

## Family Offices

### Developments in Family Office Regulation: Part One

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), signed into law on July 21, 2010, contains sweeping changes that will impact the U.S. regulatory landscape for years to come. It is comprised of a number of separate titles – Title IV, the “Private Fund Investment Advisers Registration Act of 2010,” amends the U.S. Investment Advisers Act of 1940, as amended (the “Advisers Act”).

The Dodd-Frank Act requires, *inter alia*, that the U.S. Securities and Exchange Commission (“SEC”) issue rules relating to family offices. Historically, family offices and their investment officers (and investment affiliates) have been granted exemptions from investment adviser registration under the Advisers Act on the basis that such persons (or entities) were not within the intent of Section 202(a)(11) of the Advisers Act, which contains the definition of “investment adviser.”<sup>[1]</sup> The relief came in the form of exemptive orders issued by the SEC.<sup>[2]</sup> The Dodd-Frank Act has codified this rationale by specifically excluding “family offices” from the definition of “investment adviser” under the Advisers Act and requiring the SEC to define the term “family office.” Until the SEC issues its proposed rules, the exemptive orders and other relevant guidance reflect the current family office framework. It is to that issue that this article is addressed; a follow-up article will address the proposed rules shortly after they are issued by the SEC.

#### *Present Situation*

Under the current regulatory regime, i.e., before the effective date of the Dodd-Frank Act (July 21, 2011), investment advisers who manage \$25 million or more assets under management, or are otherwise eligible to register (e.g., acting as an investment adviser to a registered investment company), are permitted to register with the SEC and investment advisers who manage \$30 million or more assets under management are required to register with the SEC, absent an exemption from registration. The key exemption, housed in Section 203(b)(3) of the Advisers Act (the “private adviser exemption”), provides that an adviser who (1) has fewer than fifteen (15) clients (where each pooled investment vehicle is counted as one client) during the preceding twelve (12) months, (2) does not hold himself out generally to the public as an investment adviser and (3) does not act as an adviser to a registered investment company or a business development company, is exempt from registration as an investment adviser under the Advisers Act. In addition to exemptive relief, many family offices currently rely on the private adviser exemption from registration because they typically have fewer than 15 clients.

#### *Dodd-Frank Act*

The private adviser exemption under Section 203(b)(3) has been eliminated by the Dodd-Frank Act, as discussed above.

Instead, the Dodd-Frank Act specifically exempted family offices from the definition of “investment adviser” under the Advisers Act, but it did not define “family office.” Congress directed the SEC to adopt a definition of “family office” that is consistent with the SEC’s previous exemptive policy and which recognizes the range of organizational, management and employment structures and arrangements employed by family offices. Until the SEC issues proposed rules, practitioners must look to the SEC’s policy relating to family offices as gleaned from the published SEC exemptive orders and from other relevant guidance to formulate a definition of “family office.” Given the Congressional mandate, the definition ultimately determined by the SEC will necessarily be reflective of those orders.

### *Exemptive Orders*

In general, the SEC’s exemptive orders granted applications for exemptions to investment personnel engaged in providing investment advice to a single individual and his or her spouse, their lineal descendants (including adopted children) and spouses and children of such lineal descendants, as well as certain entities, including trusts, private foundations and charities, exclusively owned by, for the benefit of, or funded by such individuals. There are many such orders, and all are fact-specific but there are common threads or elements in the orders from which to draw guidance. Furthermore, there may be other situations arising from fact patterns that have not been the basis of applications for exemption to the SEC. Consider these facts that are found in many of the exemptive orders:

- Where the family office has a Board of Directors or its equivalent, members of the family comprise at least a majority of such Board of Directors or its equivalent.
- Advisory fees charged by the family office are sufficient to cover its costs for providing services and other

operating expenses but are generally not designed to generate a profit.

- The family office does not hold itself out to the public as an investment adviser, is not listed in any phone book or other directory as an investment adviser, will not attend any investment-related conferences as a vendor, does not engage in any advertising and does not conduct marketing activities. See Slick Enterprises, Inc., [Investment Advisers Release No. IA-2736](#) (May 22, 2008) (notice); Woodcock Financial Management Company, LLC, [Investment Advisers Release No. IA-2772](#) (August 26, 2008) (notice); Adler Management, L.L.C., [Investment Advisers Release No. IA-2500](#) (March 21, 2006) (notice).

