

SEC Provides Relief to Family Offices under Dodd-Frank

By Miles C. Padgett, JD, CIMA®

Historically, most single-family offices have been exempt from registration as investment advisors under the Investment Advisers Act of 1940 (Advisers Act) due to the private advisor exemption, which exempted an advisor with fewer than 15 clients. However, in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), Congress revoked the private advisor exemption, changing the rules for family offices that provide investment advice. Congress created a new single-family office exclusion, however, for certain family offices and directed the Securities and Exchange Commission (SEC) to establish its scope. The SEC issued its final rule on that exclusion on June 22, 2011 (SEC 2011).¹

A family office now must address whether it qualifies for the new exclusion before providing investment advice as part of its services. If the family office qualifies for the new exclusion, then no action is required (i.e., the exclusion is self-actuating). If the family office does not qualify, it must register or restructure so as to qualify.

Threshold Question: Is the Family Office an Investment Advisor?

Because most family offices have been exempt from registration under the private advisor exemption, this question rarely has been asked. Now, whether a family office would constitute an investment advisor under the Advisers Act has become a critical threshold determination. By definition, an “investment adviser” is a person who provides 1) advice or analyses concerning securi-

ties 2) to others 3) as part of a business of providing such services and 4) does so for compensation.² Exploring each of those constituent elements is beyond the scope of this article, but it is important to note that the SEC interprets those elements quite expansively.³ Thus, if a family office concludes that it would not be an investment advisor because it fails one or more of those elements, the family office should assume that it will draw intense scrutiny from the SEC and be prepared to vigorously defend itself.

Qualifying for the Single-Family Office Exclusion

Assuming that a family office will be considered an investment advisor, the family office would be well-advised to avail itself of the single-family office exclusion, if possible. To qualify for the exclusion, the SEC’s final rule requires:

- the family office (and its employees) to provide investment advice only to family clients;
- ownership of the family office be limited to family clients; and
- control of the family office be restricted to family members and family entities.

The above are defined in the SEC’s final rule.

Family Clients

Those clients that can be advised by a family office without loss of the exclusion are limited to family members, certain family trusts and entities, key employees of the family office, and certain trusts established by a key employee. Membership in the family is based on recognized family relation-

ships: A family member is an individual descended from a common ancestor (alive or dead)⁴ and the spouse (or spousal equivalent) of that descendant. Moreover, those descendants are not simply limited to blood descendants; adopted children and stepchildren, as well as foster children and certain wards of a family member, are permitted clients. Note, however, that in-laws by marriage (i.e., parents of one’s spouse) are not permissible clients [SEC 2011, Section 275.202(a)(11)(G)-1(d)].

Moreover, former family members occupy almost the same position as current family members, so that in most cases divorce should not disqualify a person as a permissible client of the family office. This regulation accommodates the reality of families with former spouses who are parents of children who are family members. So a former family member is a spouse (or the equivalent) or a stepchild who had been a family member but through a divorce (or equivalent) has ceased to qualify as a family member. Thus, these persons can be permissible family clients for both pre-existing and new investments, but they no longer can participate in the control of the family office (as discussed below).

Family clients—that is, permissible clients—also include certain family trusts, business entities, charities, and other nonprofit organizations. Here, the final rule becomes quite complex in its terms and application. Briefly, the final rule provides that:

- revocable trusts are specifically allowed so long as the grantors qualify as family clients;
- irrevocable trusts are permitted if the current beneficiaries are family



- clients (non-family remainder and contingent beneficiaries can be disregarded);
- irrevocable trusts also are permitted if the current beneficiaries consist only of family clients or nonprofit organizations (including charities), or both, so long as funding came only from other family clients;
 - charities and nonprofit organizations⁵ are permitted if they hold assets contributed solely by other family clients, which again accommodates many currently existing entities that were funded through various family sources, not simply individual family members; and
 - family companies (limited liability companies, limited partnerships, corporations, etc.) are permitted so long as they are owned exclusively by family clients. (Control of such entities may be exercised by independent third parties so long as the ownership requirement is met. Pension plans are treated as family clients so long as no one other than a family client is a beneficiary under the plan.)

