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Family Office Insights

The Family Office Rule Under the Investment Advisers Act

In the course of managing the finances and investments of a family, a family office frequently provides advice related to the family's investments in securities. This activity would ordinarily subject the family office to regulation under the Investment Advisers Act of 1940 (Advisers Act). The Advisers Act defines an "investment adviser" as anyone who provides advice regarding securities, is engaged in the business of providing such services and does so for compensation. As it clearly falls within this particularly broad definition of "investment adviser," the family office would be required to register with the Securities and Exchange Commission (SEC) unless it can find an exemption.

In 2011, pursuant to a directive in the Dodd-Frank Act,[1] the SEC adopted a rule, codified as the Advisers Act Rule 202(a)(11)(G)-1, more commonly referred to as the "Family Office Rule," which effectively excludes family offices from the broad definition of "investment adviser." The adoption of the Family Office Rule was largely driven by the fact that families who have set up family offices to manage their wealth are financially sophisticated and less in need of the protections that the Advisers Act was intended to provide to typical investors.

Satisfying the requirements of the Family Office Rule allows a family office not only to escape the burdens associated with registration under the Advisers Act, but also to completely avoid the Advisers Act's other numerous provisions, as well as any additional state or licensing requirements applicable to investment advisers. In contrast, an investment adviser who is able to meet an *exemption* from registration (but n[1]ot an *exclusion* from the investment adviser definition, such as the Family Office Rule) will still remain subject to the other Advisers Act provisions. As a result, understanding the requirements and intricacies of the Family Office Rule is critical to successful family office compliance.

The Family Office Rule

The Family Office Rule sets forth three requirements that the family office must meet in order to qualify for exclusion from regulation under the Advisers Act. Additionally, the rule supplements these requirements with complex definitions that further limit the availability of the exclusion.

Fundamentally, a family office is a company, including its directors, partners, members, managers, trustees and employees acting within the scope of their employment. To be considered a family office that qualifies for the exclusion, it must: (1) provide investment advice only to "family clients"; (2) be wholly-owned by family clients and exclusively controlled by family members/family entities; and (3) not hold itself out to the public as an investment adviser.

Additionally, the SEC has explicitly indicated that the Family Office Rule exclusion does not extend to family offices serving multiple families – it is only available for single-family offices. For instance, family offices should be aware that the Family Office Rule does not provide an exclusion in a situation in which several families have established separate family offices, but have staffed their family offices with the same (or substantially the same) employees.

i. Family Client

While the last two elements of the Family Office Rule are relatively straightforward, the first requirement, that the family office is limited to only "family clients," is far more complex. It encompasses a multi-faceted definition that is further broken down into the following subcategories of defined terms: current and former family members, current and former key employees, the estates of such persons, a company owned and controlled by such persons, affiliated trusts and nonprofit organizations meeting certain requirements.

a. Family Members

The first subcategory included in the definition of "family client" is "family members," which generally includes all lineal descendants up to 10 generations removed from a common ancestor. The definition is relatively expansive as it recognizes adopted, step and foster children, as well as spouses and spousal equivalents of such family members. In addition, the family client definition covers individuals designated as former family members, meaning a spouse, spousal equivalent or stepchild who was, at one time, a family member, but is now no longer part of the family due to divorce or another similar event. In regard to such former family members, the rule does not place any limitation as to the time frame after such an event in which the former family member can continue to take part in the family office, nor does it restrict such person's ability to make new investments, as it does in regard to former key employees, as discussed below.

It is important to note, however, that, because the basis of the definition is linked to a common ancestor, the term "family member" does not extend to in-laws of family members. Thus, any investment by in-laws made through the family office may cause the family office to no longer be eligible for the Family Office Rule exclusion.

1 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111-203, H.R. 4173 (JUly 21, 2010).

In addition, the "family member" definition is rather flexible in several other respects because the designated common ancestor can be either living or deceased and such designation is not permanent but, rather, can be changed as the family office evolves over time.

b. Key Employees

"Key employees" of the family office, their estates, and certain entities through which they may invest are also included in the definition of "family clients." This allows the family office to attract talent by offering investment opportunities provided by the family office while, at the same time, aligning key employees' interests with the family without disqualifying the office from the Family Office Rule exclusion.

