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Financial Regulation of Family Offices in the Current Environment

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Many Single Family Offices ("SFOs") and Multi-Family Offices ("MFOs") not previously registered with the United States Securities and Exchange Commission ("SEC") spent much of the last six months of 2011 assessing their level of compliance with newly promulgated SEC rules which significantly limited the definition of family offices eligible for exemption from registration as a Registered Investment Adviser ("RIA"). Final Rule 275.202 (a)(11)(G)-1 promulgated on June 22, 2011 delineated those family offices exempt from the registration requirements of the Investment Advisers Act of 1940 as amended last July by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

During this same period and as part of the assessment process, however, family offices should have also been reviewing additional areas of financial regulation potentially applicable to many family offices. The SEC and similar regulatory bodies have been lax in their oversight of family offices. This makes sense, of course, because very few financial crimes have been perpetuated by family offices. However, the historical corresponding level of compliance by family offices can be characterized as uneven and haphazard. Some practitioners have even characterized past compliance by SFOs as constituting reckless disregard for applicable law.

Other SEC rules may require family offices to register as broker-dealers or report as the manager of hedge funds or private equity funds, or as an Institutional Investment Manager under Section 13(f), or as a control person under Section 16 of the Securities and Exchange Act of 1934. In addition, some state securities regulators impose similar registration requirements.

Moreover, family offices who are RIAs may have to make additional disclosures if Regulatory Assets under management exceed $150 million pursuant to a recently issued joint rule by the SEC and the Commodity Futures Trading Commission ("CFTC"). Further, family offices may be required to file notices of exemption or register with the National Futures Association as a Commodity Trading Adviser if the family office provides advice regarding certain investments or makes such investments, including commodities, derivatives, futures or options, or as a Commodity Pool Operator operating a fund for multiple investors.

DEVELOPMENT OF THE FAMILY OFFICE EXEMPTION

The historical, long-standing rule which exempted family offices that managed assets for up to 15 family members pursuant to the Private Adviser Exemption was repealed effective July 21st, 2011. The old rules were not very specific and failed to provide meaningful guidance for SFOs and family office executives. Consequently, some families sought exemption orders from the SEC in order to verify their compliance. Although such guidance was very helpful to the SFO which requested the ruling, it did not provide guidance to other families and could not be relied

upon by such families. In this regard, greater clarity in delineating the family office exemption may provide greater specificity and guidance, and cut down the number of requests for exemption orders. At the same time, greater clarity may also eliminate reasons for noncompliance and lead to harsher sanctions for SFOs which fail to comply. Proposed regulations promulgated and submitted for comment in 2010 were subject to much criticism from both law firms and family office groups that submitted approximately 90 commentaries. SEC Release IA-3220 was issued on June 22, 2011, adopting rule 202(a)(11)(G)-1 (the "Final Rule") under the Investment Advisers Act of 1940 pursuant to the dictates of the Dodd-Frank Act. Although the new rules are significantly more liberal than the original proposal, such rules serve to greatly increase the number of SFOs which will now fail to qualify for the exemption and need to register with the SEC as RIAs.

Time is of the essence in conducting a compliance review, obtaining an advisory memorandum or opinion letter, seeking an exemption order, restructuring and/or registering with the SEC. The compliance deadline set by the SEC for those family offices that were previously relying on the private adviser exemption from the Advisers Act is March 30, 2012. This date, however, is somewhat misleading since the SEC has estimated that it will take at least 45 days to process registrations, which will require a submission date on or before February 15, 2012. Moreover, as the SEC gets flooded with registrations and exemption ruling requests closer to the deadline, it is reasonable to assume that the processing time will be extended, requiring even earlier submission dates.

The SEC elected to generously grandfather family offices that received no action letters under the prior law. In addition, any family office that would constitute a family office under the new definition but for the handling of investments for one or more non-profit organizations that received funding from sources other than family office clients may be able to rely on the prior family office exemption until December 31, 2013. Further, a family office that fails to qualify due to the death of a family member or key employee may have up to one year to either come into compliance or face registration. It appears that the spirit and intent of the new rules is to require registration in most circumstances, except for those family office structures which clearly fall within the narrowly crafted exemption.

