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Single family office exemption from registration as investment adviser

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It is not unusual for international family clients to handle the investment of their wealth personally. The family office is often established, and hires staff, with the express goal of investment management. The United States has long required investment advisers to register with the Securities and Exchange Commission (SEC), but had exempted advisers with fewer than 15 clients. The simplicity of this exemption is now gone. A family office falling within the definition of 'investment adviser' has until March 30 2012 either to register or to qualify for an exemption. This update focuses on the new single family office exemption.

Background

The Investment Advisers Act 1940 is a federal law enacted to regulate the activities of investment advisers. Unless they are otherwise exempted or excluded from registration, the act requires larger investment advisers to register with the SEC. An 'investment adviser' is defined 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".

There is specific guidance as to what constitutes a larger investment adviser, based on assets under management. There is also considerable law interpreting each of the elements of the above definition. If a family office is in doubt as to whether it falls within the definition of 'investment adviser', it should seek the advice of counsel promptly.

Dodd-Frank Act

Financial reform legislation enacted in 2010, commonly referred to as the Dodd-Frank Act, removed an exemption from registration previously available for investment advisers with fewer than 15 clients to enable the SEC to regulate private fund advisers (eg, hedge funds, private equity funds and hybrid funds). However, the Dodd-Frank Act carved out an exclusion from registration under the 1940 act for single family offices and instructed the SEC to define which family offices providing investment advice would qualify. On June 22 2011 the SEC released details of its final rules (effective August 29 2011) regarding excluded single family offices. Now, a family managing its own financial portfolio can apply those final rules to determine whether its family office will henceforth be excluded from registration under the 1940 act.

The Dodd-Frank Act includes other exemptions from registration, including exemptions for certain private fund advisers and foreign private advisers. The SEC has also released final rules (effective July 21 2011) with respect to these exemptions. Investment advisers solely to private funds with less than \$150 million in assets under management in the aggregate are exempt from registration. Because this exemption looks to the aggregate value of assets managed in private funds, an international family office often will not qualify for this exemption due to size.

A foreign private adviser may also be exempt from registration. An exempt foreign private adviser is any investment adviser that:

- has no place of business in the United States;
- in total, has fewer than 15 clients in the United States (including investors in the United States in private funds advised by the

investment adviser);

- has aggregate assets under management attributable to clients in the United States (and investors in the United States in private funds advised by the investment adviser) of less than \$25 million; and
- does not hold itself out generally to the public in the United States as an investment adviser.

Although many foreign private advisers may have fewer than 15 clients in the United States, because of the \$25 million aggregate limit for assets under management, international family offices will not generally qualify for this exemption. The SEC has the power to raise the threshold amount and has said that it will evaluate whether doing so may be appropriate in the future.

Exempt single family office

Determining whether a family office that is considered an investment adviser will now be excluded from the registration requirement under the 1940 act is a three-prong test. An excluded single family office is any company that does not hold itself out to the public as an investment adviser and:

- provides investment advice only to "family clients";
- is wholly owned by family clients; and
- is exclusively controlled by family members or family entities.

Family clients

Family clients consist of family members and key employees, as well as certain non-profit charitable organisations, estates, trusts and companies.

Family members

'Family members' are defined as:

- all lineal descendants (including by adoption, stepchildren, foster children and, in some cases, legal guardianship) of a common ancestor who is no more than 10 generations removed from the youngest generation of family members;
- such lineal descendants' spouses or spousal equivalents; and

- certain former family members.

The SEC's final rules define 'family member' as an individual descended from a common ancestor (alive or dead) and the spouse (or spousal equivalent) of that descendant. Such individuals include not only blood descendants, but also adopted children and stepchildren, as well as foster children and wards of a family member in certain cases. In-laws are currently not included, but may be so in the future. To ensure practical limits, the final rules require that the common ancestor be no more than 10 generations removed from the youngest family member client, but are flexible in selecting and changing the common ancestor from time to time. The SEC's final rules also impose practical limits on former family members (eg, after a divorce) and former key employees.

Key employees

Key employees are the executive officers, directors, trustees, general partners or persons serving in a similar capacity for the family office or its affiliated family office and any other employee of the family office or its affiliated family office (other than a clerical or secretarial employee) who, in connection with his or her regular duties, has participated in the investment activities of the family office or affiliated family office, or similar functions or duties for another company, for at least 12 months.

Non-profit charitable organisations

Only non-profit charitable organisations funded exclusively by family clients are considered family clients.

Estates

Family clients include estates of a family member, a former family member, a key employee or, subject to certain conditions, a former key employee.

Trusts

Trusts which will be considered family clients are:

- irrevocable trusts where other family clients are the only current beneficiaries;
- irrevocable trusts funded exclusively by family clients in which other family clients and non-profit organisations are the only current beneficiaries;
- revocable trusts of which family clients are the sole grantors; and

- certain trusts of key employees.

The distinction between trusts funded exclusively by family clients and those for the benefit of family clients but funded by others is worth noting. Only irrevocable trusts funded exclusively by family clients are permitted to have charities not funded by family clients (eg, public charities such as the United Nations Children's Fund) as beneficiaries and still be classified as family clients. Irrevocable trusts funded by others will be classified as family clients only if any charitable beneficiaries are themselves family clients – that is, funded exclusively by family clients. Care must also be taken on the death of the grantor of a revocable trust in case such a trust has non-family clients.

Companies

Any company that is wholly owned by and operated for the sole benefit of family clients is considered a family client. For pooled investment funds advised by the family office, those funds must also be exempt from registration as an investment company under the Investment Company Act of 1940.

Ownership and control

To qualify for the family office exemption from SEC registration, ownership of the family office is limited to 'family clients' – that is, individual family members and key employees, as well as family trusts, business entities and non-profit organisations. This was an important concession by the SEC from its proposed rule and generally encompasses the ownership structures currently employed by family offices. On the other hand, control of the family office is more limited. Only individual family members and certain defined 'family entities' (more narrow than 'family clients') may exercise ultimate control over the family office. 'Control' means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company.

Deadline to qualify for exemption from registration

A family office that is considered an investment adviser and, before June 22 2011, qualified for the 'fewer than 15 clients' exemption from SEC registration has until March 30 2012 either to register under the 1940 act or to qualify for the new single family office exemption. To analyse whether it

qualifies, the family office should collect all data necessary to apply the provisions of the SEC's final rules to the particular family office's circumstances, such as:

- identifying all clients and, if its clients are entities, all current and future named fiduciaries (eg, general partners, managers and trustees) and owners and beneficiaries;
- identifying all persons who work in the family office, exactly which entity employs them and what their functions are;
- identifying who or what owns the family office itself and how decisions are made at the owner level; and
- creating a detailed description of how 'investment advice' (broadly defined) is generated and deployed, addressing each stage of advice.

Comment

This update provides a greatly simplified description of the SEC's final rules. The SEC has promised further guidance on certain open issues, such as when the family office provides investment advice to a family friend for no charge and whether an individual investment adviser can be a family office. Such guidance would be welcome as international family clients seek to comply with the new SEC registration rules.

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