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The Family Office Exclusion from the Investment Advisers Act of 1940

A family office is a private wealth management advisory firm that manages the wealth of a single family, often spanning multiple generations, which may provide investment advice directly to the sponsoring family, rather than engaging external investment advisers. As family offices continue to grow in size and sophistication, their asset management and investment activities may fall within the scope of the definition of "investment adviser" under the U.S. Investment Advisers Act of 1940 (the "Advisers Act"), subjecting them to potential regulatory scrutiny and compliance requirements, unless they take care to be structured and to operate within the boundaries of Section 202(a)(11)(G) of the Advisers Act and Rule 202(a)(11)(G)-1 thereunder (the "Family Office Rule"). This article discusses, in summary form, the Family Office Rule and its background, conditions, and implications.

Background

The Advisers Act regulates the activities of investment advisers, requiring that they register with the Securities and Exchange Commission (the "SEC") and adhere to stringent reporting, fiduciary, and conduct standards aimed at protecting the investors they serve. For many years a family office could rely on the so-called private adviser exemption, which excluded advisers with less than 15 clients, thereby permitting them to remain outside the scope of the Advisers Act. In June 2010, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), Congress repealed the private adviser exemption but simultaneously excluded "family offices" from the definition of investment adviser under the Advisers Act, directing the SEC to promulgate a rule that would define "family office" and set forth the details of the exclusion. In October 2010, the SEC proposed such a rule, and in June 2011, the Family Office Rule was adopted. Thus, family offices that are able to rely on the Family Office Rule are not subject to any of the Adviser Act's provisions.

What's a "Family Office"?

The Family Office Rule defines a family office as an entity providing investment advisory services that meets the following three criteria:

- Its only clients are "family clients" (e.g., family members, key employees, and certain alter ego entities formed for tax, charitable, or estate planning purposes).
- It is wholly owned by family clients and is exclusively controlled by "family members" or "family entities."
- It does not hold itself out to the public as an investment adviser.

The Big Tent of "Family Clients"

The Family Office Rule defines "family clients" broadly. It includes the following:

- *Family Members Having a Common Ancestor within a Ten-Generation Limit:* "Family members" are all lineal descendants of a common ancestor, who may be living or deceased, as well as the descendants' current spouses or spousal equivalents, so long as the common

ancestors is no more than ten generations removed from the youngest generation of family members. The ten-generation limit means that the family will be able to choose a common ancestor and, as older generations disappear, may over time choose new common ancestors in order to "shift down" to new generations. Family members also include adopted children, foster children, and stepchildren. Family members do not extend to in-laws related through the spouse of the common ancestor or through spouses or spousal equivalents that are family members, which the SEC staff made clear in a January 2012 FAQ.

- ***Former Family Members:*** Family clients include a spouse, spousal equivalent, or stepchild that was a family member but is no longer a family member due to a divorce or other similar event.

- ***Key Employees:*** The definition of a "key employee" includes employees of the family office or its affiliated family office that (i) serve as executive officers, directors, general partners, or trustees, or in similar capacities; (ii) participate in the investment activities of the family office as part of their regular duties and have been performing such duties at the family office or similar duties at another company for at least 12 months; and (iii) do not hold exclusively secretarial, clerical, or administrative roles.

    - Key Employees of Affiliated Family Offices: The definition acknowledges that families might operate multiple family offices due to various structuring preferences or for business or tax reasons and extends the definition to include key employees of an "affiliated family office," which is a separate family office that (i) is wholly owned by family clients of the other family office, (ii) is controlled by family members or family entities associated with the other family office, and (iii) has no clients other than family clients of the other family office.

    - Spouses of Key Employees: The definition also covers the key employee's spouse or spousal equivalent who, at the time of contribution, holds a community property, joint, or other similar shared ownership interest with the key employee.

    - Former Key Employees: Former key employees cannot receive investment advice from the family office or invest additional assets with a family office–advised entity after their employment ends, except for assets that were already being advised by the family office before their employment ended. However, they can receive advice on additional investments they were contractually obligated to make that relate to existing family office–advised investments prior to their departure.

- ***Certain Associated Entities:*** Family clients also include certain trusts, estates and other entities formed for tax, charitable, or estate planning purposes by family clients as described below.

    - Trusts: A family client includes irrevocable trusts funded exclusively by one or more family clients in which the only current beneficiaries, in addition to other family clients, are charitable and nonprofit entities, including not only family-funded and created charities but also public charities. Notably, the adopting release for the Family Office Rule expressly notes that "a trust that meets the conditions of the rule for qualifying as a family client is unaffected by whether the trust is managed by an independent trustee." Revocable trusts may be family clients so long as one or more family clients are the sole grantors, even if non-family members are beneficiaries.

    - Estates: Additionally, estates of current or former family members and key employees may be family clients, so that their executors may receive advice from the family office.