So, for example, individual family members and qualified family business entities could create a trust for the sole purpose of supporting a non-family public charity such as one's alma mater, and the family office could provide investment advice to that trust, for example, as a partner in the family's investment partnership without compromising qualification for the exclusion.

Importantly, though, the SEC categorically refused to allow de-minimis amounts of non-family ownership of family entities and generally refused to allow de-minimis amounts of non-family contributions to family charities. (Certain segregation of non-family contributions to family charitable entities is permitted.⁶) Thus, the single-family office exclusion does not accommodate the practical reality that many family entities are owned, in part, by non-

family even though to an immaterial degree, or that many family charities often wish to accept donations from friends of the family.

Key Employees

The SEC's final rule permits key employees (and certain trusts they create) to be clients of the family office. "Key employees" generally are defined as individuals who serve the family office as executive officers, directors, trustees, general partners or those in a similar capacity, and those persons who perform substantive investment functions (and have done so for at least 12 months prior).⁷ Critically, a key employee can be employed by the family office or by an affiliated family office. This was an important critical accommodation by the SEC; it allows situations in which the family uses sister-brother entities for tax and business reasons, such as an unregulated private trust company that provides comprehensive services (except investments) and an investment advisory arm that limits its services to investment advice and reporting.⁸

Grace Period for Involuntary Transfers

If an involuntary transfer occurs and the transferee is not qualified, then the family office is provided a grace period of one year to arrange for the transferee to cease to be a client, and this period does not begin to run until after title has passed to the transferee. In the typical case, (that is, death or divorce), the family office could resolve the issue by paying the involuntary transferee and arranging for the transferee to engage his or her own investment advisor for the transferred assets.

Owning the Family Office

The proposed rule allowed ownership of the family office only by individual family members, but the final rule permits family clients to own the family office. This was an important change coming out of the comment process.

It expands permissible ownership to include key employees who are not family members as well as—and most importantly—family-related entities. Ownership of the family office by family-related entities is the current state of affairs for many family offices, and disallowing this would have caused significant disruptions to those organizations. Moreover, allowing key employees to own interests in the family office itself allows family offices flexibility in how they compensate key employees (although it is more common for key employees to own carried interests at the investment or family investment fund level). Fortunately, the SEC was open to constructive criticism of the proposed rule on both of these points and broadened its approach.

Controlling the Family Office

Ownership of the family office is limited to family clients, but control of the family office is restricted to family members and family entities, directly or indirectly (recall that a family entity is a family client who is not a key employee or a person or entity related or attributable to a key employee, such as a former key employee). Of course, definitions are important here, but the reasoning behind the SEC's position is that the policy behind the family office exclusion—that a family was simply investing its own money and was thus advising itself—required family control of the office by either individuals or a defined class of family entities. Thus, by using the terms "family member" and "family entity" rather than the broader term of "family client," the SEC in the final rule precluded direct control of the family office by key employees or by former family members. Those persons can be clients and are permitted to own part of the office, but they cannot exercise control.

Control for this purpose means the control over policies of the office, not managerial control through one's position as an officer. Moreover, according to the SEC, it does not

mean the ability to control policy. For example, as a shareholder in a corporation, merely having the power to elect a majority of the board of directors does not constitute control; control means occupying a majority of the seats on the board.

