DISSECTING DODD-FRANK

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Changes to the regulatory environment introduced following the Dodd-Frank Act have significantly altered the landscape for family offices with any investment activities in the US. Family offices based in Europe may now be required to register as an investment adviser with the US Securities and Exchange Commission (SEC), unless they can take advantage of an exemption from the adviser registration rules.

The Dodd-Frank Act cannot be ignored by any family office based in Europe, which may now find itself required to register with the SEC and subject to strict reporting and compliance requirements.

While there remain a number of exemptions which may permit family offices to avoid registration in the US, complex and numerous permutations of qualification criteria make it essential for professional advice to be sought before assuming a particular exemption applies as there are potential civil and criminal sanctions.

History of Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act, known as the 'Dodd-Frank Act', is the US response to the 2008 financial crisis. It affects the regulation of financial activity and financial conduct by domestic and international participants in US financial markets.

The objectives are wide-ranging as the Act tries to protect and enhance the stability of the American financial system while safeguarding American consumers.

While, seeking to regulate the whole of the American financial system, it has introduced:

- The Financial Stability Oversight Council, a new body to oversee, monitor and resolve failures of large financial institutions;
- An overhaul of the existing regulatory agency oversight system;
- Increased capital adequacy requirements;
- Reformed regulation of over-the counter derivatives and securitisation markets;
- Reform of rules relating to credit rating agencies;
- Imposition of the Volcker Rule which prohibits US banking entities and their affiliates from engaging in proprietary trading of certain financial instruments, and from investing or sponsoring hedge funds or private equity funds subject to certain very limited exemptions;
- Changes to corporate governance and executive pay; and
- The creation of a new body to protect consumers.

With such a broad scope, much consultation and a lengthy period of implementation, it has been understandably difficult for family offices based outside of the US to identify the elements that directly affect them, most significantly the potential requirement to register as an investment adviser with the SEC and the associated compliance with the requirements of the Investment Advisers Act 1940.

The way it was

Prior to Dodd-Frank, many advisers to private funds, including family offices, relied upon an exemption within the Investment Advisers Act to avoid registration with the SEC.

The exemption applied to investment advisers who, within the previous 12 months, had fewer than 15 clients and neither held out generally to the public as an investment adviser nor acted as an investment adviser to any registered investment company or business development company.

The private adviser exemption was repealed under the Dodd-Frank Act and new rules were mandated which came into force on 22 June 2011 in which the SEC now requires a greater number of private fund advisers to become registered, implement compliance programmes, report and become subject to visits.

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The new rules also raised the threshold for SEC registration for assets under management to $100 million and facilitate the transition of 'mid-sized advisers' from SEC to state registration.

Advisers who are no longer eligible for SEC registration have until 28 June 2012 to register in the relevant US state.

The new rules also require the submission of periodic reports by certain advisers to private funds that are exempt from registration under the Investment Advisers Act.

For family offices based in Europe, the challenge is to identify whether they meet the criteria for the family office exemption to the definition of investment adviser under the Investment Advisers Act; if not - are they eligible for the Foreign Private Advisor exemption? Otherwise, they face possible registration, compliance and reporting requirements.

Family office exemption

The new rules resulting from the Dodd-Frank Act now provides a ▶

tighter definition of 'family offices' – see Box A – and provided all criteria are met, family offices will not be required to register with the SEC, with the consequent reporting and visit requirements.

Single family offices that have previously received SEC exemption orders are also exempt from the new definition and requirements for registration. In addition, if a single family does not provide any remunerated investment advice, the new rule does not apply to it.

Box A: Family office exemption from SEC registration and reporting for family offices who meet ALL the following criteria

- Advise only 'family clients'*; and
- Are wholly owned by 'family clients' and exclusively controlled by 'family members' or 'family entities'; and
- Does not hold itself out to the public as an investment adviser.

***Family clients**

Family clients' are family members related within ten generations of a common ancestor. The term also includes current and former spouses, 'spousal equivalents,' adopted children, foster children and some children under guardianship. In addition, 'family clients' includes various trusts for the sole current benefit of family clients, some non-profit and charitable organisations, estates of family members and companies wholly owned and operated for the sole benefit of family clients. Only present (not contingent) beneficiaries of trusts are family clients. Certain senior key employees of family offices are also considered family clients.

Foreign private adviser exemption

If the family office exemption does not apply, and your family office advises others for remuneration as to the value of securities or the advisability of investing in, purchasing in or selling securities, including discretionary investment management, then you need to consider if your family office may be eligible for the 'foreign private adviser' exemption in Box B, in which case no registration is required.

Box B: Foreign Private Adviser exemption from SEC registration for advisers who meet ALL the following criteria:

- No place of business in the United States; and
- In total, has fewer than 15 advisory clients and investors in the United States in private funds advised by the investment adviser; and
- Has less than US$25 million in assets under management attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser (or such higher amount determined by the SEC); and
- Does not hold itself out generally to the public in the United States as an investment adviser or advises a business development company or an SEC- registered investment company.

Advisers solely to private funds (non-US advisers to private funds)

If none of the above applies, then non-US advisers solely to private funds may qualify for this exemption this is provided the adviser manages assets of less than $150m for no US persons other than a qualifying private fund from a US place of business.

This means they will not be required to register with the SEC but would instead be Exempt Reporting Advisers who must comply with a subset of reporting, record keeping requirements and be subject to possible SEC visits.

Venture capital funds

A non-US adviser might potentially rely on the venture capital exemption providing it solely advises venture capital funds that satisfy all the elements of the rules, which are fairly stringent, or the grand-fathering provision. This is an unlikely scenario for a Europe-based family office unless they only advise venture capital as defined in the exemption.

New reporting requirements

Family offices that qualify as 'Exempt Reporting Advisers' should have made their first filing to the SEC no later than March 30 2012.

In the past only SEC registered investment advisers were required to file Form ADV. Exempt Reporting Advisers, albeit exempt from registration under the Advisers Act, are required to submit periodic reports for specific items in Part 1 of Form ADV and that information is publicly available. The SEC will also impose record-keeping obligations and visits where there is cause.

The Dodd-Frank Act also created new reporting requirements for hedge fund and other investment advisers as well as a new Schedule D to the Form ADV, which seeks information relating to funds organised in the US, offered in the US or beneficially owned by US investors.

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On an on-going basis, Exempt Reporting Advisers will be required to file updating amendments to reports on an annual basis within 90 days of the end of the adviser's fiscal year and a final report if no longer seeking to rely on the exemption.

Exempt Reporting Advisers, like registered advisers, must promptly update certain defined items if they become inaccurate. Non-US investment advisers with a place of business in the US need also consider local SEC registration and reporting requirements.

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