- Charities and Other Companies: A charitable or nonprofit entity is a family client only if it is funded exclusively by family clients. A family client also includes any company, such as a pooled investment vehicle, that is wholly owned, directly or indirectly, by one or more family clients and operated for the sole benefit of family clients.

Exclusive Ownership and Control

To qualify for an exemption under the Family Office Rule, a family office must:

- be wholly owned by family clients and
- be exclusively controlled by one or more family members or family entities.

Based on the broad definition of "family clients," both family members and certain key employees may hold an ownership interest in the family office.

- Carried Interest for Key Employees: Accordingly, this allows family offices to adopt the equity compensation structures of investment firms to remain competitive in attracting and retaining key investment employees, including the use of carried interest.

However, effective control and direction over the family office's operation must remain exclusively with family members or their "family entities," the definition of which excludes any entities associated with key employees.

- "Control": "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." This definition makes clear that the role of an executive officer may be held by a non-family member without fear that it would jeopardize the exclusive control requirement. The SEC staff has also indicated that the exclusive control requirement under the Family Office Rule exemption would be met if the majority of the family office's board of directors consists of family members, as long as there are no special agreements or arrangements that would grant control over management or policies to non-family members or non-family entities.

No Holding Out to the Public

To qualify for the exemption under the Family Office Rule, a family office cannot hold itself out to the public as an investment adviser. This includes refraining from advertising as an investment adviser or financial planner, using letterhead that suggests the provision of investment advisory services, maintaining a public website that offers advisory services, or engaging in any activities that imply availability for new advisory clients. This does not mean that a family office cannot hold itself out to the public as a family office or an institutional investor.

Other Related Topics

Multi-Family Offices

There are many firms in the market that provide advisory services to a handful of high-net-worth families, particularly where a family's need for advisory services does not warrant full-time employment for an internal manager or team of managers. Firms with this business model have been known in the market as "multi-family offices" for many years. Although multi-family offices historically were able to rely on the private adviser exemption (provided that they provided services to fewer than 15 families), as a result of the Dodd-Frank Act, multi-family offices either had to restructure their businesses so that advisory teams serviced a single family, or – as was more typically the case – register with the SEC as "investment advisers." Upon registration, such firms were required to operate within the framework of

the Advisers Act and the regulations thereunder, which include (among other things) implementing a Code of Ethics and compliance program and appointing a Chief Compliance Officer.

Joint Ventures and Co-investments

When participating in joint ventures, co-investments, or other similar transactions where the family office is taking an active role in managing the joint venture, or controlling a co-investment vehicle or otherwise acting in concert with third-party investors that are not family clients, a family office must be careful not to inadvertently take on a role of investment adviser to the other non-family client participants. Actions such as actively sponsoring a co-investment vehicle, providing quarterly reports on underlying investments, and exercising control over dispositions of assets could be seen as providing investment advisory services to non-family clients.

GP Stakes

Family offices should also be aware of the regulatory risks associated with acquiring minority equity interests in the general partner or management company of a private investment fund. These "GP Stakes" can be an attractive incentive offered by an emerging manager to a lead investor. However, direct ownership of an investment manager could, under some circumstances, jeopardize reliance on a Family Office Rule if the family office is deemed to have control of an investment adviser providing advice to non-family clients. If a person owns 25% or more of an investment adviser, they must rebut the presumption of control by proving that they have no right to be consulted on material corporate actions and have no sole veto power over any extraordinary corporate actions. In addition to ownership, the SEC considers additional factors, including but not limited to (i) the person's voting power, (ii) the person's participation in the adviser's day-to-day management, (iii) the person's control of a majority of board seats, and (iv) the person's sole veto rights over major transactions. Preferential access to information about the underlying adviser's or general partner's investment decision-making should also be strictly avoided. In short, the family office's ownership interest in an underlying adviser or general partner must be strictly passive. Given the importance of the facts and circumstances of each, family offices are urged to consult their counsel prior to acquiring any GP stake.

Spinouts

For larger family offices that have hired a team of investment professionals that deploy investment strategies that cover a number of different asset classes, an inherent tension can develop in that there is a cap on the assets available for investment. Often an investment team will be of the view that its strategies would be attractive to additional clients, which would result in increased revenues, if only they were permitted to manage assets other than those of the family office. In response to this phenomenon, some family offices have restructured to permit a subset of their investment team to spin out and deploy their strategies with third-party capital, including with the family office having a passive stake in the new manager entity. However, given the importance of the family office being able to continue to rely on the Family Office Rule with respect to the team that stays behind, and in an effort to proactively limit regulatory access to family office information through the back door of the regulated, spun-out manager, these restructurings have to be designed with extreme caution.

Other Applicable Laws and Regulations

It is important to note that despite the exemption from the requirements applicable to investment advisers under the Advisers Act, family offices must still adhere to other applicable laws and regulations, including state-level registration and estate laws, which are beyond the scope of this article.

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For more information on the issues discussed here, please contact your Morgan Lewis Impact Investing attorney.

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