
Family Offices: An Overview of the New Dodd-Frank Exemption

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Topics for Discussion

- Overview of Family Offices Exemption
- Illustrative Case Studies
- Q&A

Section 1 – Overview of Family Offices Exemption

Family Office Exemption

Background

- Dodd-Frank Act revoked the “less than 15 client exemption” effective July 21, 2011
- Pre-existing family offices have until March 30, 2012 to be either qualified for an exemption or register with the SEC
 - Extension period is only available for advisers that qualified for the private adviser exemption on July 20, 2011

Family Office Exemption *(cont.)*

Qualifying for Family Office Exemption

- The family office can provide investment advice only to “family clients”
- Only “family clients” can own the family office
- Only “family members” and “family entities” can exercise control of the family office
- The family office cannot hold itself out to the public as an investment adviser

Permissible Family Clients

(Family clients are also the only permissible owners of the family office)

Family Members (and their Estates)	Descendants of Common Ancestor	Within 10 generations
	Spouses	No in-laws
	Step, Foster, Adopted Children & Certain Wards	Former family members retain status (but not for control)

Family Trusts, Entities	Revocable Trusts	Grantor must be a permissible family client
	Irrevocable Trusts	Family clients are only <u>current</u> beneficiaries; outside charities can be current beneficiaries if funding solely from family clients
	Charities & Non Profits	Funding only from family clients
	Business Entities	Owned by & operated only for family clients

Key Employees (and their Estates)	Execs, Directors, Trustees, & GPs of Family Office	Affiliated family office can be the employer Former employees limited to prior "assets"
	Substantive Investment Employees	12 months experience required for investment employees (either at family office or another company)
	Key Employee Trusts	Trustee must be a Key Employee and the Key Employee must be sole contributor

Control is More Limited

“Controlling influence” over management or policies other than as an officer

Family Members (and their Estates)	Descendants of Common Ancestor	Within 10 generations
	Spouses	No in-laws
	Step, Foster, Adopted Children & Certain Wards	<u>Former family members are not permitted to exercise control</u>

Family Trusts & Entities	Revocable Trusts	Grantor must be a permissible family client
	Irrevocable Trusts	Family clients are only <u>current</u> beneficiaries; outside charities can be current beneficiaries if funding solely from family clients
	Charities & Non Profits	Funding only from family clients
	Business Entities	Owned by & operated only for family clients

Key Employees (and their Estates)	<u>Neither current nor former Key Employees, nor their trusts are permitted to exercise control</u>
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Family Office Exemption *(cont.)*

Miscellaneous

■ **Common Ancestor**

- Selection is highly flexible and can change

■ **Involuntary Transfers**

- Grace period of one year from change of title
- Applies for purposes of permitted clients and owners, but likely not control

■ **Family charities accepting outside donations**

- No longer permitted
- Have until December 31, 2013 to distribute outside contributions
- Favorable worst-in-first-out presumption

Section 2 – Illustrative Case Studies

Example 1 – Internal Family Office

Facts:

- A founder of an investment adviser that manages several large hedge funds (“**HF Adviser**”) wants to create a family office to manage the founder’s family assets. The family office would utilize the personnel and resources of HF Adviser to manage the family assets. HF Adviser is not a registered investment adviser (in reliance on the SEC’s extension of the private adviser exemption). The investors in HF Adviser’s hedge funds include third-party investors that are not members of the founder’s family or key employees of HF Adviser.

Issues:

- Can HF Adviser qualify for the family office exemption?

Example 1 – Internal Family Office *(cont.)*

Answer:

- Will depend on the circumstances, but generally will be difficult for the HF Adviser to operate under the family office exemption while managing the assets of its hedge funds.

Analysis:

- The family office exemption requires, among other things, that a family office must have no clients other than “family clients”
- Assuming the hedge funds managed by HF Adviser are not owned by and operated for the sole benefit of “family clients,” the hedge funds (which are clients of HF Adviser) will likely not be “family clients” thus rendering the exemption unavailable for HF Adviser.

Example 1 – Internal Family Office *(cont.)*

What about an internal family office contained within a privately-owned operating company?

