By Miles C. Padgett

SEC Rules on the Family Office

Another unnecessary necessity

Family offices must now square the corners of their ownership and investment process with a new regulation. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) fundamentally changes the rules for family offices that provide investment advice. Prior to the passage of that law, many family offices considered themselves exempt from registration under the Investment Advisers Act of 1940 (Advisers Act) due to the exemption for advisers with less than 15 clients. In enacting Dodd-Frank, however, Congress revoked that exemption effective as of July 2011, but created a new exemption for family offices—the single-family office exclusion—and directed the Securities and Exchange Commission to establish its scope. The SEC began that process on Oct. 12, 2010, with its release of Proposed Rule 202(a)(11)(G)-1 (proposed rule), and after considering comments from dozens of organizations, issued its final rule on June 22, 2011 (final rule).[1] Family offices must now address whether they qualify for the new exemption; if a family office doesn't qualify, it must decide promptly how to restructure and must then execute that restructuring without delay.

Framework of the Advisers Act

Whether a family office constitutes an "investment adviser" under the Advisers Act has now become an important threshold determination. Unfortunately, there's precious little authoritative guidance that translates directly to the family office context because, in the past, most offices were exempt from registration under the prior 14-client exemption. In any event, under the key language of the Advisers Act, an "investment adviser" is a person who provides to others advice or analyses concerning securities as part of a business of providing such services, and does so for compensation.[2]

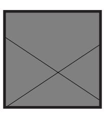
"To others." The SEC broadly interprets the first element—"to others"—and has found that it can be as broad as giving advice to one's partner in a two-partner joint venture.[3]

Providing "advice or analyses concerning securities." This includes not only advice as to a particular security or securities, but also advice regarding:

- the relative merits of investing in securities generally versus other assets (for instance real estate, physical commodities);
- the retention or termination of investment managers;
- asset allocation (that is, investing certain percentages of one's portfolio in particular asset classes); and
- performance reporting on actual portfolios or securities.[4]

Part of a "business." Similarly, whether one is in the "business" of being an investment adviser depends upon the degree of the person's advisory activities. The giving of advice needn't be one's primary business activity, nor constitute any particular proportion of that activity. It need only be done with regularity and in "other than rare, isolated and non-periodic instances."[5]

"Compensation." The term "compensation" includes any form of fee such as a "commission," a single "flat fee"



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for a variety of services or a combination of those. It includes indirect fees such as a fee-sharing arrangement and could even include mere reimbursement of investment-related expenses.[6]

Accordingly, many family offices will fall within this definition and be considered an "investment adviser" under the Advisers Act and therefore will need either to qualify for an exemption from registration or to register with the SEC (or appropriate state regulators for small advisers). With that background, let us now turn to the exemption that will be most frequently relied upon: the new family office exclusion.

Summary of Final Rule

The final rule contains three general conditions to qualify for the single-family office exclusion:

- the family office (and its employees) can provide securities advice only to "family clients;"
- ownership of the family office is limited to family clients; and
- control of the family office is restricted to "family members" and "family entities."

Family Clients

The final rule contains critical and somewhat complex terminology that defines "family clients"—that is, those clients that can be advised by a family office without loss of the exemption. This category includes a "family member," certain family trusts and entities and "key employees" of the family office and certain trusts established by a key employee. The final rule, unlike the proposed rule, defines who's in the family by reference to recognized family relationships: a "family member" is as an individual descended from a common ancestor (alive or dead) and the spouse (or spousal equivalent) of that descendant. Moreover, those descendants aren't limited to blood descendants; they include adopted children and stepchildren, as well as foster children and wards of a family member (if the ward was a minor when the family member became his guardian). Allowing foster children and certain wards, and more importantly tracing to a common ancestor, were material revisions to the proposed rule the SEC made in response to comments received as part of the comment process. Note, however, that in-laws aren't included in the definition of family member.[7]

> The final rule requires that the common ancestor be identifiable within no more than 11 generations.