It's All about Process

Ascertaining whether a family office qualifies for the new exclusion (before beginning to provide investment advice) is for the most part a mechanical, yet important, exercise that entails:


- creating a current and accurate family tree;
- creating a detailed description of how investment advice will be generated and delivered;
- identifying all of the persons and entities that will be clients, and if an entity, all of the current and future named fiduciaries (general partners, managers, trustees, etc.) and owners and beneficiaries;
- identifying all individuals who work in the family office, exactly which entity employs them, and what their functions are;
- reviewing all employment contracts and job descriptions;
- identifying who or what owns the family office itself and how decisions get made at the owner level;
- reviewing all buy-sell arrangements in family entities and the family-office itself, including pre-nuptial and ante-nuptial agreements; and
- identifying how day-to-day versus strategic policy decisions of the family office are made and by whom.

All of the above information will be needed to determine whether a family office qualifies for the exclusion initially and for ensuring that it remains qualified as time passes. To reduce costs, most of the work in compiling the above information can and should be performed by the family office staff. However, a well-advised family office would procure some form of written

confirmation by legal counsel that the family office qualifies for the exclusion. In cases where qualification is ambiguous or not entirely clear, having that written confirmation could mean the difference between draconian, compared to merely punitive, sanctions if it is ultimately determined that the family office did not qualify.

If, after analysis, it is clear that the family office would not qualify, the family office must decide how to resolve the problematic issue(s). Solutions could take many forms, some more palatable than others, including, for example, sending those who would not be qualified clients to outside investment advisors.

Final Thoughts

Looking on the bright side, given today's intense regulatory and legislative climate, family offices were fortunate to garner an exclusion from the Advisers Act rather than a mere exemption. An exclusion from the Advisers Act means that qualifying family offices need not be concerned with state regulation of investment advisors (other than preventing fraud, preventing unregistered solicitors, etc.) and that the family office need not file any sort of report with the SEC (unlike, for example, venture capital or private fund advisors). Yet, due to the terms of the final rule, creative structuring of family offices will be constrained in the future. While the final rule accommodates a wide range of structures and factual patterns, it is not designed to accommodate relatively unusual structures that exist today and certainly not unusual structures to be created in the future, even though those structures might embody better, more efficient ways to organize a family's affairs. 

Miles C. Padgett, JD, CIMA[®], is an attorney with Kozusko Harris Duncan in Washington, DC. He earned a BA with distinction from Cornell University and a JD from Vanderbilt University. Contact him at mpadgett@kozlaw.com.

Endnotes

- 1 See SEC Release No. IA-3220, 76 FR 37983, for the final rule (release). <http://www.gpo.gov/fdsys/pkg/FR-2011-06-29/html/2011-16117.htm>. Other exemptions created under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) are for venture capital fund advisors, private fund advisors with less than \$150 million in assets under management, and certain foreign private advisors, the details of which were addressed in other SEC releases.
- 2 "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..." Investment Advisers Act of 1940 (Advisers Act), Section 2(a)(11).
- 3 For example, advice regarding securities is interpreted to include the relative merits of investing in securities generally versus other assets (real estate, physical commodities, etc.); the retention or termination of investment managers; asset allocation; and performance reporting.
- 4 The rule states that the common ancestor can be "no more than 10 generations removed from the youngest generation of family members." Final rule section 275.202(a)(11)(G)-1(d)(6). The family office itself is allowed to identify the common ancestor and to change the common ancestor from time to time, and there's no prescribed process for how this identification or change must occur. See final rule release at footnote 27.
- 5 It is now clear that "non-profit organizations" that may or may not have been "charitable" for certain purposes (for example, income tax versus gift tax deductibility) are permitted clients if they meet the noted funding requirement.
- 6 See Staff Responses to Questions about the Family Office Rule, released January 19, 2012. <http://www.sec.gov/divisions/investment/guidance/familyofficefaq.htm>.
- 7 The Family Office Rule also explains what constitutes an executive position: it is one

Continued on page 51



Cooper

Continued from page 48

Endnotes

- 1 See the “Stronger Super” website at <http://strongersuper.treasury.gov.au/content/Content.aspx?doc=home.htm>.
- 2 See the Superannuation Roundtable press release of January 29, 2012, at <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2012/004.htm&pageID=003&min=wms&Year=&DocType>.

