

# Proposed Securities Legislation Could Significantly Change the Landscape of Family Office Investment Management Activities

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A key aspect of the management of multi-generational wealth is the diversification of a family's investments. Whether investment management is done through a single-family office, a multi-family office, or a virtual family office, the same asset allocation concerns arise. A family office that advises on a family's investments must consider whether and to what extent it (or its associated private investment company) is subject to the investment adviser or investment company rules administered by the US Securities and Exchange Commission ("SEC").

In the wake of the Madoff, Stanford and other scandals involving investment funds and advisers, the US Congress is considering a series of legislative proposals that could significantly alter SEC regulation and reporting requirements. Though these proposals are directed primarily at hedge, private equity and other investment funds sold to unaffiliated investors in private placements, by their terms they may also apply to family offices and family investment vehicles. The primary proposals are:

- Hedge Fund Advisers Registration Act of 2009, which was introduced in the House on January 27, 2009 by Representatives Capuano (D, MA) and Castle (R, DE) and subsequently referred to the House Committee on Financial Services;
- Hedge Fund Transparency Act, which was introduced in the Senate on January 29, 2009 by Senators Grassley (R, IA) and Levin (D, MI) and subsequently referred to the Senate Committee on Banking, Housing and Urban Affairs;
- Private Fund Transparency Act of 2009, which was introduced in the Senate on June 16, 2009 by Senator Reed (D, RI) and subsequently referred to the Senate Committee on Banking, Housing and Urban Affairs; and
- Private Fund Investment Advisers Registration Act of 2009, which was released by the Obama Administration on July 15, 2009.

Any of these proposals, if enacted, could subject family offices and family investment vehicles to enhanced SEC oversight and new reporting requirements, significantly changing the way family offices and family investment vehicles operate. For example, all of the proposals would require family offices and family investment vehicles to provide significant data to the SEC and subject them to both regular and unannounced inspections, thereby compromising their ability to protect the confidentiality of data concerning the family's economic interests and overall investment structures. This is especially troublesome, as some of the proposals specifically require the SEC to share information with other government agencies. The proposals would also significantly increase operating expenses and burdens by requiring family offices and family investment vehicles to appoint chief compliance officers and adopt and comply with written procedures regarding record keeping, conflicts of interest, trading restrictions and other matters required by newly-applicable securities laws.

It is important to note that the SEC will have significant rulemaking authority to implement the broad policy objectives outlined in the proposals. As such, the full impact of the increased disclosure obligations and administrative burdens and expenses will not be known until the SEC rulemaking process has been completed. However, it is reasonable to believe that the burdens will increase rather than decrease during SEC rulemaking proceedings.

## Summary of current law

Under current law, investment advisers and investment companies are required to register with the SEC, unless they qualify for an exemption.

### Investment advisers

An "investment adviser" is generally any individual or entity that, for compensation, engages in the business of advising others regarding investment in securities. Unless an exception applies, such advisors must register with the SEC. Registered investment advisers must comply with SEC rules relating to record keeping, compliance programs, advertising and marketing, solicitation arrangements, and annual disclosures. However, the Investment Advisers Act of 1940 currently contains an exemption for "private advisers" that have fewer than 15 clients and that neither hold themselves out generally to the public as investment advisers nor act as investment advisers to any Registered Investment Company. Currently, most family offices qualify for and rely on the "private adviser" exemption to avoid regulation by, and registration with, the SEC.

Family offices can usually rely on the "private adviser" exemption because they advise fewer than 15 clients. To make this determination, certain

client counting rules apply. For example, a US-based adviser must count all US and non-US investors. However, a non-US adviser need only count clients who are US residents. Individuals who are related and share the same principal residence are counted as a single client. In most cases, “legal organizations,” including corporations, general partnerships, limited partnerships, limited liability companies, and trusts are treated as a single client.

### **Investment companies**

An “investment company” is generally any company (including a corporation, business trust, partnership, or limited liability company) that pools investment capital and reinvests that capital in securities. Unless an exception applies, such companies must register with the SEC. Registered investment companies are subject to a wide array of disclosure, record keeping, compliance, and conflict of interest rules that can significantly increase operational burdens and expenses.

Family offices often form collective investment pools to facilitate diversification strategies, reach threshold capital concentrations and achieve operational and management efficiencies. Such collective investment pools fall within the general definition of an investment company set forth above. However, the Investment Company Act of 1940 currently contains two exclusions from the definition of an investment company that provide relief to such “private funds.” Most family offices qualify for and rely on one of these “private fund” exemptions to avoid regulation by and registration with the SEC.