- A privately owned operating company (e.g., a manufacturing company) could have an internal qualifying family office provided that the requirements of the exemption were met.
 - The operating company can provide investment advice only to “family clients”
 - Only “family clients” can own the operating company (no JV partners or minority interest holders)
 - Only “family members” and “family entities” can exercise control of the operating company
 - The operating company must not hold itself out to the public as an investment adviser

Example 2 – Multijurisdictional Family Office

Facts:

- A family office with a principal place of business in Zurich, Switzerland has branch offices located in London and New York (“**Global Family Office**”). Global Family Office manages the assets of a single family. The members of the family are scattered throughout the world and include U.S. residents, non-U.S. residents, U.S. citizens and non-U.S. citizens.

Issues:

- Is Global Family Office subject to U.S. jurisdiction such that the U.S. Investment Advisers Act could apply?
- Can Global Family Office qualify for the family office exemption?

Example 2 – Multijurisdictional Family Office *(cont.)*

Answer:

- **U.S. Jurisdiction** – Global Family Office would likely be subject to the U.S. Investment Advisers Act because it uses U.S. jurisdictional means in the course of its investment advisory business.
 - New York City office
 - Likely uses U.S. jurisdictional means (phone calls, mailings) with respect to family members that are located in the United States.
- **Family Office Exemption** – Global Family Office could satisfy the family office exemption if it (i) has no clients other than family clients, (ii) is wholly owned by family clients and controlled by one or more family members (or family entities) and (iii) does not hold itself out to the public as an investment adviser.
 - It would likely not be able to utilize the exemption if it has any clients other than “family clients”

Example 3 – Individual Trustee

Facts:

- An individual acts as a co-trustee of several trusts established by a wealthy friend for members of that friend's family. Those trusts hold \$99 million of assets. The individual is also a co-trustee of a \$2 million trust established for members of his own his family. As a co-trustee of each trust, the individual shares fiduciary responsibility for selecting, monitoring and replacing third-party investment managers and receives some form of compensation.

Issues:

- Assuming the individual trustee could be viewed as an investment adviser with respect to the friend's trusts, may the trustee qualify for the family office exemption?
- If not, what is the basis for concluding that the trustee is not required to register and comply with the Advisers Act with respect to the friend's trusts?

Example 3 – Individual Trustee *(cont.)*

To qualify for the family office exemption with respect to the friend's trusts, the individual may need to:

- Disregard the trust for the benefit of his own family (because the family office exemption generally does not extend to those serving multiple families)
- Qualify as a Family Office
 - SEC rule specifies that a family office is a “company” (so the SEC may view a “family office” only as an advisory firm or company, not as an individual)

What is the impact of disregarding the \$2 million?

What about the private funds adviser exemption?

Example 3 – Individual Trustee *(cont.)*

What is the basis for simply concluding that a trustee is not an investment adviser?

- Legal guidance is mixed in this area and the answer heavily depends on the particular facts and circumstances.
- If an individual trustee is providing investment advice and receiving compensation for his services, there is a risk that the arrangements may require compliance with the Investment Advisers Act (or applicable state law).
- Based on guidance, the factors listed on the next slide could be relevant to the determination
- It could potentially be helpful if the individual is serving as a co-trustee together with (or delegating investment authority to) a registered investment advisor or a bank exempt from registration

Example 3 – Individual Trustee *(cont.)*

- Based on guidance, the factors that could be relevant to determining whether a trustee is an investment advisor may include the following:
 - Whether the arrangement specifically contemplates securities advice that is not merely incidental to a broader, non-investment advisory relationship (e.g., an investment trustee vs. an investment and distribution trustee);
 - Whether the trust is revocable or irrevocable, and potentially whether the trust is a testamentary or inter-vivos trust and whether the trustee also holds legal title to the trust property or is, for example, directing an "administrative trustee" that holds legal title;
 - Whether the trustee is engaged in the business of providing such services to multiple parties and may be seen as holding itself out as providing investment advisory services; and
 - Whether compensation is tied directly to a securities portfolio for which the trustee provides investment services (such as asset-based fees).