To ensure a workable limit to this common ancestor concept, however, the final rule requires that the common ancestor be identifiable within no more than 11 generations of the family. Indeed, 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.[8]

The final rule also puts "former family members" in almost the same position as current family members, so in most cases, divorce shouldn't disqualify clients of the office, which makes sense given that the former spouse remains a parent of children who are still family members. A "former family member" is a spouse (or the equivalent) and stepchildren who had been family members but through a divorce (or equivalent) have ceased to qualify as such. Thus, these persons can be permissible "family clients" for both pre-existing and new investments.[9] As we'll see, however, former family members can't remain in a direct position of control over the family office because they're no longer "family members."

"Family clients"—that is, permissible clients—also include certain family trusts, business entities, charities and other non-profit organizations. This is where the final rule becomes more complex in its terms and application. It 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, so that non-family remainder and contingent beneficiaries can be disregarded;
- **irrevocable trusts** are also permitted if the current beneficiaries consist only of family clients or non-profit organizations (including charities), or both, and if the trust's funding came only from family clients (such as individual family members or qualifying trusts or other organizations);
- **charities and non-profit organizations**[10] are permitted if they hold assets attributable solely to other family clients, which again allows the family office exception to accommodate many currently existing entities that were funded through various family sources, not simply individual family members; and
- **family entities** (limited liability companies, limited partnerships, corporations, etc.) are permitted so long as they are owned exclusively by "family clients"—unlike what the proposed rule required, however, the final rule allows control of such entities to be exercised by independent third parties so long as the ownership requirement is met.[11]

So, for example, individual family members and qualified family business entities could create and fund a trust for the sole purpose of supporting a non-family public charity such as a local school. In this case, the family office could provide investment advice to that support organization, such as by keeping the trust's assets invested in the family's investment partnership, but couldn't give advice as to funds actually distributed, so the partnership units couldn't be held by the school directly.

However, notwithstanding the improvements the final rule makes to the definition of "family clients," the SEC refused to allow non-family ownership of family entities or non-family contributions to family charities in de minimis amounts, despite many comments as to the necessity of such a provision. Thus, the final rule doesn't accommodate the practical reality that many family entities have been funded, or are owned, in part, by non-family members, even though to an immaterial degree. So, for example, if a close family friend who shares the family's philanthropic values makes a contribution to the family's foundation, the foundation wouldn't qualify as a family client, even if the friend's assets are held in a segregated account and that account has its own, independent, registered investment adviser (unless the contribution is spent prior to 2013).

Key Employees

The final rule permits key employees and certain trusts they create to be clients of the family office. As in the proposed rule, "key employees" are defined as:

- individuals (and their spouses or equivalents)[12] who serve the family office as executive officers, directors, trustees, general partners or in a similar capacity; and
- those persons who aren't executives, but who perform substantive investment functions and have done so for at least 12 months prior (whether for the family office or any other company).[13]

Not only the family office but also an "affiliated family office" can employ the key employee.[14] This accommodates 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. This is a welcome change to the proposed rule and allows flexibility.

The final rule also allows certain key employee trusts to qualify as family clients. Under the general provision for revocable trusts, a revocable trust funded by a key employee will be qualified so long as the individual remains a key employee. An irrevocable trust qualifies as long as its fiduciaries are key employees and the only contributors to the trust are (and continue to be) a key employee (or a key employee's spouse or former spouse).[15] This change enables key employees to use typical estate planning devices such as funded revocable trusts and irrevocable gift trusts, but once the individual is no longer serving as a key employee, the trust would no longer qualify as a family client due simply to that change (subject to the grace period for involuntary transfers discussed below).

