SEC Raises Questions for Family Offices

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By THOMAS COYLE

Though a new definition of the noncommercial family office signals status quo for most ultra-wealthy families, it could force some to register as investment advisers like their commercial counterparts.

Under a Securities and Exchange Commission proposal prompted by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the majority of family offices--entities that provide investment and wealth-management services to families with assets of hundreds of millions of dollars--seems likely to escape the potential loss of privacy and added costs associated with registration and ongoing compliance.

For others, though, it could mean choosing between registration and complex workarounds.

Family offices number a few thousand in the U.S. and account for around $1 trillion in assets. Multifamily offices--commercial versions of the family office that number in the hundreds--are generally registered as investment advisers or licensed as trust companies, and most have minimum client portfolio values in the low tens of millions of dollars.

For decades, family offices have been specifically exempt from SEC registration as investment advisers to fewer than 15 clients. With this exclusion removed in Dodd-Frank's desire to regulate hedge funds, the SEC now proposes to exempt firms that don't position themselves as investment advisers to the public, are wholly owned and controlled by family members, and provide advice exclusively to family members (now including stepchildren and former spouses), "certain key employees," charities and trusts established by family members and businesses owned by family members.

Including employees as approved co-investors with the controlling family makes sense to Alois Pirker, research chief for consulting firm Aite Group. "As financial advisors that work for a single-family office are, in effect, employees of the family, the relationship between adviser and client is substantially different from the one at multifamily offices or any other investment-advisory firm," he said. In other words, employee co-investing comes down to letting senior family-office personnel eat what they have cooked.

Prior to this clarification, family-office attorney Karen Yates, a partner at law firm Withers Bergman LLP, saw employee co-investing as a potential trigger for SEC registration under Dodd-Frank.

Though it clears up the co-investing conundrum, the SEC proposal presents new challenges.

Thomas Handler, head of law firm Handler Thayer LLP's family-office practice, noted that families with operating businesses sometimes employ people for the business and for

the family-office. If viewed as employees primarily of businesses that aren't wholly owned by the family, their status as co-investors could force the family office to register under the new definition.

"I'm talking about businesses that are 80%, 90% owned by the family," said Handler.

Creating phantom equity to track the family's investments is a possible fix, but it would be difficult to administer and anything but liquid.

The SEC definition is also a head-scratcher for families that have banded together to form "closed" family offices--noncommercial outfits that serve several wealthy families for the sake of cutting costs and building scale. In Handler's view, these would probably have to register because they aren't focused on a single family.

Another puzzling feature of the SEC's definition is its apparent willingness to let family offices advise any number of family members. "Do they really mean there's no limit?" asked Handler. "It's not just 15 anymore; could it be 200?"

Handler also said he wonders whether family offices that became registered investment advisers solely because they cater to more than 15 individual family will be permitted to "de-register" if the new proposal goes into force as it stands.

The SEC is accepting comments on the proposal until Nov. 18.

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