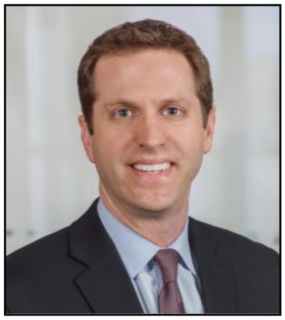
Family Office Structuring and Operating Pitfalls: Observations from the Field

By R. Scott Beach and Greg H. Kahn, Day Pitney LLP



Family offices that meet certain criteria are excluded from registration with the U.S. Securities and Exchange Commission ("SEC") as an investment adviser ("Family Office Exclusion"). Registration with the SEC involves significant regulatory burdens, including compliance with the Investment Advisers Act of 1940 ("Advisers Act"), reporting and periodic examination by the SEC. Is your family office properly structured to ensure it is, and will continue to be, excluded from required registration with the SEC as an investment adviser? Are you confident that is the case?

The Family Office Exclusion was created in 2011 by Rule 202(a)(11)(G)-1 ("Family Office Rule") of the Advisers Act pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Family Office Rule, despite appearing at first glance to be straightforward in nature, is both nuanced and complex.

To qualify for the Family Office Exclusion, the family office must:

(i) not have clients other than "family clients[1]",

(ii) be wholly owned by family clients and controlled exclusively by family members[2] or family entities, and

(iii) not hold itself out to the public as an investment adviser.

[1] "Family clients" include (a) all current and former family members; (b) "key employees" of the family office; (c) charities funded exclusively by family clients; (d) estates of current and former family members or key employees; (e) trusts existing for the sole current benefit of family clients; (f) trusts funded solely by family clients if both family clients and charitable and non-profit organizations are the sole current beneficiaries; (g) certain key employee trusts; and (h) companies wholly-owned exclusively by, and operated for the sole benefit of, family clients (with certain exceptions).

[2] "Family member" includes no more than 10 generations of family members and includes all lineal descendants of a common ancestor as well as current or former spouses or spousal equivalents of those descendants.

We have observed family offices that oversee significant wealth make certain mistakes when structuring or operating their family office that could result in the family office's loss of the Family Office Exclusion and could put the business goals of the family at risk. These structuring and operating missteps are typically due to a misunderstanding of the finer points of the Family Office Rule. Fortunately, as discussed below, several straightforward solutions can correct some of these structuring mistakes.

Pitfall #1: Lack of "Exclusive Control" by Family Members/Family-Owned Entities

Families qualifying for the Family Office Exclusion must maintain control over their family office. We have observed that the legal entities functioning as a family office (e.g., limited liability companies, partnerships or corporations) may not be controlled by family members or family entities in the manner required by the Family Office Rule. For example, trusted advisers or key family office employees who are not family members cannot represent a majority of the voting members of the board or such other governing body of the family office entity, even if family members have full authority to appoint and remove the board members at any time and for any reason. Therefore, the board of the family office must be structured so any non-family members and non-family entities involved in management of the family office: (i) do not represent a majority of the voting board members; or (ii) have voting power limited to administrative action items only.

Pitfall # 2: Improperly Structured "Key Employee" Investment Vehicles

"Key employees" (discussed below) are permissible "family clients" of the family office and can invest alongside the family, as the SEC recognizes such an exception is necessary in order to attract and retain talented professionals as employees of family offices. Key employees may co-invest in their individual capacity with the family office or enter into certain types of investment advisory agreements with the family office without triggering the need for the family office to register with or report to the SEC. However, the SEC strictly limits the types of investment vehicles that key employees may use to make such investments.

Key employees include any executive officer, director, trustee, general partner or person serving in a similar capacity for the family office. Certain key employee-affiliated entities, certain charitable organizations and certain trusts associated with key employees are permissible family clients. We have observed that several entities used by key employees who are not family members to invest along with family members in investments advised or managed by the family office do not technically meet the SEC's key employee definition and, as a result, put at risk the reliance on the Family Office Exclusion.

