonable rules of general applicability for family offices and family investment funds. TE

Endnotes

1. H.R. Report 111-517, 111th Congress, 2nd Session, June 29, 2010. *See* Brody Mullins, "Family Trusts Lobby to Avoid New Rules," *Wall Street Journal*, Oct. 21, 2009.
2. The Investment Advisers Act of 1940 (Advisers Act), Title IV, Section 202(a)(11).
3. *Ibid*, Section 202(a)(11)(A).
4. *Ibid*, Section 203.
5. *Ibid*, Section 202(a)(11)(G).
6. Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), Section 403.
7. *Ibid*, Section 407.
8. Senate Report on S.3217, 111-176, April 30, 2010. The joint conference report does not provide any meaningful guidance.
9. The Act, Section 408.
10. *Ibid*, Section 402(a).
11. *Ibid*, Section 402(a).
12. *Ibid*, Section 409.
13. *Ibid*, Section 409(b)(3).
14. *Ibid*, Section 410.
15. *Ibid*, Sections 407-408.
16. *Ibid*, Section 410.
17. *Ibid*, Section 419.
18. If a family currently has both a family office and a regulated trust company, consider an immediate structure review, and take steps to shift as many of the family office advisory clients to the regulated trust company as is feasible before the end of the one-year transition period.



SPOT LIGHT

Welcome Distractions—Beatriz Milhazes' 2005 acrylic on canvas, "Moreno," about 117 inches by 117 inches, sold for U.S. $814,040 at Christie's "Post War and Contemporary Art Evening Auction" in London on June 30, 2010.