In other exemptive orders, the SEC granted relief to family offices even when unrelated key officers or employees of the family office were permitted to co-invest alongside family members in the family’s collective investment vehicles. See WLD Enterprises, Inc., [Investment Advisers Release No. IA-2804](#) (October 17, 2008) (notice) and Adler Management, L.L.C., *supra*. In the WLD exemptive order, the SEC granted relief, but only where that applicant agreed that if such key employee who owned an interest in a family collective investment vehicle was no longer employed by the family, or ceased to be a key employee, his interest in such family collective investment vehicle would be limited to his investment at the time of termination (or at the time as of which he was no longer a key employee), together with reinvestment of accretions or distributions on that interest. No new investments would be allowed. In the Adler exemptive order, the applicant was required to represent that the single employee who had a beneficial interest in a family collective investment vehicle would not be permitted to increase his existing investment or to invest in other family collective investment vehicles.

### *Legislative Pronouncements*

It is helpful in better understanding legislation to consider what the legislators may have said or written about such legislation. Senator Blanche Lambert Lincoln (D-Arkansas) is one of the top ranking members of the Senate Finance Committee. As reported in the Congressional Record, she said:

The Dodd-Frank Act provides specific direction for the SEC to recognize that most family offices often have officers, directors, and employees who may not be family members, and who are employed by the family office itself or affiliated entities owned, directly or indirectly, by the family members. Often, such persons co-invest with family members, which enable those persons to share in the profits of investments they oversee and better align the interests of those persons with those of the family members served by the family office. In addition, family offices may have a small number of co-investors such as persons who help identify investment opportunities, provide professional advice, or manage portfolio companies. However, the value of investments by such other persons should not exceed a de minimis percentage of the total value of the assets managed by the family office. Accordingly, section 409 [of the Dodd-Frank Act] directs the SEC not to exclude a family office from the definition by reason of its providing investment advice to these persons. See Cong. Rec. July 15, 2010.

### *Grandfather Provision*

The Dodd-Frank Act provides that the SEC rules must contain a grandfather provision that includes in the definition of “family office” any person or entity that was

not registered or required to be registered as an investment adviser under the Advisers Act on January 1, 2010 solely because the person provides investment advice (or was so engaged before January 1, 2010) to natural persons who are officers, directors or employees of the family office who have invested with the family office before January 1, 2010, and are “accredited investors” under Regulation D; any company owned exclusively and controlled by members of the family of the family office, or as the SEC may prescribe by rule; and any SEC-registered investment adviser that provides advice and identifies investment opportunities for the family office, invests in these opportunities on the same terms as the family office and whose assets as to which the family office directly or indirectly provides investment advice represent no more than five percent of the value of the total assets as to which the family office provides investment advice.

This grandfathering provision was intended to protect family offices that currently allow employees to co-invest with the family. Because the mandate limits the grandfathering to participation prior to January 1, 2010, this may suggest that Congress intends to prohibit such co-investment in the future. To be sure, this is unclear. Although the SEC did historically allow such co-investment on a case-by-case basis through its exemptive orders, it may seek a more restrictive or limited approach in its definition of family office.

### *Conclusion*

While it remains difficult to predict what definition of “family office” the SEC will propose through its rules, the exemptive orders and other relevant guidance do shed some light on the current regulatory landscape.

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<sup>[1]</sup> "Investment adviser" is defined in Section 202(a)(11) of the Advisers Act to mean "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." The definition specifically carves out certain persons and includes a "catchall" carve-out in subsection (G) for "such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order."

<sup>[2]</sup> Generally, many family offices operate within the current exemption from registration provided in 203(b)(3) of the Advisers Act as discussed herein because they have fewer than fifteen clients. However, many family offices historically applied for exemptive relief as they neared this number because the exemption operated as a constraint on the family office's ability to provide investment advisory services to clients as children of the family cease to be minors and leave their childhood households. Such exemptive orders do not provide a general exemption to family offices but rather only exempt the specific family office or adviser who applied for the exemption from registration.