If the trust of the former employee is disqualified as a permissible client, does the same result apply to investments that the former key employee holds directly? Yes and no. Unlike former family members, a former key employee may remain a client of the family office, but "only with respect to assets advised ... by the family office immediately prior to the end of such individual's employment ..." including new investments that the former employee was contractually obligated to make (such as private equity commitments). The rationale for this change in status is that, once a key employee's access to investment information and analysis ceases, he needs the protections of the Advisers Act. The SEC recognized that adverse tax and investment consequences could result if precipitous changes to the key employee's investments were required by the rule, and so permitted retention of pre-termination assets.[16]

Owning the Family Office

The final rule permits only "family clients" to own the family office. This actually improved on the proposed rule, which allowed ownership only by individual family members, because family clients now also include:

- key employees who aren't family members (and their trusts); 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 permits family offices flexibility in how they compensate key employees (although it's 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.

Controlling the Family Office

The final rule requires control of the family office by family members and "family entities," directly or indirectly.[17] The SEC concluded that the rationale for 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.[18]

By using the term "family entity" rather than the broader term of "family client," the final rule precludes direct control of the family office by key employees. Key employees can be clients and now are

> "Family entity" may include a family trust controlled by a non-family member in a fiduciary capacity.

permitted to hold ownership in the office, but they still can't exercise control (except for the control that accompanies a position as an officer).

Using the term "family entity" is, however, not entirely restrictive. It could include, for example, a family trust controlled by a non-family member in a fiduciary capacity, such as a key employee or a commercial trustee. In this instance, if the family trust owns the voting interests in the family office, the commercial trustee appears to be the person ultimately exercising control over the family office, which seems consistent with the rationale for the exclusion when the trustee is duty bound to serve the interests of the family beneficiaries. Allowing this result also seems imminently realistic since key employees are often relied upon to serve as trusted and informed trustees for family trusts.

Important Grace Periods

The final rule (and its accompanying release) attempts to ameliorate certain restrictions with grace periods, such as:

- **Involuntary transfers.** If an involuntary transfer occurs and the transferee isn't 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 doesn't 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 this issue by paying the involuntary transferee and arranging for the transferee to engage his own investment adviser for the transferred assets and redeeming any ownership interest in the family's entities that are advised by the family office;[19]

- **Family charities accepting outside donations.** For a charity or nonprofit that's disqualified as a "family client" because it previously accepted non-family contributions, a generous grace period allows the charity until Dec. 31, 2013 to fix this problem if it accepts no more outside donations. Also, a favorable "worst-in-first-out" accounting method allows the charity to treat distributions as having been made first from non-family contributions (ignoring gains or losses), thus curing the defect if aggregate distributions exceed aggregate non-family contributions by the deadline.[20]

Further Guidance

Despite the SEC's hard work and generally successful approach to implementing Congress' mandate, certain issues remain unresolved or less than entirely clear. Further guidance on these issues would be helpful:

- For trusts created by key employees, the final rule requires that "each trustee or other person authorized to make decisions with respect to the trust is a key employee ...." The SEC intended this to mean that only key employees can make investment decisions.[21] As written, though, the rule requires that key employees "make decisions," and thus arguably all decisions—which could result in adverse consequences to the key employee (for example, subject an irrevocable trust to estate tax).

- The final rule allows former key employees to remain clients of the family office "with respect to *assets* advised ... immediately prior to the end of such individual's employment ...." (emphasis added). Does this mean that no investment changes can be made in a portfolio that had been managed by the family office prior to cessation of the individual's employment or simply that no funds can be added to that portfolio after cessation? Also, which exact asset is the subject of the proviso? For example, what if one real estate holding company is merged into another, but the underlying buildings don't change; has the "asset" changed?

- What happens to descendants of a stepchild when a divorce occurs? The stepchild may remain a client, but must his children cease to be clients?

- What happens if a former family member remarries? What if the family member spouse had died and then the non-family widow remarries?

