FEATURE:
HIGH-NET-WORTH FAMILIES & FAMILY OFFICES

By **Nathan J. Greene**

A U.S. Federal Securities Law Primer

Help family offices consider their responsibilities

An investment organization dedicated to managing a family's wealth is often referred to as a "family office." While the term encompasses enterprises that vary widely in scope and business models, I'll focus on the rights and responsibilities of an organization serving a single family, large enough to require professional staff and subject to U.S. jurisdiction because of U.S. family members or staff.

The business of a family office—management of one's own family assets—is inherently a private activity, yet it touches the U.S. federal securities laws in many ways. Managing a family office thus requires care to understand and mitigate the impact of these laws on family and staff. Here's an overview of the securities laws to assist a family office as it considers its responsibilities.

Investment Advisers Act

The U.S. Investment Advisers Act of 1940 (Advisers Act) may impact family offices in the following ways:

Regulation of the family office as an "investment adviser." The Advisers Act regulates businesses that provide securities investment or valuation advice when the advice is delivered to others for compensation. Such a business is regulated at either the federal or state level, depending on the amount of assets under management (AUM). Larger advisers typically are subject to U.S. Securities and Exchange Commission (SEC) registration, while smaller firms are covered by the states.

A family office is often exempt from both federal and state regulation under an exclusion from the Advisers Act's definition of an "investment adviser." Called the "family office rule," Advisers Act Rule 202(a)(11)(G)-1 excludes any family office that serves a single family (meaning one descended from a single lineal founder), if: (1) the only "clients" of the office are family members, family entities and related key staff, (2) the family office is solely controlled by the family or family entities, and (3) the family office doesn't "hold itself out" to the public as an investment adviser. Concerns that arise under the rule include limiting advice to permitted beneficiaries and maintaining control within the family.

Interaction by the family office with SEC-registered investment advisers. While the family office itself often can avoid SEC registration, third-party investment advisers engaged by the family office typically will be SEC-registered investment advisers (RIAs) who are required to report a variety of information to the SEC on both a public and non-public basis. Those reports can include information specific to the family.

For example, if the family office invests through a family vehicle, that vehicle may be deemed to be a "private fund" (as described further below). RIAs list information on their public Form ADV for each private fund client, including the name of the fund, the name of its managing member or general partner, AUM and number of investors. More detailed private fund information is reported non-publicly on Form PF. New requirements will become effective in October 2017, under which RIAs must report aggregated information on separate account clients.

RIAs also are subject to SEC rules that limit their ability to charge performance-based fees except to "qualified clients." A qualified client is generally one with either $2.1 million in net worth or a specific level of AUM with the RIA. While families that establish family offices might appear to easily meet those net worth

Nathan J. Greene is a partner at Shearman & Sterling LLP in New York City

tests, individual family members and/or individual family entities may have trouble satisfying them.

Securities Act

Family offices that wish to invest in privately offered securities must consider the U.S. Securities Act of 1933 (the Securities Act), which requires securities issuances to be registered with the SEC unless an exemption is available.

Regulation D, which offers the most widely used exemption for privately offered securities, permits unlimited sales of unregistered securities if the investors are accredited, and the offering is generally made on a private basis. An "accredited" investor must meet a specified net worth or income test, which generally requires $1 million in net worth for individuals and $5 million in net worth for entities. Individual family members or entities that can't satisfy the tests may be unable to participate in private offerings.

Rule 144A offers another commonly used exemption, which is limited to participation by qualified institutional buyers (QIBs). The QIB standard is much higher than the accredited standard.

The Securities Act is also relevant if a family office organizes one or more investment vehicles, as those vehicles often will be considered issuers of securities. Being an issuer of private securities (rather than just a purchaser) also triggers additional Regulation D requirements, including the filing of a public Form D with the SEC and potentially with state securities regulators. Form D is publicly accessible through the SEC's EDGAR system and requires disclosure of information that family offices may find sensitive, including the identity of board members, executive officers and persons carrying out similar functions for the investment vehicle, total offering amount, sales compensation paid in connection with the issuance, total number of investors and whether persons who don't qualify as accredited investors may participate in the offering.

Another requirement is compliance with what's often termed the "bad actor rule." Under this rule, the issuer and its close affiliates must not be subject to disqualifying securities law or fraud violations. While it's unlikely that a family office will have family or staff subject to disqualifications, that's a matter for due diligence. Diligence also might extend to third-party service providers such as investment advisers.

It can be argued that a family investment vehicle jointly managed by each of its participants isn't an "issuer of securities" in the first place, because being an active owner/manager puts one in a different place from a passive investor, with the latter requiring protection under the securities laws and the former able to look after his own interests. When a family vehicle is deemed not to be an "issuer of securities," Regulation D requirements (investor accreditation, Form D filings and the bad actor rule) no longer apply.

