Family Offices: Structuring for Investment Adviser Compliance

With family offices increasingly building sophisticated operations and engaging larger management teams, many are now looking for ways to manage or co-invest with third party capital in addition to the family’s capital. At times, this is limited to a small circle of peers and, at other times, is expanded to traditional institutional investors. In addition, many families offer deal-by-deal opportunities to their personal network even if they have not established a more institutionalized family office. In this environment, family offices must keep in mind compliance with applicable investment adviser regulations and exemptions that can impact the structure and operations of a family office, its investments and its transactions with third parties, including co-investors or joint venture partners.

Investment Advisers Act Considerations — Background

The Investment Advisers Act of 1940, as amended (the “Advisers Act”), regulates a wide variety of asset managers, including family offices, if the manager: (1) advises others (2) regarding securities (3) for compensation. “Advisory compensation” is broadly interpreted by the SEC and includes the payment of management fees, carried interest or performance fees, and reimbursement of family office overhead expenses such as salaries. However, if no advisory compensation is paid to the family office, or if the family office manages solely private funds with less than $150 million in assets, the Advisers Act generally will not apply.\(^1\)

Prior to the adoption of the Dodd-Frank Act, many private investment firms, including family offices, could rely on the fewer-than-15 client exemption from registration under the Advisers Act, which exempted from registration any manager, including a family office, that provided investment advice for compensation to fewer than 15 clients (with each fee-paying natural person, trust, private fund or other person counted as a client). However, the Dodd-Frank Act repealed such exemption and, as a result, brought significant changes to the application of the Advisers Act to family offices. In connection with such repeal, and in recognition that the Advisers Act was not designed to regulate families managing their own wealth, the SEC instead adopted a new rule describing the conditions family offices must meet in order to be excluded from Advisers Act regulation (the “SEC Family Office Rule”).

Requirements for the SEC Family Office Rule

To qualify for the SEC Family Office Rule, a family office must satisfy three general conditions:

1. **Clients of the Family Office.** The family office must have no clients (i.e., recipients of the family office’s advisory services) other than “family clients.” “Family clients” generally include:

   - Any “family member” or “former family member,” which includes all lineal descendants of a common ancestor (who is no more than 10 generations removed from the youngest generation of family members, and who may be living or deceased), and their spouses or “spousal equivalents”;

   - Any “key employee” or “former key employee” of the family office, which includes:
     - the president; a vice president in charge of a principal business unit, division or function; an...
officer who performs a policy-making function, or a person who performs similar policy-making functions; or a director, trustee, general partner or person serving in a similar capacity;

» an employee of the family office who does not perform solely clerical, secretarial or administrative functions, and whose regular functions or duties include participation in the investment activities of the family office; provided that such employee has performed such functions or duties for or on behalf of the family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months; and

• Certain trusts, estates, companies or other entities of a family client.

2. Ownership and Control of the Family Office. The family office must be wholly owned by family clients and be exclusively controlled (directly or indirectly) by one or more family members and/or family entities.

• Ownership of the Family Office. Because the definition of family clients includes both family members and key employees, family members do not necessarily need to have exclusive ownership of the family office to meet this requirement.

• Control of the Family Office. In contrast, the SEC Family Office Rule requires that family members and/or family entities exclusively control the family office.

This two-pronged approach to ownership and control of the family office allows for key employees to own non-controlling stakes in a family office (e.g., as part of an incentive compensation package to recruit and retain talent), but requires that control of the family office remain in the hands of family members and certain family entities (e.g., wholly owned companies and certain family trusts). The SEC does, however, allow key employees to participate in management (e.g., as a board member) provided that such key employees are limited to a minority of the governing body and are not permitted by other arrangements (e.g., in the family office governing documents) to exercise control.

3. Family Office Representations to the Public. A family office may not represent, or otherwise hold itself out, to the public as an investment adviser.

• While family offices often maintain websites to provide information to potential portfolio companies and signal to the market they are serious institutional investors, a family office should avoid any advertisements or other communications with the public that could be perceived as offering advisory services to non-family clients or generally holding itself out as an investment adviser or financial planner.

• The SEC has indicated that a family office may not market non-public offerings or other investment products to persons or entities that are not family clients.

Multifamily Office Arrangements and Operational and Deal Considerations

• Multifamily Office Arrangements. Although two or more families may benefit from certain efficiencies and cost savings of a multifamily office, the SEC Family Office Rule explicitly applies only to single family offices and does not apply to multiple family office arrangements.

» To rely on the SEC Family Office Rule, a family office should avoid (1) entering into any multifamily office arrangements and (2) providing advisory services to (or providing investment advice to, or making investment decisions for) investors that do not meet the SEC’s “family client” definition.

• Operational and Deal Considerations. Similar to the issues raised by multifamily office arrangements, a family office that engages in any joint venture, co-investment or other
deal structures involving third parties that are not “family clients” could potentially become subject to registration as an investment adviser.

Accordingly, to rely on the SEC Family Office Rule, a family office should carefully evaluate the relevant deal structures and role of the family office in a transaction (e.g., whether any family office is providing co-investors with investment advice for compensation).