- Under the prior 14-client rule, if an adviser provided investment advice to a person at no charge, that person didn't constitute a "client" for purposes of that exclusion. Does the same hold true for family offices that provide investment advice to a person, such as a family friend, for no charge? Footnote 47 of the final rule release implies that the family friend wouldn't be a client. What if, instead of investment advice, the family office only prepares income tax returns for a family friend, perhaps even for a small annual fee; presumably the family friend isn't a client for purposes of the family office exemption.

- Are joint ventures between two, unrelated but friendly families now impermissible? Many of those are currently in existence.

- An individual can be an investment adviser, but can he be a family office? The definition of "family office" requires a "company."[22]

- Does a purpose trust, which has a suitable not-for-profit purpose, qualify as a "family client," for example as a non-profit organization, if all of the funding came from family clients? If so, how does one interpret the control requirement in the context of a purpose trust if the purpose trust owns all of the voting interests in the family office?

What to do Now?

Family offices, at a minimum, must promptly:

- create a current and accurate family tree;
- create a detailed description of how investment advice is generated, including the setting of overall strategy, selection of asset classes, analysis of client risk tolerance, selection of actual investments or managers, how advice is communicated to the clients, how investments are implemented and how monitoring, rebalancing and reporting occurs;
- identify all of their clients, and if their clients are entities, all of the current and future named fiduciaries (such as general partners, managers and trustees) and owners and beneficiaries;
- identify all individuals who work in the family office, exactly which entity employs them and what their functions are;
- identify persons to whom a family office executive (or employee) may be providing investment advice, outside of his role with the family office;
- review all employment contracts and job descriptions;
- identify who or what owns the family office itself and how decisions get made at the owner level;
- review all buy-sell arrangements in family entities and the family-office itself, including pre-nuptial and ante-nuptial agreements; and
- identify how day-to-day versus strategic, policy decisions of the family office are made and by whom.

All of the above information will be crucial in determining whether a family office qualifies for the exemption, and if currently qualified, for ensuring that it remains qualified as time passes. If not currently qualified, the family office must decide how to resolve the problematic issues. Solutions could take many forms, some more palatable than others. For example:

- sending non-qualifying clients to another investment adviser, or in the right case, re-arranging their assets (such as a spouse of a key employee putting investments into joint name with the key employee);
- electing not to receive compensation from non-qualifying clients for investment advisory services (although removing the compensation element may be problematic depending on the circumstances and the identity and other roles held by the decisionmakers);
- liquidating the interests of a non-qualifying client in an otherwise qualifying entity;
- seeking guidance from the SEC; and
- outsourcing the investment management and advice functions to third-party service providers, with the family office providing only tax planning and preparation, fiduciary and administrative services.

Some family offices may take the draconian step of outsourcing the investment management services.

Regardless of the particular solution, the process must begin as soon as possible. For those family offices that currently qualify for the prior private adviser exemption (14 clients or less), the grace period to qualify for the new single-family office exemption expires on March 30, 2012. Less than nine months isn't a long time to effect a major change if one is necessary.

Final Thoughts

Given its mandate, the SEC did a commendable job in crafting the family office exclusion. Query what the final product would have looked like had the SEC been able to overcome its tendency to think only about "companies;" being focused on "companies" clearly constrains the SEC's thought process and thus by definition must have constrained its final work product. Would the proposed and final rules have taken an entirely different approach? Perhaps they would have taken a more principles-driven approach, yielding fewer restrictions on who can control a family office or who can be an owner, yet producing just as good a result from a policy standpoint?

Finally, creative structuring of family offices may be constrained due to the terms of the final rule. That rule is designed to accommodate a wide range of structures and factual patterns that currently exist. It's not designed to accommodate relatively unusual structures that exist today, and certainly not unusual structures to be created in the future, regardless of whether those structures would embody better ways to organize a family's affairs than are employed, envisioned or even possible today. In the future, how many creative and effective structuring devices won't even be considered due to these new restrictions?

