

The Uninvited Guest: Dodd-Frank and the Family Office

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") significantly changed the law regarding required registration as an investment adviser pursuant to the provisions of the Investment Advisers Act of 1940 (the "Act"). Because of these significant changes every family office that provides services falling within the Act's definition of an "investment adviser" needs to determine as an urgent matter whether it is required to register as an investment adviser pursuant to Dodd-Frank. If registration is required the deadline for becoming registered is March 30, 2012.

Background

Prior to the enactment of Dodd-Frank, there was a so-called private adviser exemption from the registration requirements of the Act that was generally available for investment advisers that had fewer than 15 clients during the preceding 12 months and that did not hold themselves out to the public as an investment adviser. Dodd-Frank eliminated this private adviser exemption and generally requires any person or entity that acts as an investment adviser to register with the SEC or a state securities commissioner and comply with the record keeping, periodic examination and other provisions of the Act (regardless of the number of clients) unless an exemption or exclusion from such registration requirement is available. Generally an investment adviser with less than \$100M in assets under management registers with the state in which it has its principal place of business and an investment adviser with assets under management of \$100M or more registers with the SEC.

However, Dodd-Frank also created an exclusion from the provisions of the Act for a so-called "family office." The SEC has stated that the core policy rationale behind the new family office exclusion is that a family managing its own wealth does not need the protections afforded to investors pursuant to the Act. Because a family office is excluded from the definition of an investment adviser under the Act, it is not subject to the registration, record keeping, periodic examination or other provisions of the Act and cannot be required to register as an investment adviser by a state, but is subject to state antifraud regulation. Similarly, the supervised persons of a family office cannot be required to register with a state as investment adviser representatives.

Recognizing that sufficient time would be required in order for family offices that had previously relied on the repealed private adviser exemption to evaluate their available legal options for compliance with the new law (i.e., satisfy the new family office exclusion without any need to restructure the existing family office business, restructure the existing family office business to satisfy the new family office exclusion, register as an investment adviser or seek an exemptive order from the SEC), Dodd-Frank provides that a family office that was exempt from SEC registration in reliance on the private adviser exemption on July 21, 2011 and that provided investment advice primarily to members of a single family but did not qualify at that time for the new family office exclusion has until March 30, 2012 to either restructure its business to satisfy the new family office exclusion or to register as an investment adviser. Because registration applications can take up to 45 days to be processed, a family office that elects to register as an investment adviser should submit its registration application by February 14, 2012.

Discussion

1. Investment Adviser Definition

In order to be subject to the provisions of the Act a family office must be engaged in activities that fall within the definition of an "investment adviser." An investment adviser for purposes of the Act is defined as any person that is

engaged in the business of providing advice or of issuing analyses or reports with respect to the value of securities or the advisability of investing in, purchasing or selling securities in return for compensation. The SEC has consistently construed each aspect of this definition in favor of a determination that investment adviser status exists.

As long as all of the aspects of the investment adviser definition described above are satisfied, the legal structure of an investment adviser relationship can take a wide variety of forms, including the general partner of an investment limited partnership. A federal appeals court has ruled that the general partner of an investment limited partnership was engaged in providing investment advice to the limited partners regarding securities in its capacity as the general partner and that when these services are performed for compensation with sufficient regularity to constitute a business the general partner will be deemed to be an investment adviser within the meaning of the Act.

2. Family Office Definition

In order to qualify for the new family office exclusion, the investment advisory activities of the family office must come within the definition of a "family office." A family office is defined as a company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their position or employment) that:

1. Is wholly owned by "family clients" (as defined below) and is exclusively controlled (directly or indirectly) by one or more "family members" (as defined below) and/or family entities;
2. Has no clients other than family clients (subject to certain 12-month transition rules in the case of a transfer upon death or other involuntary transfers from a family client to a non-family client); and
3. Does not hold itself out to the public as an investment adviser.

3. Family Member Definition

The core of the "family" for purposes of the new family office exclusion is the defined group of "family members." The SEC has adopted a family tree approach for determining which persons constitute family members which is centered on the designation of a single common ancestor. The designation of the single common ancestor is neither formal nor permanent – there is no reporting or required documentation to designate the common ancestor and the designation can change over time. Family members are defined as (i) all lineal descendants (blood relatives in direct line of descent) of the designated common ancestor (not more than 10 generations removed from the youngest generation of family members), including adopted children, stepchildren and foster children of such designated common ancestor, (ii) spouses and spousal equivalents of such lineal descendants and (iii) former family members (ex-spouses or ex-stepchildren as the result of a divorce or similar event). Note that although former family members remain family clients when they cease being family members their branches of the family tree cannot grow after they cease to be family members. Also note that family members do not include (i) parents, siblings or anyone else in the family of a spouse who is not a lineal descendant of the designated common ancestor and (ii) lineal descendants of an adopted child, stepchild or foster child of the designated common ancestor. Determining which persons are family members is important because the new family office exclusion requires that family members control the family office and family members are one of the categories of family clients that a family office qualifying for the exclusion is permitted to serve.