Investment Company Act

Family offices that wish to invest in private investment funds organized by third-party investment managers must consider provisions of the U.S. Investment Company Act of 1940. Most funds seek to rely on either the Section 3(c)(7) exemption for qualified purchaser funds or the Section 3(c)(1) exemption for 100-person funds. The former exemption generally requires that each beneficial owner of a private fund's securities is a "qualified purchaser," which generally means an individual with $5 million in investment securities or an entity with $25 million in investment securities. The latter exemption has no stated investor qualification terms but generally limits ownership of the fund's securities to 100 persons. Family members or entities that fail to meet the necessary tests are ineligible to participate.

> Under existing SEC guidance as to what constitutes a broker or dealer, family offices generally don't face appreciable risk of being regarded as either.

An investment vehicle organized by a family office

also may be considered an "investment company" and needs to rely on the Section 3(c)(7) or Section 3(c)(1) exemptions. As already suggested, some vehicles jointly managed by their participants may not be "issuers of securities." If that were the case, the vehicle also wouldn't be an investment company.

Vehicles that rely on these exemptions are considered to be "private funds" or "covered funds"—terms defined under different regulations. Being a private fund triggers special Form ADV and Form PF reporting for registered investment advisers. Being a covered fund triggers application of the Volcker Rule to which many global banks are subject; banks have policies for dealing with covered funds.

Commodity Exchange Act

A family office that trades commodity interests (generally, futures contracts, options on futures, commodity options and swaps) may be subject to regulation by the U.S. Commodity Futures Trading Commission (CFTC) as a commodity pool. The sponsor or manager of such a pool may be required to register as a commodity pool operator (CPO), and persons providing commodity trading advice to the pool may be required to register as commodity training advisers (CTAs) under the U.S. Commodity Exchange Act (CEA). "Trading in commodity interests" encompasses direct trading activities as well as investments in collective investment vehicles that trade commodity interests. As a result, investment portfolios that include participations in hedge funds, private equity funds and real estate funds raise considerations as to CPO/CTA registration requirements. While CFTC registration rules generally don't distinguish hedging from speculation, de minimis exemptions may be available.

The CFTC staff has issued a no-action letter providing for CPO and CTA registration relief for pools that satisfy the family office definition under the SEC's family office rule (Advisers Act Rule 202(a)(11)(G)-1, discussed above). To the extent a family office falls outside the SEC's family office rule (making the CFTC no-action position unavailable), a family office might look to a body of historical CFTC staff letters issued to family-owned pools.

Also, if a family office wishes to trade in commodity interests (again, including indirect investments in commodity pools), then the investing entity and/or the family members (to the extent there's a look-through requirement) may be required to meet investor qualification tests imposed by the CEA. Off-exchange swap transactions, for example, generally require the investing entity to be an "eligible contract participant," which includes entities with more than $10 million in assets (or net worth of $1 million if hedging) or commodity pools with $5 million in assets. Indirect investments in certain exempt commodity pools also require that the investing entity meet the "accredited investor" definition (discussed above) or the "qualified eligible person" definition under CFTC Rule 4.7. The latter generally requires that an eligible person meet both a net worth test and a portfolio test. For individuals, the net worth test is the same as the accredited investor test outlined above, and the portfolio test requires a $2 million investment portfolio. Family members or entities that fail to meet the necessary tests are ineligible to participate.

A family office also should be aware that CFTC-registered CPOs or CTAs with which the family office interacts must make a variety of mandated reports with the CFTC or National Futures Association (NFA), a self-regulatory membership organization authorized by the CFTC to regulate CPOs and CTAs. Family offices are in a better position under these reporting rules than under those for SEC-registered investment advisers. The SEC's approach exempts a family office only from investment adviser status (and thus generally continues to treat family vehicles as "private funds" subject to reporting by registered investment advisers). The CFTC generally doesn't require CTAs to report pool-specific information for family offices that are operated pursuant to a registration exemption.

Finally, an NFA rule known as "By-Law 1101" prohibits an NFA member firm from doing business with a firm that's required to be registered with the CFTC in various capacities but isn't so registered. NFA interpretations require its members to perform diligence on their counterparties (including investors in pools) to confirm exemption from By-Law 1101 compliance. A family office thus should be prepared to respond to questions as to its CFTC status.

Broker-Dealer Regulation

The U.S. securities laws are fragmented and treat different functions in the markets separately. Investment adviser regulation falls under the Advisers Act, while broker-dealer regulation falls under the U.S. Securities

Exchange Act of 1934 (the 1934 Act).

"Broker" is defined in the 1934 Act as any person engaged in the business of effecting transactions in securities for the account of others, and "dealer" is defined as any person engaged in the business of buying and selling securities for such person's own account. Any entity meeting the definition of broker or dealer and making use of the means or instrumentalities of U.S. interstate commerce to conduct its business must register with the SEC as a broker-dealer and become a member of the U.S. Financial Industry Regulatory Authority (FINRA).

Under existing SEC guidance as to what constitutes a broker or dealer, family offices generally don't face appreciable risk of being regarded as either because they generally don't distribute securities to third parties or seek compensation for arranging or effecting securities transactions. That said, certain factors heighten that risk, including significant marketing efforts around family office vehicles, payments of transaction-based compensation (such as commissions) to family office personnel for solicitation of securities transactions or compensation based on the size or occurrence of a disposition transaction.