Trust Company Alternative

In addition to the SEC Family Office Rule, an alternative option available to larger family offices to avoid Advisers Act registration is to form the family office as a state trust company. The Advisers Act has an exclusion from the definition of investment adviser for any “bank,” which is defined to include any trust company supervised by state banking authorities. Any such entity will be outside the scope of the Advisers Act, but will be subject to state banking authorities and regulation. Some families have found certain states (e.g., Nevada, Florida, South Dakota) to have favorable banking regimes that permit family offices to effectively organize as trust companies. While such entities are swapping one form of regulation under the Advisers Act for another form of regulation under state banking laws (which typically include regulatory capital requirements, the maintenance of comprehensive policies and procedures, regular periodic onsite examinations and regulatory approval requirements with respect to the appointment of senior executive officers and directors and changes in control), many such family offices believe that state regulation is lighter touch than the SEC and affords greater privacy when compared to Advisers Act registration.

Implications of Registration as an Investment Adviser

If a family office cannot meet the requirements of the SEC Family Office Rule and is not structured as a state trust company excluded from the Advisers Act, the family office will need to register as an investment adviser. Registration as an investment adviser subjects a family office to additional regulatory requirements and operational expenses associated with complying with such requirements, but provides a family office with flexibility to expand its clients to third parties. Registered investment advisers are considered fiduciaries for their clients and generally will need to treat third party clients fairly and equitably to family clients and to disclose and manage any conflicts between third party and family clients. Advisers Act requirements include the following:

• **Registration as an Investment Adviser with the SEC; Publicly Available Disclosure Documents.**

  » Investment advisers required to register under the Advisers Act must file a Form ADV Part 1A and Part 2A with the SEC.

  • The Form ADV Part 1A and Part 2A are publicly available online through the SEC’s Investment Adviser Registration Depository and include information relating to the investment adviser, including assets under management, key personnel and names of 5 percent direct and 25 percent indirect owners, regulatory disciplinary history, types of services and clients, custody arrangements for client funds, investment methodology, compensation paid to the adviser and material relationships and conflicts of interest.

  » Generally, the entire registration process takes about three to four months, including a period of up to 45 days awaiting SEC approval.

  » Once registered, an investment adviser is required to update (at least annually) its Form ADV.

• **SEC Oversight and Inspections.** Registered investment advisers must maintain required books and records and are subject to periodic inspections by the SEC for compliance with U.S. federal securities laws, including the Advisers Act. Newly registered advisers are often examined within six months of registration.

• **Formalized Compliance Procedures and Chief Compliance Officer.** Registered investment
advisers must maintain detailed compliance procedures, including procedures on valuation, voting proxies, anti-money laundering, privacy, insider trading, political contributions, cybersecurity and disaster recovery, brokerage and allocation, monitoring for conflicts of interest and other matters. A registered investment adviser must also have a designated chief compliance officer responsible for compliance issues, including compliance monitoring, testing and SEC interaction.

- **Restrictions on Performance-Based Fees.** Registered investment advisers cannot charge a carried interest or other performance-based fee or allocation to any private investor (other than key employees) in any 3(c)(1) fund (i.e., a fund that has 100 or fewer beneficial owners and is not a “qualified purchaser” 3(c)(7) fund) unless such investor has a net worth of at least $2.1 million (excluding the value of their primary residence) or $1 million invested in the fund and/or affiliated funds.

- **Restrictions on Change in Control.** Advisory contracts entered into by registered investment advisers must provide that no “assignment” or change of control (generally changes in 25 percent or more voting owners) of the family office may be made without the consent of the other party to the agreement, although in practice it may be easier to obtain for family office clients.

- **Custody.** Registered investment advisers with the ability to direct client securities or cash, such as with pooled vehicles and certain separate accounts, including family accounts, will have regulatory custody of such accounts. The Advisers Act Custody Rule may impose audit requirements for pooled vehicles or surprise audit verification for separate accounts or pooled vehicles.

- **Code of Ethics, Personal Securities Reporting and Insider Trading.** Registered investment advisers are required to adopt a code of ethics, maintain records regarding their securities trading activities and the securities and trading activities of their employees, and have insider trading policies reasonably designed to prevent and detect insider trading.

**Summary**

We hope this article provides a useful overview of the regulatory framework applicable to family offices. As described in this article, the current options available to larger family office investment advisers are to: (1) structure the family office to comply with the SEC Family Office Rule and avoid Advisers Act registration; (2) form a trust company eligible to operate under the bank exemption to Advisers Act registration; or (3) register under the Advisers Act. However, because each family office is unique and compliance with applicable investment adviser regulations and exemptions is highly fact-specific, there is no “one-size-fits-all” approach to compliance and the optimal structuring to achieve each family office’s distinct goals and objectives.

1. Generally, the Advisers Act regulates larger managers, typically managing $100 million or more ($150 million or more solely in private fund assets), while smaller to mid-size managers are overseen by state securities “blue sky” laws and regulators. For a family office to rely on the exemption for managing solely private funds with less than $150 million in assets, the office would need to file a short-form exemption notice with the SEC on Form ADV as an “exempt reporting adviser” and annually test assets under management to ensure the $150 million maximum is not exceeded.

   This article focuses on the Advisers Act. A parallel exemption from CFTC regulation also is available for family offices whose investments would otherwise bring them under CFTC jurisdiction. Smaller to mid-size managers that meet the definition of investment adviser will need to consult the relevant blue sky laws of the applicable states to determine if exemptions are available from state regulation.

2. This category does not extend to employees of family office affiliated operating companies.
If you have questions about the topics addressed in this Private Investment & Family Office Insights, please contact familyoffice@kirkland.com or one of the attorneys listed below.

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