References

- Australian Trade Commission. 2011. Australia: A Wealth of Opportunities, Benchmark Report 2011. <http://www.austrade.gov.au/ArticleDocuments/2792/Benchmark-Report-2011.pdf.aspx>.
- Australian Treasury. 2010a. Intergenerational challenges. http://archive.treasury.gov.au/igr/igr2010/Overview/html/overview_01.htm.
- Australian Treasury. 2010b. Review into the Governance, Efficiency, Structure and Operation of Australia’s Superannuation System. <http://www.supersystemreview.gov.au/>.
- Beaman, Lucinda. 2012. Do platforms need a revolution? *Money Management* (May 12). <http://www.moneymanagement.com.au/analysis/investment-management/2012/do-platforms-need-a-revolution>.
- Cumbo, Josephine. 2012. Webb Floats Idea of Money-Safe Pension. *Financial Times* (July 3). <http://www.ft.com/intl/cms/s/0/f6286940-c430-11e1-9c1e-00144feabdc0.html#axzz22ve555ii>.
- Financial Services Council. 2012. Australians living longer—increase workforce participation for older workers (press release, February 8, 2012). http://www.fsc.org.au/downloads/file/MediaReleaseFile/2012_MR_Speech_JB_Longevity.docxFinal.pdf.
- McCraw, Thomas K. 2007. *Prophet of Innovation: Joseph Schumpeter and Creative Destruction*. Cambridge, MA: Harvard University Press.
- National Seniors Association. 2012. *Financial Wellbeing: Concerns and choices among older Australians*. http://www.nationalseniors.com.au/icms_docs/126453_0612_PAC_Report_Financial_Wellbeing.pdf.
- Sherry, Nick. 2012. Some Challenges Facing Australia’s Defined Contribution (DC) Superannuation System. 20th Annual Colloquium of Superannuation Researches University of NSW [New South Wales]. July 12–13, 2012. <http://bit.ly/MvYVMX>.

Maloney–Miller

Continued from page 21

- 11, 2007 University of Miami School of Law: Heckerling Institute on Estate Planning.
- Center for Retirement Research at Boston College. 2010. The MetLife Study of Inheritance and Wealth Transfer to Baby Boomers. MetLife Mature Market Institute. <http://www.metlife.com/assets/cao/mmi/publications/studies/2010/mmi-inheritance-wealth-transfer-baby-boomers.pdf>.
- King, A. W., and Pierce McDowell. 2006. Delegated vs. Directed Trusts, 145 *Trusts & Estates* 26 (July 2006). Available by subscription at <http://wealthmanagement.com/practice-management/delegated-vs-directed-trusts-0>.
- Mutnick, Deborah. 2011. Occupy Wall Street And The Rhetoric of Equality. *Forbes Personal Finance* (blog), <http://www.forbes.com/sites/deborahljacobs/2011/11/01occupy-wall-street-and-the-rhetoric-of-equality/>.
- Office of the Comptroller of the Currency (OCC). 2001. Investment Management Services—Comptroller’s Handbook. <http://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/invmgt.pdf>.

 To take the CE quiz online, visit www.IMCA.org.

Padgett

Continued from page 24

- that involves policy-making decisions and includes vice president positions in charge of principal business units of the family office. Final rule Section 275.202(a)(11)(G)-1(d)(8). This definition of “executive” is substantially identical to definitions used in other parts of the Advisers Act (Advisers Act Rule 205-3) and in rules under the Investment Company Act of 1940 (specifically, Rule 3c-5).
- 8 That term is defined as “a family office wholly owned by family clients of another family office and that is controlled (directly or indirectly) by one or more family members of such other family office and/or family entities affiliated with such other family office and has no clients other than family clients of such other family office.” In English, if the same family owns and controls both family offices, and those offices have appropriate clients, the family offices are considered “affiliates.”

 To take the CE quiz online, visit www.IMCA.org.