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Endnotes

1. *See* Securities and Exchange Commission Release No. IA-3098 for the proposed rule and SEC Release No. IA-3220, 76 FR 37983 for the final rule (release). Other exemptions created under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) are for venture capital fund advisers, private fund advisers with less than $150 million in assets under management and certain foreign private advisers, 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. *See* Touche Holdings, 1987 SEC No-Act. LEXIS 6 (Dec. 30, 1987).
4. *See e.g.,* Richard K. May 1979 SEC No-Act. LEXIS 3967 (Dec. 11, 1979) and Thomas Beard 1975 SEC No-Act. LEXIS 898 (May 8, 1975); *see* William Bye Co., Inc. 1972 SEC No-Act. LEXIS 3144 (April 26, 1972); and *see* Jack N. Alpern Co., L.P.A. 1986 SEC No-Act. LEXIS 2080 (April 23, 1986).
5. Release IA-1092 (1987), pp. 8-9. Telltale signs of being "in the business" of providing investment advice are holding oneself out as providing such advice (like an admission against one's self interests) and receiving any form of compensation that is a clearly identifiable charge for advice regarding securities. *See* Securities Int'l, Ltd., 1989 SEC No-Act. LEXIS 422 (March 14, 1989).
6. See Release IA-1092 (1987), p. 10. The fee could even be paid by someone else, who receives the fee paid by the client. In fact, the adviser need never communicate with the client if the investment advice is communicated to a client through a third-party. *See* Financial Psychology Corp., 1988 SEC No-Act. LEXIS 413 (March 23, 1988) and Touche Holdings, 1987 SEC No-Act LEXIS 6.
7. *See* final rule Section 275.202(a)(11)(G)-1(d).
8. 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). *See* final rule release at footnote 27.
9. The SEC apparently became convinced that, in many modern families, step-children and ex-spouses are often treated the same or similar to blood-family members even after divorce. Thus, the SEC accepted the advice of commentators that it shouldn't, through a rule, change how those individuals are treated and instead should leave that decision to the family itself. *See* final rule release 76 FR 37983, at 37986.
10. It's 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.
11. Note that pension plans are treated as "family clients" so long as no one other than a family client is a beneficiary under the plan. See final rule release, text accompanying footnote 103.
12. Note that spouses (or equivalents) of key employees can only be clients of the family office with regard to joint or community property investments with the key employee. The SEC believes that the key employee provides sufficient protection to the spouse in such a case, and absent that, the spouse needs the protection of the Advisers Act. *See* final rule release, text accompanying footnote 97.
13. The final rule also explains what constitutes an executive position: it's one that involves policymaking 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).
14. 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."
15. Again, a joint or community ownership requirement is imposed at the time of contribution by the spouse or former spouse.
16. Final rule Section 275.202-1(a)(11)(G)-1(d)(4)(iv) and final rule release 76 FR 37983, at 37990.

17. The concept of "control" employed in both the proposed rule and the final rule is that of "exercising a controlling influence over the management or policies" of the family office other than as an officer of a company. The definition of "family entities" is simply the definition of "family clients" with the exclusion of key employees and those persons or entities related or attributable to key employees, such as former key employees.
18. *See* final rule release, text accompanying footnote 109.
19. More problematic is the case in which the transferee is a bankruptcy trustee or a judgment creditor. This would be a highly unlikely event—though not impossible—and most likely preventable by employing best practices in procuring proper insurance or when making risky investments.
20. Final rule Sections 275.202(a)(11)(G)-1(d)(4)(iv) and (e)(1). *See also* final rule release, footnote 66 and accompanying text.
21. *See also* final rule release, footnote 94 and accompanying text.
22. What if the "family office" were in reality an individual who was a trustee of various family trusts and provided investment advice only to those family trusts? In certain cases, this situation wouldn't be correctable due to the terms of the trust document. In others, this could be corrected by forming a company and providing the investment advice through that company. Note however, that forming a company to serve as a fiduciary isn't a simple task and often requires exemption from state or federal banking regulations.