Some Questions to Consider (including how far you want to go without additional SEC guidance)

- If the family office is not “compensated” for investment services, is that person a “client” for purposes of the family office exemption?
- Changes within the family
 - Descendants of step-children?
 - Widow (non-family) remarries?
- Key Employees:
 - For trusts, does controlling only investment decisions suffice?
 - Practically, must ex-employee assets be paid out ASAP?
- Sharing employees with another office is ok? How many?
- Can 3rd party control the family office as trustee of a “family entity”?

Alternatives to Conforming with New Exemption

Potential Alternatives

- Conclude individual or office is not subject to Advisers Act
- Find an alternative exemption
 - Private fund advisers w/ less than \$150MM in AUM in the United States
 - Foreign private advisers
 - Venture capital fund advisers
- Apply to the SEC for an exemptive order (or, more likely in the case of an individual trustee, a no-action letter)
- Register with the SEC
- Reincorporate as a Private Trust Company (for reasons other than evading the Advisers Act)

Consequences of SEC registration

Impact of SEC Registration

- Must appoint a chief compliance officer
- Must establish a compliance program and a code of ethics
- Must comply with custody and recordkeeping requirements
- Subject to periodic SEC inspection
- Subject to anti-fraud provisions of the Advisers Act
- Subject to recordkeeping and reporting requirements

Private Trust Company Considerations

- Benefits

- All family office clientele may be served
- All family office investment and other services may be provided
- Full fiduciary powers with good insulation from fiduciary liability
- May import favorable state trust, trust company and tax environments
- No SEC-dictated “risk management”

- Issues

- Critical mass: sufficient assts to warrant cost of entity
- Some low to moderate regulatory burden (including “true” risk management)
- “Bank exclusion” conditioned on (i) substantial portion of business “exercising fiduciary powers” and (ii) not operated for purposes of evading Advisers Act
- Start up costs

Compliance Options—Overview

Options	Main Strengths	Main Weaknesses
Qualifying Family Office	<ul style="list-style-type: none"> ❖ Full Investment Powers ❖ Same Single Family Office (SFO) Role in Investments as currently 	<ul style="list-style-type: none"> ❖ Limited Clientele ❖ No SFO investment role with Non-Qualifying Family Clients
Partially-Qualifying Family Office	<ul style="list-style-type: none"> ❖ Full Investment Powers ❖ Same SFO Role in Investments as currently 	<ul style="list-style-type: none"> ❖ Limited Clientele ❖ No SFO Role with Non-Qualifying Family Clients
Outsourced Chief Investment Officer (CIO) with Discretion	<ul style="list-style-type: none"> ❖ Unlimited Clientele ❖ No Internal-SFO Investment Expense 	<ul style="list-style-type: none"> ❖ No SFO Investment Advisory Powers ❖ Almost No Role for SFO in Family Investments ❖ Investment Advisory Fee considerations
Outsourced CIO without Discretion	<ul style="list-style-type: none"> ❖ Unlimited Clientele ❖ Coordination/Communication Role of SFO with Investments ❖ No Internal-SFO Investment Expense 	<ul style="list-style-type: none"> ❖ No SFO Investment Advisory Powers ❖ Limited Role of SFO in Family Investments ❖ Investment Advisory Fee considerations ❖ Complexity of each investor (individuals, entities, trusts) making own investment decisions
Family Registered Investment Adviser	<ul style="list-style-type: none"> ❖ Full Investment Powers ❖ Unlimited Clientele 	<ul style="list-style-type: none"> ❖ Cost ❖ Regulatory approach, structure and other burdens
Family Private Trust Company	<ul style="list-style-type: none"> ❖ Full Investment Powers ❖ Unlimited Clientele ❖ Trust Powers ❖ All Other PTC Benefits 	<ul style="list-style-type: none"> ❖ Cost ❖ Fiduciary Structure (or a strength?) ❖ Regulatory requirements

Section 3 – Q&A

Notice: The presentation *Family Offices: An Overview of the New Dodd-Frank Exemption* and the materials related thereto are for general information only. They are not full analyses of the matters presented and should not be relied upon as legal advice.