Family office news: Regulatory reform: Family offices need to prepare

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David Guin
PARTNER | US

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On December 11, 2009, the full US House of Representatives passed "The Wall Street Reform and Consumer Protection Act of 2009." This omnibus bill to reform regulation of US financial markets includes the provisions of the Private Fund Investment Advisers Registration Act of 2009. As reported in our prior Updates on this subject, the Private Fund Investment Advisers Registration Act of 2009 could subject both domestic and international families, as well as family offices, to regulation under the US Investment Advisers Act.

Summary Of Current Law

An "investment adviser" is generally an individual or entity that engages in the business of advising others regarding investment in securities. Unless an exception applies, such advisers must register with the United States Securities and Exchange Commission (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 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.

Summary Of Proposed Legislation Affecting Family Offices

The Private Fund Investment Advisers Registration Act of 2009 would eliminate the "private adviser" exemption and would, instead, require all investment advisers with more than $150 Million in assets under management ("AUM") to be fully registered with and regulated by the SEC, including the filing of form ADV. Investment advisers with less than $150 Million in AUM would still be subject to recordkeeping and annual reporting requirements.

All investment advisers would report: the amount of AUM, the use of leverage (including off-balance sheet leverage), identification of counterparties, trading and investment positions, trading practices, and other information to be determined by the SEC. The SEC would be permitted to set different reporting requirements for different classes of investment advisers.

The records of any private fund advised by a fully registered investment adviser (over $150 Million in AUM) would be "deemed to be the records and reports of such investment adviser." As such, all records of any collective investment vehicle maintained and managed by a family office with greater than $150 Million in AUM would be subject to SEC review in both periodic and special SEC examinations.

The information filed with the SEC on Form ADV by a fully registered investment adviser (over $150 Million in AUM) will become publicly available in an electronically searchable format. The proposed legislation specifically provides that the SEC may share any other information it obtains in required reports or upon examination of an investment adviser's internal records with any other Federal agency or department and any self-regulatory organization (such as a stock exchange or the Financial Industry Regulatory Authority); and would allow (but not require) the sharing of information with foreign regulatory authorities. In addition, the SEC would be permitted to require registered investment advisers to provide reports to investors, prospective investors, creditors and counterparties of any collective investment vehicle advised by such registered investment adviser. Obviously, these rules will pose a serious threat to the ability of families and family offices to maintain the confidentiality of their private information.

Effect On International Families

The Private Fund Investment Advisers Registration Act of 2009 would also create a new class of adviser known as a "foreign private fund adviser." Any investment adviser that satisfies the definition of a foreign private fund adviser would be exempt from regulation. A foreign family or family office that provides investment advisory services to family members resident in the US and fails to meet the definition of a foreign private fund adviser would be subject to one of the two sets of rules described above (based on whether they have greater or less than $150 Million in AUM).

A foreign private fund adviser is defined as 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 clients in the United States. The legislative proposal does not attempt to define the phrase "attributable to

clients in the United States," thereby highlighting the importance that future SEC rulemaking proceedings will have in determining the scope and application of the new legislation. The SEC may adopt rules that "look through" private funds or other collective investment vehicles such as corporations, partnerships, limited liability companies and trusts to the residency of the underlying beneficial owners. The SEC could also adopt attribution rules that require the assets of the entire collective investment vehicle to be attributed to "clients in the United States" in the event that a certain minimum level of US ownership exists.

If the SEC adopts a broad interpretation of the phrase "attributable to clients in the United States," it is easy to see that even a small number of family members resident in the US could cause an entire family office structure to become subject to regulation by the SEC.

Secondary Effects On Family Offices And Family Investment Vehicles

Many families are also concerned about the secondary effects of the proposed legislation. That is, the Private Fund Investment Advisers Registration Act of 2009 would require the private advisers who manage families' assets to provide information to the SEC and other governmental agencies concerning their 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 the Private Fund Investment Advisers Registration Act of 2009 become law.

The Senate Proposal

On November 10, 2009, Senator Dodd (D-CT) introduced a bill, entitled the Restoring American Financial Stability Act, which has been referred to the Senate Committee on Banking, Housing and Urban Affairs (the "Dodd Proposal"). The Dodd Proposal would specifically exclude "family offices" from the definition of an Investment Adviser under the US Investment Advisers Act. The Dodd Proposal would also set the threshold for full registration with and regulation by the SEC at $100 Million rather than the $150 Million provided in the House's Private Fund Investment Advisers Registration Act of 2009, just discussed.

Significantly, the Dodd Proposal does not attempt to define "family office," leaving that definition to later SEC rulemaking. If the SEC defines a family office in a manner consistent with its prior exemptive orders in this area, the exemption will be limited to single family offices serving the lineal descendants of a single individual, their spouses and entities and charities owned by, for the benefit of, or created by, such individuals. However, the SEC could always take such an opportunity to narrow – or broaden – its prior interpretations of a family office.

Both Democrats and Republicans on the Senate Banking Committee have criticized the Dodd Proposal and the Committee has been broken into working groups to which specific topics have been assigned. Further action on the Dodd Proposal has not yet been decided.

Conclusion

The treatment of single-family offices differs under the two proposals described above. One cannot predict which treatment will prevail. It is also impossible to predict how the SEC rulemaking proceedings that will be necessary to implement any legislation will impact the scope and application of the proposal that is eventually approved by both houses of the US Congress. However, it is almost certain that stricter regulatory requirements of one sort or another will be imposed upon currently exempt investment advisers. Because both proposals would impact on the ability of families and family offices to protect the confidentiality of their private information, you should begin considering additional steps to protect such information. In addition, since there is a real chance that family offices will become subject to some form of direct regulation, it is not too early for you to begin to consider how you might respond, in terms of new compliance obligations and potential restructuring.

Authors

David Guin

PARTNER | NEW YORK

Corporate

+1 212 848 9870

david.guin@withersworldwide.com