Single Family Offices and Regulation

Pre-2011, family offices relied on the private adviser exemption which was simple. If the family office had fewer than 15 clients, the family office didn't have to register. The Dodd Frank Act changed that.

"The Private Fund Investment Adviser Registration Act did away with the de minimum exemption and put in place a pure regulatory asset test. If the family office was not excluded or exempt and had $25 million or more under management, it would be required to register," said Greg Florio, founding member of Orical LLC, speaking at Peltz International's "Regulatory Update for Family Offices" seminar.

Under Dodd Frank, "family office" was defined and excluded from the definition of "investment adviser" so it didn't fall under the Act. Florio explains: "Rather than an exemption that might have some conditions, it became an outright exclusion. However, as a definitional exclusion, it's important that family offices understand the nuances of the definition, so that they don't inadvertently act as an investment adviser."

Definition of family members, clients, key employees

Family members include lineal descendants from a single ancestor within 10 generations including spouse, spousal equivalents and children (adopted and foster).

Key employees can have their money managed by the family office. A key employee is defined the same as "knowledgeable employees" and must have at least 12 months of experience acting in such capacity.

Heath Weisberg, general counsel of CAM Capital, points out that a spouse of a key employee is considered a family client only if they hold a joint, community property, or other similar shared ownership interests with the key employee. Independent assets of a spouse are not included.

Family clients don't include in-laws, adds Weisberg. "You can't manage money for in-laws without getting a separate exemption. The SEC has been willing to issue no-action relief when asked for in-laws but is not willing to provide a blanket rule including in-laws in the definition of family client. You have to apply separately for no-action relief in each instance."

Expanding services outside the family

The key element of the family office exemption is that the family office can't provide services to anyone outside the family or outside the family office, says Tim Terry, general counsel for Hartz Capital.

Florio explains: "If you want to take on third party capital, the private fund exemption provides that as long as your only clients are private funds (pooled investment vehicles exempted under section 3c-1 or 3c-7 of the Investment Company Act), you can manage up to $150 million in regulatory assets before registration would be required. The gross asset number includes leverage and the cash proceeds from shorts. You still must file as an exempt reporting adviser which has a much lower burden than an RIA. But if you are above $150 million in regulatory assets under management or you have at least $25 million and have separately managed account clients, you have to be registered with the SEC or a state regulatory authority."

If a family office decides to expand and have some fee-paying third party clients, in most cases, it will have to be an RIA. Terry comments: "In that case, the SEC can see into your whole business. Some families have opted to build a separate organization and keep the family office separate."

If the family office would like to keep its family office activities separate from its RIA, the entities need to be operationally independent. "You need to have non family members running it, separate office space and personnel, etc. Since the RIA is going to be examined by SEC, you need to make sure proper barriers are in place," says Florio. "The SEC is going to come in and check books and records. They can come in and look at emails and all forms of communications."

When the SEC comes into examine the RIA, it creates a real risk. Weisberg says they may be curious and take a look at the family office as well. "Even if you're doing everything the right way, you have regulatory risk."

Once registered, Florio says you need to have a chief compliance officer, an annual review and maintain books and records. There are strict restrictions on advertising and marketing. In marketing materials, you have to guard against cherry picking. If discussing the performance of good investments, you may need to disclose all your investments over the past 12 months. You could show your top five and bottom five investments.

General rules that apply to family offices

Terry points out that family offices are market participants and the general class of laws are applied to family offices like other participants. Four key ones that require filing with the SEC are 13D and 13G where larger interests in publicly traded companies are reported. 13F - if you have $100 million or more, quarterly reports are filed to disclose your interest to the SEC and to the public. For family offices with private exemption holdings, the files are confidential and only seen by SEC, not the public. 13H is the large trader report. If you trade more than $20 million in a day or $200 million a month, you need to get a large trader number.

These regulatory/disclosure regimes affect family offices each day.

In addition, the SEC aggressively pursues investigations and enforcement actions against all sorts of market participants, including family offices, for violations related to beneficial ownership reporting, front running, insider trading etc.

And in the normal course of doing business, a family office may receive an informal request or subpoena from the SEC and should have policies and procedures in place to guard against such violations, adds Florio.

Terry said they received an inquiry about an outside manager they didn't even invest with. "We got a call from the SEC about our conversation and emails with the manager. The SEC wants cooperation. You have to be secure in how you monitor information. Even when doing the right thing, you can be pulled into investigations. You need to make sure you're on correct footing."