- First, a pooled investment vehicle with fewer than 100 beneficial owners is not considered an investment company. A US-organized company must count all investors, both US and non-US, toward the 100-beneficial-owner limitation. Where an entity is an investor, the company need not count other entities that invest if they have identical ownership or beneficiaries. An entity that is not a private investment company or a registered investment company will count as one beneficial owner.
- Second, a pooled investment vehicle all of whose owners are “qualified purchasers” is not considered an investment company. Qualified purchasers are investors who are deemed to have sufficient sophistication in financial affairs. These are typically individuals or family-owned entities with \$5 million or more in investments, certain trusts of which the trustee and settlor are qualified purchasers, and any person acting for his own account or the accounts of other qualified purchasers who invests \$25 million or more.

The proposals – The changing landscape for Family Offices

### **Proposed changes affecting investment advisers**

Three of the proposals would eliminate or change the private adviser exception under the Investment Advisers Act of 1940. The Hedge Fund Advisers Registration Act of 2009 would require all private advisers to register while the Private Fund Transparency Act of 2009 and the Private Fund Investment Advisers Registration Act of 2009 would require all domestic private advisers with assets under management (“AUM”) in excess of \$30 million and all foreign private advisers who do not meet the definition of “Foreign Private Adviser” to register as investment advisers under the Investment Adviser Act. A Foreign Private Adviser is generally any investment adviser who has no place of business in the US, fewer than 15 US clients, and less than \$25 million in AUM attributable to US clients.

If any of these proposals are enacted, a family office will no longer be able to avoid registration and regulation as an investment adviser merely because it has fewer than 15 clients. Rather, the family office’s regulatory status will be determined on the basis of the amount of assets the family holds and, in the case of non-US family offices, the number of US family members. In the case of multi-national families with US family members, it may become prudent to create dual structures with both US and non-US components, so that at least the non-US portion of the family office can remain outside the scope of SEC oversight.

### **Proposed changes affecting investment companies**

One proposal, the Hedge Fund Transparency Act, would eliminate the current Investment Company Act exclusions for private funds. Under this proposal, companies with assets (or AUM) of \$50 million or more will be required to register with the SEC and comply with certain SEC reporting and record keeping requirements, including the filing of an annual information form that may include information concerning the owners of fund interests. Additionally, the proposals would require newly regulated funds to establish anti-money laundering programs and report suspicious transactions.

If this proposal were enacted, family offices would no longer be able to avoid registration and regulation as an investment company because they have fewer than 100 beneficial owners or because all of their beneficial owners are qualified purchasers. Rather, any family office that maintains a collective investment vehicle with assets (or AUM) of \$50 million or more would be required to register with the SEC and become subject to SEC regulation. This proposal does not, on its face, include any provisions designed specifically to address foreign investment companies. As such, a non-US family office with only a limited number of US family members would be subject to the same \$50 million test as a US family office.

### **Secondary effects on Family Office and Family Investment Vehicles**

Many families are also concerned about the secondary effects of the proposed legislation. That is, the proposals would require the private funds in which families invest and the private advisers who manage families’ assets to provide information to the SEC and other governmental agencies concerning their investors and clients. In addition, both the Reed and the administration proposals seek to remove existing prohibitions on investment adviser’s disclosing the identity of their advisory clients. As such, even if a particular family office or family investment vehicle is able to avoid direct application of these proposals, the family’s ability to protect the confidentiality of potentially sensitive economic data may be compromised. In this regard, it is not too early for you to begin to carefully consider the information that you are being asked to disclose when making investments in private funds or engaging investment advisers. In cases where potentially sensitive data is being requested, it is advisable to closely review privacy policies and ask the fund sponsors or investment advisers how they intend to limit disclosure of personal information should one or more of the forgoing proposals become law.

Conclusion


It is too early to tell which of the proposals outlined above will be enacted. However, it is generally believed that enhanced regulatory requirements in one form or another will be imposed upon currently exempt investment advisers and/or investment funds. Because the proposals each seek to modify or eliminate exemptions from registration and regulation generally relied on by family offices, it is not too early for you to begin to consider how you would respond to registration (and the policies and procedures required to be implemented in connection therewith) and any restructuring alternatives in advance of legislation.

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