As with the definition of "family members," the definition of "key employees" is also quite complex. The term encompasses an employee of the family office or its affiliated family office who: (1) is an executive officer, director, trustee, general partner or is serving in a similar capacity; or (2) in connection with his or her regular duties, participates in the investment activities of the family office (excluding those who are solely clerical, secretarial or administrative employees and those who have participated for less than 12 months).

The complexity of the "key employees" definition is offset by its flexibility. First, it recognizes that some families may have more than one family office due to any number of structuring preferences or for business or tax reasons. The rule, therefore, extends the definition to cover key employees of an "affiliated family office," which is defined as a separate family office that: (i) is wholly owned by family clients of the other family office; (ii) is controlled by family members/family entities of the other family office; and (iii) has no clients other than family clients of the other family office. Second, the definition further includes trusts where a key employee is the sole contributor and decision-maker. And third, it also includes such key employee's spouse or spousal equivalent, but only to the extent that they hold a joint, community interest in the investment property.

That being said, it is important to note that this flexibility does not extend to key employees of family companies other than the family office or its affiliated family office. Therefore, investment by such other key employees may cause the family office to not qualify for the Family Office Rule exclusion.

Finally, just as with former family members, the rule also recognizes former key employees – individuals who were at one time, but are now no longer, key employees – and it allows them to keep their preexisting investments under the family office's management. However, in contrast to former family members, the rule does limit former key employees from making additional investments after their employment has ended.

c. Estates and Trusts

To accommodate common estate planning activities for testamentary and charitable giving purposes, the Family Office Rule's definition of "family client" also includes any estates of current and former family members, as well as those of current and former key employees. This has the effect of allowing the family office to advise the executor of such estate even if the estate will ultimately be distributed to non-family members.

Furthermore, trusts are included in the definition, but the rule places certain limitations that are particularly dependent on the circumstances. Any revocable trusts that have one or more family clients as its grantors are included as family clients (its beneficiaries can be non-family clients and still qualify under the rule). In contrast, irrevocable trusts are also included, but only if the current beneficiaries are also family clients.

d. Nonprofit Organizations

The definition of "family client" further includes any nonprofit organization, charitable foundation, charitable trust or other charitable organizations that are funded exclusively by one or more other family clients. While such charitable organization is permitted to be originally established by non-family members, all of the funds currently held by the charitable organization must have come solely from family members, and any funding received from persons other than family members will disqualify the organization from the Family Office Rule exclusion.

e. Other Family Entities

To facilitate the family office's ability to conduct its activities through the use of typical investment structures, including pooled investment vehicles, the rule also extends the definition of family client to include "any company, wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more other family clients." This means that any investment in the company by a non-family client will disqualify it from receiving investment advisory services through the family office.

ii. Wholly-Owned by Family Clients and Controlled by Family Members

The second element of the Family Office Rule requires that a family office be: (1) wholly-owned by family clients; and (2) exclusively controlled by family members/family entities. This means that, while any family client (including key employees) may hold an ownership interest in the family office, control must remain exclusively with family members/family entities and not with its key employees, their affiliated entities or trusts. "Control" is defined as "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."

iii. No Holding Out as Investment Adviser

The final requirement of the Family Office Rule is that the family office must not hold itself out to the public as an investment adviser. This restriction has been interpreted broadly and prohibits any behavior that suggests the family office is attempting to enter into a traditional investment adviser relationship with non-family clients. Unsurprisingly, if a family office engages in this type of behavior, it must register as an investment adviser under the Advisers Act.

Conclusion

Family offices may not be aware that, as a result of giving investment advice, they fall within the purview of the Advisers Act and, thus, must fit their ownership and investment process within the parameters of the Family Office Rule to avoid the registration requirements of the Advisers Act. Family offices that do not satisfy the requirements of the Family Office Rule may need to restructure to qualify for the exclusion, analyze whether they qualify under an applicable exemption, apply for a specific exemptive order from the SEC or register as an investment adviser. Family offices that are currently in compliance with the Family Office Rule must remain vigilant and have policies in place to ensure that there is no inadvertent disqualification from the exclusion. Please contact your principal Squire Patton Boggs lawyer or any of the lawyers listed in this publication for additional information or for help on these matters.

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