FAMILY OFFICE EXEMPTION NARROWLY DEFINED BY S.E.C.

July 15, 2011

OVERVIEW

Following the stock market crash of 1929 and the Great Depression which followed, Franklin D. Roosevelt's 1932 democratic campaign platform called for regulation of the securities exchanges "to the full extent of federal power." The current fear shared by most Single Family Offices ("SFOs") that are not registered with the United States Securities and Exchange Commission ("SEC") is that they may soon come to appreciate the full scope and breadth of such power exercised in the almost unfettered discretion of one of the most powerful government agencies in existence. Although the recently released final regulations, which delineate the limits of the new family office exemption, reflect a more moderate position than initially set forth in the 2010 proposed regulations, the new regulations serve to significantly limit the number of SFOs which will be exempt from registration with the SEC. Perhaps as many as one-half of all SFOs not currently registered with the SEC may now be required to do so on or before March 30, 2012.

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. The Final Rule exempts "Family Offices" from regulation under the Advisers Act. The long-standing Private Advisor Exemption which included SFOs that managed assets for up to 15 family members was repealed effective July 21, 2011. Family offices which fail to qualify for the new Family Office exemption or another exemption must register with the SEC as a registered Investment Adviser under the Advisers Act.

Consequently, SFOs may be well advised to retain counsel immediately in order to assess their level of compliance with the new Final Rule, provide time to register, seek an exemption order, or restructure to avoid SEC registration. The greatly increased clarity and specificity of the new Final Rule will exclude a significant number of previously exempt SFOs and is likely to result in greater scrutiny and concomitant greater compliance.

THE NEW FAMILY OFFICE EXEMPTION

The Final Rule defines a Family Office as a company that: a) has no clients other than Family Clients (as defined under the Final Rule); b) is wholly owned and exclusively controlled by family members or family entities; and, c) does not hold itself out to the public as an investment advisor. In reaction to numerous public comments submitted in response to the proposed rule, the SEC expanded some key definitions while adhering to most of their initial positions. In this regard, the legislation is generally considered overly restrictive and unnecessarily heavy handed; however, the SEC generously grandfathered in a limited group of SFOs that previously received exemption orders or meet a narrow set of standards.

Generally, the determination of what constitutes a "family" has followed the SEC's previous policies. In the Final Rule, the SEC has broadened some definitions (for example, the definition of "spouses" is broadened 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 under the Final Rule) and narrows others (for example, the definition of "family member" is limited by the introduction of a common ancestor concept and the imposition of a "10-generation" rule). In the Final Rule, the SEC provides some flexibility by allowing families to designate a new, or replace an old, founding ancestor as the SFO evolves, in contrast to the prior common ancestor limitation from the proposed rule. Furthermore, while the proposed rule required the Family Office to be owned and controlled by individual family members, the Final Rule permits certain entities such as trusts to own the Family Office.

With respect to charitable entities, the proposed rule was very restrictive in the type of entities to which an SFO could provide investment services. Commonly used advanced planning structures such as charitable lead annuity trusts and charitable remainder trusts would have been precluded. Further, management of investments held by family foundations which received contributions from non-family donors was precluded. The Final Rule broadly construes the type of charitable entities and non-profit entities for which investment advisory services can be provided. Moreover, any SFO that would constitute an SFO under the Final Rule, but for it having one or more non-profit organizations that have received funding from sources other than Family Clients, should be deemed a Family Office until December 31, 2013. At such time, the SFO will either have to register with the SEC, restructure its activities so that it falls within the new, limited exemption or spend all the charitable funds contributed by non-family sources.

In addition the Final Rule greatly broadens the types of eligible trusts and estates to include trusts in which the beneficiaries are family members and public charities. The Final Rule also extends the amount of time that a person who becomes a "Family Client" due to the death of a Family Member or Key employee or due to an involuntary transfer may be advised by the Family Office from four months to one year.

AREAS OF CONCERN

Private families and their advisors share some significant concerns despite the improvements made to the Final Rule following the comment period. Many of these concerns stem from the relatively unrestrained power of the SEC coupled with onerous on-going requirements for Registered Investment Advisors. These requirements include submission and updating of filing obligations for the RIA entity (Form ADV) and for each investment advisor (Form U-4). These filings are maintained in the investment advisor registration depository managed by the Financial Industry Regulatory Authority ("FINRA").

The licensing period is annual and carries with it record keeping, custody disclosures, audits and possible fiduciary duty requirements. Although a statutory fiduciary duty standard is opposed by the insurance industry, the Financial Planning Coalition (the "FPC") is advocating the imposition of a fiduciary-duty regulation by the SEC. The FPC, composed of the Financial Planning Association, the Certified Financial Planner Board of Standards and the National Association of Personal Financial Advisors, is pushing the SEC to enact a single standard of care for all retail advisors pursuant to authority granted by the Dodd-Frank legislation.

These requirements in turn, highlight additional concerns relating to the invasion of privacy and complete lack of confidentiality. This angst is exacerbated by the SEC's policy of complete disclosure in press releases, websites, etc., in addition to the Dodd-Frank directive that the SEC share its information with other government agencies. Of course, compliance and audits cost money and carry risks which are particularly unwelcome by SFOs facing escalating costs, decreasing margins and diminishing investment returns. Families see precious little upside in registration which brings with it related audits, risk of prosecution, possible adverse publicity and increased costs. In addition, private families are also concerned about potential registration and filing obligations under other SEC rules. The over-arching concern is that any regulation by a heavy-handed, extremely powerful government agency is completely unwelcome.

Moreover, additional technical issues remain. For example, the types of employees and trusts that fall within the definition of Family Client are quite limited. Similarly, recipients of family investment assets through certain involuntary transfers must be jettisoned by Family Offices within one year of receiving such assets. Families are struggling with the justification for these rules and their propriety.

STRATEGIES FOR DEALING WITH THE FINAL RULE

1. Every SFO should review its structure and carefully assess the current state of its compliance.

2. SFOs that clearly do not need to register should carefully monitor their ongoing status in order to maintain the exemption and avoid registration. Of course, these SFOs may be required to register with various state securities agencies or with the SEC for other reasons.

3. If a compliance assessment is inconclusive, SFOs are well advised to promptly seek an exemption order.

4. For SFOs that face registration, consider the following: a) registration after creating a captive investment firm or spinning off an investment subsidiary in order to limit SEC scrutiny to that enterprise alone; b) outsourcing the investment function to a multi-family office, institutional trust company, or other independent RIA; c) moving (for global families) the investment function to their international SFO outside SEC jurisdiction or, creating an international SFO to compliment the U.S. based SFO; or, d) forming a private trust company, captive insurance company or private family bank. SFOs should be aware, however, that these approaches necessarily trade one set of government regulators for another.

CONCLUSION

In order to meet the SEC compliance deadline of March 30, 2012, SFOs should immediately begin to assess their current level of compliance. After this determination the registration process, exemption order process or restructuring process can begin with sufficient time remaining. Failure to act in a timely and prudent manner could subject private families to unwanted adverse publicity, risk of prosecution, lack of privacy and expensive on-going registration and compliance obligations.

Thomas J. Handler
Chair of Advanced Planning and Family Office Practice Group
Handler Thayer, LLP Attorneys and Counselors at Law