For example, non-compliant key employee investment vehicles include, but are not limited to: (i) corporations or irrevocable trusts for which the key employee's children are the beneficiaries;

and (ii) limited liability companies or corporations that a key employee controls but whose ownership is shared with the key employee's siblings or children or with a non-compliant family trust. If key employees are utilizing entities or trusts to participate in family office investments, it is important that the family office evaluate those key employee vehicles to confirm they are permissible under the Family Office Rule, and if they are not, then such key employee investments should be transferred directly to the key employee or into compliant investment vehicles.

Pitfall #3: Inadvertently Holding Itself Out as an Investment Adviser

The Family Office Rule prohibits a family office from holding itself out to the public as an investment adviser. Although managing capital for third parties, including close friends (unless they are qualifying key employees), or actively seeking third-party clients for the family office would not comply with the Family Office Rule, other not-so-obvious family office-related investment activities could also be problematic for a single-family office seeking to avail itself of the protections under the Family Office Rule. For example, family offices often provide financial backing for startup investment managers that are managing third-party capital, including private equity funds or hedge fund managers. These investments often involve the capital of the family office being managed by such investment manager on preferential economic terms and may also include a direct ownership stake in the investment manager and/or general partner of the fund. Depending on the terms of such investment, the family office may have significant rights to influence or control the management or policies of the investment manager. Depending on the level of control the family office has over the investment manager in that situation, the SEC could deem the family office to be indirectly holding itself out to the public as an investment adviser. This determination could put at risk the family office's qualification under the Family Office Exclusion. Although this risk may be remote, family offices should be cognizant of it when structuring these types of seed capital investments and negotiating the associated management rights in the manager and general partner of the fund.

A growing trend in the family office marketplace is the "club deal," whereby several families co-invest to buy a controlling interest in an operating business. Although some of these investments do not involve the payment of any fees or compensation by any of the families to one another, other structures strongly resemble a private equity-style investment. In such investment structures, the family office that has sourced the transaction takes on the role of a quasi "deal sponsor" charging certain fees to the other families. These fees can include carried interest or a "promote" fee (i.e., a share of the profits upon the sale of the business or another liquidity event), as well as the equivalent of a management fee (sometimes labeled a "monitoring" or "advisory" fee) for their efforts in sourcing, negotiating and monitoring the investment on behalf of the families that collectively made the investment. Although each of these investment structures needs to be analyzed independently to assess its compliance with the Family Office Rule, families should be aware that certain activities, including compensation received for serving as the deal sponsor, could be viewed by the SEC as the family office holding itself out to the public as an investment adviser, which could jeopardize the availability of the Family Office Exclusion and potentially require that the deal sponsor family register with the SEC and/or state regulatory authorities. Additionally, if the deal sponsor family charges the other families a "closing fee" or other commission-type fee that is contingent on the closing of the underlying transaction, there is a risk such family may be deemed to be acting as an unregistered broker-dealer in violation of broker-dealer regulations. Thus, any family office structuring a club deal investment in which it proposes to charge certain fees to other co-investing families should consult with counsel in order to ensure such investments and related fee arrangements are properly structured so as to comply with the Family Office Exclusion and federal and state broker-dealer regulations.

The Family Office Exclusion permits those family offices that are willing to take the steps necessary to comply with its requirements the ability to focus on their investment activities for the benefit of family members and key employees without intrusion on their privacy by the SEC. Family offices interested in protecting their privacy while avoiding the cost, in both time and money, of reporting to the SEC as an investment adviser should not only carefully structure their family office, but diligently monitor its operations, to ensure strict compliance with the Family Office Rule.

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R. Scott Beach is a partner with Day Pitney and chair of the Corporate and Business Law department and the Private Equity and Investment Funds practice group. Greg H. Kahn is counsel in Day Pitney's Corporate and Business Law department.

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