FAMILYWEALTHREPORT

June 28, 2011

The Family Office Exception: Greater Clarity Could Force Greater Compliance

Thomas Handler

Chairman, Advanced Planning & Family Office Practice Group - Handler Thayer

Editor's Note: Below are some comments provided by Thomas Handler, chairman of the Advanced Planning & Family Office Practice Group at Handler Thayer, on the final regulations delineating the family office exception to the registration requirements of the Investment Advisors Act of 1940.

The recently released, final regulations which delineate the family office exception to the registration requirements of the Investment Advisors Act of 1940 generally serve to liberalize the exemption from the initial version set forth in the 2010 proposed regulations. Although the SEC adhered to its earlier position in many respects, it reacted favorably to the 90 comments submitted (mostly by law firms) and provided better definitions for the family office industry to follow. The previous definition was limited and provided very little meaningful guidance; consequently, families were often forced to seek exemption orders from the SEC in order to determine the true parameters of the exemption. Such orders were private and provided no guidance to other family offices. In this regard, greater clarity will be seen as a positive step, allowing families to comply with greater certainty without the necessity of an exemption order.

The long-standing exemption which defined family offices as enterprises that manage assets for up to 15 family members is set to expire on 21 July 2011 pursuant to Dodd-Frank. In view of the short time available for family offices to analyze the new rules and register, the SEC has provided an extension until 30 March 2012. Family offices may be well advised to retain counsel immediately in order to determine their compliance with the new rule, provide time to register or seek an exemption order, or restructure to avoid registration or limit SEC scrutiny of family office operations by spinning out a separate Registered Investment Advisor subsidiary. At least one law firm commentator estimated that family offices would incur $25,000-35,000 in legal fees just to determine their compliance status with the new regulations.

Several key definitions have been expanded and are likely to be well received by family offices. These include the nature of family foundations and not-for-profit entities, what constitutes a “family member” and what constitute other qualifying family entities. In addition, the SEC took the position that former spouses could be included and included “spousal substitutes” to this definition thereby including married gay couples and possibly other similar relationships. Moreover, the regulations provide a generous grandfathering rule for family offices which received an exemption order pursuant to the previous exemption definition.

The downside of these rules is that greater clarity will likely force greater compliance and provide a platform for increased SEC scrutiny of family offices which cannot avoid the registration requirements. This can happen in a number of minor ways even though the family office would otherwise be exempt, such as where

certain employees who are not key employees are included in family investments or where the family manages funds for businesses they do not control or own completely. Note that many family offices are required to register (or arguably required to do so) as broker-dealers under the SEC's expansive construction of those registration requirements, but the vast majority are not registered and are largely unaware of their compliance lapses. Similarly, many family offices should have been registered as RIAs under the old rules, but completely failed to do so; SEC enforcement was considered lax in this regard.

The enactment of the current rules is likely to be accompanied by increased enforcement activities and penalties for failure to comply. The compliance burden is considered expensive on an ongoing basis due to the documentation requirements, need for an internal or external compliance officer, increased legal fees and the significant staff downtime incurred during an SEC audit of the RIA. It is likely that families with international family offices will use such offices for their investment functions in order to avoid SEC scrutiny and the related costs and lack of privacy. Similarly, it is anticipated that many families which can do so will outsource their investment function (possibly to MFOs) in order to avoid registration. Of course, many families will simply register and hope for the best.

Most family offices that are not currently registered fail to appreciate the burdensome nature of SEC registration and the risk of regulation and often heavy-handed enforcement carried out by one of the most powerful government agencies which operates with little meaningful Congressional oversight. We find that our single family office clients are very concerned regarding the true impact of these new rules.