4. Family Client Definition

Family clients are defined as (i) family members, (ii) key employees of the family office or an affiliated family office and, under certain circumstances, former key employees of the family office or an affiliated family office, (iii) certain trusts and estates of family clients, (iv) charitable entities exclusively funded

by family clients and (v) certain entities owned exclusively by family clients. The rules for fitting within each of these categories of a family client are described in detail below.

a. Family Members.

See Item 3 above for a discussion of the definition of a family member.

b. Key Employees and Former Key Employees

Key employees are defined as (i) any natural person (including any key employee's spouse or spousal equivalent who holds a joint, community property or other shared ownership interest with such key employee) who is an executive officer (the president, any vice president in charge of a principal business unit, division or function, any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the family office), director, trustee, general partner or person serving in a similar capacity of the family office or its affiliated family office or (ii) any employee of the family office or its affiliated family office (other than an employee performing solely clerical, secretarial or administrative functions with regard to the family office or affiliated family office) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office or affiliated family office, provided that such employee has been performing such functions and duties for or on behalf of the family office or its affiliated family office, or substantially similar duties or functions for or on behalf of another company, for at least 12 months.

Former key employees remain as family clients after ceasing to be executive officers, employees, etc. but with respect to only those assets which were advised by the family office immediately prior to the termination of key employee status. Former key employees are not considered to be family clients with respect to any investments advised by the family office made after the termination of key employee status (unless the key employee was contractually obligated to make the new investment prior to the termination of key employee status).

c. Certain Trusts and Estates.

Family clients include (i) any irrevocable trust in which one or more family clients are the only current beneficiaries, (ii) any irrevocable trust funded exclusively by one or more other family clients in which other family clients and non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations (which need not themselves be family client charitable organizations) are the only current beneficiaries and (iii) any revocable trusts of which one or more other family clients is the sole grantor (regardless of whether the beneficiaries of the trust are family clients). For purposes of determining whether a trust is a family client, contingent beneficiaries are disregarded (unless and until they become current beneficiaries).

Family clients also include (i) any estate of a family member, former family member, key employee or, subject to certain conditions, former key employee and (ii) any trust as to which each trustee or other person authorized to make decisions with respect to the trust is a key employee and each settlor or other person who has contributed assets to the trust is a key employee or the key employee's current and/or former spouse or spousal equivalent who, at the time of contribution, holds a joint, community property, or other similar shared ownership interest with the key employee.

d. Charitable Organizations.

Non-profit organizations, charitable foundations, charitable trusts and other charitable organizations qualify as family clients if they are funded exclusively by one or more family clients. In order to determine which charitable organizations qualify as family clients, the source of the investment funds "held" by each such charitable organization must be identified. If 100% of the investment

funds held by a charitable organization comes from one or more other family clients, the charitable organization will qualify as a family client. However, if any portion of the investment funds held by a charitable organization comes from a source other than one or more other family clients, the charitable organization will not qualify as a family client.

For purposes of determining whether funding provided by a non-family client to a charitable organization is "currently held" by the charitable organization (which would disqualify the charitable organization from being a family client), the charitable organization is permitted to offset any spending by the charitable organization occurring at any time in the year of the non-family client contribution or any subsequent year against the amount of the non-family client contribution (*i.e.*, the charitable organization may treat the non-family client contribution as the first funding spent by the charitable organization, with the result being that such non-family client funds will not be deemed to be currently held by the charitable organization if they have been fully spent).

In addition, the SEC has provided a transition provision for charitable organizations that have accepted non-family client contributions that permits family offices that otherwise qualify for the new family office exclusion to continue to advise such charitable organizations until December 31, 2013, by which time the charitable organization must have spent all of the non-family client contributions, provided that the charitable organization does not accept any additional contributions from non-family clients after August 31, 2011 (other than a non-family client contribution received prior to December 31, 2013 that is provided in fulfillment of a pledge made prior to August 31, 2011).

Similarly, the receipt of a non-family client contribution in the future will not automatically disqualify a charitable organization from continuing to qualify as a family client as long as the amount of the non-family client contribution can be deemed to have been fully spent by the charitable organization through the application of this first spending provision described above in the year of receipt. If, however, the full amount of such future non-family client contribution is not deemed to have been fully spent in the year of receipt the unspent portion will be deemed to be held by the charitable organization and will disqualify the charitable organization from continuing to qualify as a family client until it is fully spent in a subsequent year.

e. Family Entities.

A family client includes any company wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more other family clients, provided that, if such company is a pooled investment vehicle, it is exempted from the definition of an investment company under the Investment Company Act of 1940.

Conclusion

Determining whether a particular family office qualifies for the new family office exclusion requires a careful legal review of the ownership, control, operations and clients of the family office. Registration as an investment adviser entails a loss of privacy for the family office as well as a significant additional legal and administrative compliance burden in maintaining the records, policies and procedures imposed by the Act on registered investment advisers. Accordingly, if the family office does not currently qualify for the new family office exclusion counsel should be consulted regarding possibilities for restructuring the ownership, control, operations or clients of the family office in order to satisfy the new family office exclusion. ♦

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