OVERVIEW OF THE NEW SEC REQUIRMENTS

MFOs are specifically excluded from the definition of family offices qualifying for the exception under the Final Rule. The rules adopted by the SEC define a family office as a company that: (a) has no clients other than family clients; (b) is wholly owned and exclusively controlled by family members or family entities; and, (c) does not hold itself out to be an investment adviser. The term “family client” includes family members (defined as all lineal descendants, including adopted, step and foster children, of a common ancestor who may be living or deceased, and such lineal descendants' spouses or spousal equivalents; provided that the common ancestor is no more than 10 generations removed from the youngest generation), key employees and various types of non-profit organizations, trusts and companies that are funded by, created for the

exclusive benefit of, or controlled by family members. Pursuant to this definition a single non-family investor can trigger a registration requirement under the Investment Advisers Act.

In at least one instance, however, the SEC broadened its view in the new definition of "spouses." The definition in the final rules was expanded to include a "spousal equivalent" which means a co-habitant occupying a relationship generally equivalent to that of a spouse, which allows same-sex couples to qualify as family clients. On the other hand, the definition of "family member" has been limited by the introduction of a common ancestor concept and the imposition of the so-called "10-generation" rule. The SEC provided some flexibility from these restrictions by allowing families to designate a new, or replace an old, founding ancestor as the SFO evolves and matures.

In contrast with the old rules, the new rules are much more specific and more clear. Unfortunately, this greater clarity may warrant greater scrutiny, higher levels of compliance and more onerous sanctions. For this reason, private families and their professional advisers have many concerns regarding registration, on-going compliance requirements (whether or not RIA registration is required) and SEC examinations. The requirements for RIAs include submission and updating of filing obligations (Form ADV). Similarly, each person responsible for providing investment advice must file Form U-4 annually. These filings are maintained in the investment advisers registration depository maintained by the Financial Industry Regulatory Authority, better known as FINRA.

Although the SEC has initially indicated that they have little interest in regulating family offices, family office industry experts anticipate increased enforcement activities and penalties for failure to comply. Generally, the new compliance burden is considered heavy handed and expensive. In part, this view obtains due to on-going compliance requirements, need for an internal or external compliance officer, increased legal and accounting fees, and significant staff down time incurred during SEC audits.

COURSE OF ACTION

Family offices that are already established need to assess their level of compliance with the new requirements imposed pursuant to the Dodd-Frank Act in a timely manner. Similarly, every new family office being organized needs to consider the impact of these rules. At the same time, compliance with other financial regulations should be reviewed initially and on an on-going basis whether or not the SFO is required to register or report, or both.

It is critical that these initial and periodic reviews include assessments of compliance with other SEC rules in addition to the rules of state securities regulators, the CFTC. and international securities regulators, if applicable. These reviews should be carefully documented and periodically updated in order to demonstrate due diligence, good faith, compliance or exemption on an on-going basis. Any advisory memoranda or opinion letters received from outside professionals should be included in the review records.

SFOs should address registration issues each time they consider a co-investment opportunity. Entering into partnerships or other business arrangements with non-family members can easily trigger registration issues due to the "family client" investment restrictions. In situations where the assessment is inconclusive, SFOs may wish to consider requesting an exemption order from the SEC. Moreover, this review process provides an excellent opportunity to reconsider the comprehensive design of the family office structure including its affiliates and related entities.

For registered SFOs, it may be prudent to isolate the RIA activity in a separate entity in order to limit the concomitant SEC Scrutiny to that entity alone. Further, it may warrant consideration of locating the RIA in an international jurisdiction. While considering the alternatives available to SFOs, it may be an opportune time to also consider any changes in structure or procedures warranted by higher levels of scrutiny from other governmental regulatory bodies, including the new "IRS Wealth Squad."

Other SFOs may consider outsourcing the investment function to an MFO or other established RIA, or forming a private trust company, captive insurance company, captive bank or other enterprises which may remove some or all investment assets from SEC reporting obligations and scrutiny. These approaches, however, necessarily trade one set of government regulators for another.

In establishing new family offices, much greater care will be required in order to properly structure the new enterprise so that it falls within the family office exemption and is in

compliance with all other controlling financial regulations. Consequently, control, liability issues, income taxation, executive compensation and benefits should all be taken into consideration in order to thoughtfully design a family office structure that will serve the family and their objectives well into the twenty-first century.

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