CLIENT BRIEFING

REGULATORY HEAT FORCES TOUGH DECISIONS FOR FAMILY OFFICES IN 2012 (PART 1)

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Regulatory heat forces tough decisions for family offices in 2012 (part 1).

In 2011, the focus of regulatory change was firmly on the banks and major financial institutions with a view to preventing a recurrence of the problems of 2008. Although family offices were not considered in the grand scheme, they now face a number of unanticipated consequences and need to make some critical strategic decisions.

Rosalyn Breedy, of Breedy Henderson Solicitors, surveys the regulatory landscape for family offices and explains why they urgently need to make a decision about whether or not they wish to manage third party money.

In the first of a three-part series, Rosalyn Breedy examines the Dodd-Frank reforms and the AIFMD. In part 2, she outlines the implications of the regulations on family offices and in Part 3, she considers whether private investors will be better protected under the new regime.

In 2011 George Soros announced that he planned to give back almost $1 billion to outside investors because of the changes to the US private investment adviser exemption.

Dodd-Frank Wall Street Reform and Consumer Protection Act 2010

Soros's decision was influenced by the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010, which would have required Quantum Fund to register with the Securities and Exchange Commission by March 2012. Registration would require the fund to report information about its investors and employees, the assets they manage, potential conflicts of interest and their activities outside of fund advising. As a registered fund, they would also be subject to periodic inspections by the SEC.

An exemption exists for organisations that manage **only** family client money, and Soros is taking advantage of this to continue to control around $25 billion for himself, his family and his foundations.

Unfortunately, the definition of "family office" in the final rule does not extend to multi-family offices. This is because to qualify for the exemption for registration, a single family office must

- advise only ‘family clients’
- be wholly owned by ‘family clients’ and exclusively controlled by ‘family members’ or ‘family entities’; and
- not hold itself out to the public as an investment advisor.

Family clients are family members related within ten generations of a common ancestor. The term includes current and former spouses and adopted children. Family clients include some not-for-profit charities and trusts for the benefit of family members, but only present beneficiaries can be family clients as indeed can certain key family employees.

What does this mean for family offices?

Each family office will need to decide whether or not they are caught by the Act. If so, and if the family office is eligible for any exemptions, they will need to act quickly as the required filing date for initial application is 14 February 2012, with registration completed by 30 March 2011.

There are three questions that need to be considered.

First, are you acting as an 'investment advisor'? The broad answer is that you probably are, if you accept remuneration to advise others as to the value of securities or as to the advisability of investing in, purchasing or selling securities.

Second, do you have sufficient contact with the US to bring you within scope? The key issue here is whether you maintain a place of business in the US or have US investors. Specific facts and circumstances will need to be reviewed, as the place of business may just mean regular contact with and US clients and could catch US entities owned by non-US persons to hold US investments.

Finally, do you qualify for an exemption?

There are numerous exemptions to the Act but the two exemptions of most interest to the wealth management sector are:

1. Private trust company exclusion – this only applies to private trust companies formed under US laws and supervised by US federal or state banking agencies.

2. The foreign private advisor exemption – this will be the one of most interest to the multi-family offices. It applies to an investment advisor who has not got a place of business in the US, fewer than 15 clients in the US and less than $25mn assets under management from such clients. Be careful if you are getting close to these limits as there is a lot of detail on who or what counts as a client and rules around calculating assets under management for regulatory purposes.

Alternative Investment Fund Management Directive

In 2011, the European Union finally passed the Alternative Investment Fund Management Directive (AIFMD) which is due to be implemented by member states by July 2013.

This aims to create a comprehensive and effective regulatory and supervisory framework within the EU for alternative investment fund managers or an AIFM.

The scope of the directive is broad; it captures the management of alternative investment funds which covers most vehicles you would think of as funds as well as vehicles that you might not think of as a fund such as a joint venture.

This is because the definition of alternative investment fund is a collective undertaking, other than an UCITS (basically an EU-authorised investment fund) which raises capital from a number of investors and invests in accordance with a defined investment policy for the benefit of investors.

The AIFMD, unlike the US family office exemption to Dodd-Frank, has not received much commentary from the family office press and fund lawyers because there is a recital to the Directive which explicitly excludes 'family office vehicles which invest the private wealth of investors **without** raising external capital' from the definition of an alternative investment fund caught by the Directive.

However, it may catch family office managers who manage third party money and this presents a danger for those family offices that drift into managing third party money without realising the AIFMD requirements.

What does this mean for family offices?

Managers of alternative investment funds, who are established **in** the EU will require authorisation.

Managers **outside** the EU can still market funds within the EU under current transitional arrangements pursuant to individual country private placement regimes. But after 2015, third country regulators of those non-EU managers will need to put in place co-operation arrangements with EU regulators to monitor systemic risk.

In order to be granted authorisation from its Member State (or for non- EU managers their Member State of reference) a manager will need to submit information on its activities (including its structure, constitution, managers, shareholders, investment strategy and remuneration policy) and to provide evidence of its ability to comply with the Directive, its capital adequacy, the reputability and experience of its management and the prudence of its shareholders.

The key policy issue under this Directive is the question of who will be an AIFM. The Directive is unclear for a reason. It wants to provide for a multitude of legal and operational structures and to cover internal or external management.

Again, you will need to consider whether your family office will be caught, and if so what are the implications? There is a *de minimis* exemption where you do not need to be authorised but still must register and report.

To fit within this partial exemption, the manager must manage alternative investment funds with a cumulative value of less than EUR 100mn, or EUR 500mn if the alternative investment funds are unleveraged and subject to a minimum 5 year lock-in period.

Opportunities for family offices

However, providing you have the capital and the stomach to get authorised there are also plenty of opportunities.

As a result of Dodd- Frank US investment banks have shed their proprietary trading desks sending out talent that was previously difficult to access. Those traders need even more capital to start funds and so are more open to seeding conversations from family offices which offer capital in return for a slice of the management company and lock in lower fees.

Authorisation can act as a shield for investors' privacy and categorisation as an eligible market counterparty opens the door to a wider range of investment opportunities.

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