Insider Trading

The prohibitions on insider trading apply to all participants in the markets and strictly limit trading while in possession of material non-public information. All U.S. securities laws are enforceable both by civil regulators like the SEC and by criminal prosecutors, but insider trading is the element of the securities laws most frequently invoked criminally. It therefore requires maximum care, and most organizations have some level of formal training and controls to manage insider information risks.

Large Holder Reporting

Beyond insider trading, the 1934 Act includes a number of reporting and anti-manipulation rules that apply to all market participants. Examples include requirements to publicly report:

- Portfolio detail for an investment portfolio of $100 million or more in listed securities on Form 13F quarterly;
- Positions (and changes in those positions) in publicly traded securities in excess of 5 percent of the class on Forms 13D/G; and
- Insider reports (sometimes called "Section 16 reports") by officers, directors and 10 percent owners of public companies; Section 16 insiders are also subject to a "short-swing profits" rule that limits the insider's ability to trade the securities by matching buy and sell trades made within six months of each other and requiring the imputed profits of matched trades to be disgorged to the issuer.

Regular investors in the securities markets also need to monitor a broad range of other potential regulatory "tripwires." For example, antitrust laws may establish their own filing and trading standstill requirements.

Family offices intending to buy in a public offering must ensure compliance with Rule 105 of Regulation M.

Anti-Manipulation Rules

Regulation M is a generally applicable anti-manipulation regulation that seeks to prevent persons with certain financial interests in a securities offering from taking certain actions that could manipulate the market for the offered securities. Family offices intending to buy in a public offering must ensure compliance with Rule 105 of Regulation M. Under Rule 105, short selling is prohibited close in time to public offerings (during the restricted period) to prevent market manipulation and to ensure the pricing integrity of securities distributed in public offerings.

FINRA IPO Allocation Rules

FINRA Rules 5130 and 5131 restrict U.S. broker-dealers' sales of initial public offering (IPO) securities to accounts in which certain types of covered persons hold a beneficial interest. Family offices can be caught within the prohibitions if a family member is such a restricted person.

FINRA Rule 5130 generally prohibits U.S. broker-dealers from selling IPO securities to accounts in

which an associated person of a U.S. broker-dealer has a beneficial interest and is intended to ensure that broker-dealers don't take advantage of their insider position to withhold IPO securities for their own benefit or the benefit of their personnel.

FINRA Rule 5131 (known as the "anti-spinning rule") generally prohibits U.S. broker-dealers from allocating IPO securities to accounts in which executive officers or directors of a particular U.S. public company or of a particular "covered non-public company" (a privately held company with high value or income, which can include family offices), or anyone they support financially (each, a "5131 covered person"), hold a collective beneficial interest exceeding 25 percent of the account, if:

> A family office should expect extensive anti-money laundering or "know your customer" diligence by the banks, investment advisers and broker-dealers with whom the office does business.

- Such company is currently an investment banking client of the broker-dealer;
- In the 12-month period prior to the allocation, the broker-dealer received compensation from the company for investment banking services;
- The broker-dealer expects to provide or be retained for investment banking services in the 3-month period following the allocation; or
- The allocation is made on the condition that such executive officer or director, on behalf of the company, retain the broker-dealer for performance of future investment banking services.

Although Rule 5131 only restricts IPO allocations to accounts held by 5131 covered persons associated with companies having investment banking relationships described above, many broker-dealers prohibit allocations to such accounts regardless of whether an investment banking relationship exists, to reduce compliance burdens.

To be able to receive IPO allocations from U.S. broker-dealers, family office vehicles affected by Rule 5131 may "carve down" the profit and loss from IPO securities allocated to 5131 covered persons of a particular company to no more than 25 percent through an affirmative allocation procedure. This carve-down procedure isn't available for Rule 5130 compliance.

Anti-Money Laundering/Privacy

Anti-money laundering rules are increasingly important. While family offices may themselves not be subject to the rules, many regulated businesses are. Accordingly, a family office should expect extensive anti-money laundering or "know your customer" diligence by the banks, investment advisers and broker-dealers with whom the office does business.

Privacy regulations are also of rising regulatory importance both at federal and state levels. Physical and systems safeguards for a variety of sensitive personal information are now required for businesses in most jurisdictions.

Confer With Experts

The rules covered here are treated in intentionally summary fashion, and the nuances that each family office may present need to be considered carefully, often with professional advice. In many instances, the regulatory volume effectively means a member of the family office's staff will operate as a de facto compliance officer managing the office's exposure to these requirements and liaising with external lawyers and compliance specialists.

A family office also needs to be attuned to the rules to which its regulated service providers are subject, even when the family office is itself exempt from a given requirement. Service provider regulation can have direct impact on the family office, especially in investor qualification and mandated disclosures.

—The author gratefully acknowledges the contributions to this article made by his Shearman & Sterling LLP colleagues Steven Blau, Nhung Pham and Russell Sacks.