



JONES DAY  
**COMMENTARY**

## WEALTH MANAGEMENT PLANNING ALERT

# FAMILY OFFICES NOT EXEMPTED FROM HEDGE FUND REGISTRATION

The Securities and Exchange Commission (“SEC”) on December 8, 2005, issued a no-action letter relevant to all family offices. In the no-action letter, the SEC (among other things) declined to adopt a complete exemption for family offices that advise “private funds.” (The rule behind “private funds” is intended to apply to hedge funds.) Family offices must therefore continue to analyze whether their activities bring them within the scope of the Investment Advisers Act of 1940 (the “Advisers Act”), and if so, whether they fit within any of the exceptions or exemptions to registration.

### BACKGROUND—ADVISERS ACT AND HEDGE FUND RULE

The Advisers Act generally requires persons providing securities and investment advice (for compensation) to register with the SEC and meet certain standards, including certain disclosure, record-keeping, and

reporting requirements. Investment advisers are also subject to unannounced SEC examinations. Failure to comply with the Advisers Act can lead to negative consequences. The SEC can impose civil monetary penalties and prohibit persons from acting as investment advisers.

In 2004, the SEC adopted a rule intended to require advisers of certain “private funds” to register under the Advisers Act. This new rule was primarily aimed at hedge fund advisers, who had historically not been required to register under the Advisers Act because of an exemption for advisers with fewer than 15 clients (sometimes called the “private adviser exemption”). Under the private adviser exemption, investors in a single hedge fund were collectively considered a single client. Under the new rule, however, each investor in a fund is generally counted as a separate client if the fund meets the definition of a “private fund.”

## THE NO-ACTION LETTER

The American Bar Association requested the no-action letter. Several portions of the request are relevant to family offices. The ABA asked for several clarifications of the hedge fund rule, including (a) that funds comprising solely family members be excluded, if the adviser is a family member or family-controlled entity (such as a family office), and (b) that advisers to a family fund be required to count only non-family members toward the private adviser exemption. Unfortunately, the SEC declined to exclude completely such family funds (although it acknowledged that they might not fit within the rule for other reasons), and it also confirmed that all investors, including family members, must be counted for purposes of the private adviser exemption (although the SEC pointed out that some family members can be counted as a single client, such as those living in the same principal residence).

Advisers to private funds required to register due to the new rule must obtain their SEC registration effective February 1, 2006. Because a registration takes time to be effective, applications would have to be filed as soon as possible to meet this deadline.

## ARE FAMILY OFFICES SUBJECT TO REGISTRATION?

Family offices provide many valuable services to the families they serve, including preparing tax returns, paying bills, reviewing insurance policies, supervising household staff, coordinating travel, administering payroll, planning family meetings, fostering family succession and communication, administering foundation grant and scholarship programs, and implementing estate-planning activities. Many family offices also provide crucial investment functions, including developing asset allocation strategies, managing cash, and recommending, reviewing, and monitoring investment advisers and investments (including private equity investments, such as hedge funds). Family offices may also create and manage investment vehicles with family members and affiliated entities, such as trusts, as investors.

Depending upon its specific activities, a family office's investment functions may subject it to registration under the Advisers Act generally, and a family office investment vehicle may be a "private fund" requiring registration of the family office pursuant to the hedge fund rule unless an exception or exemption applies. The primary exception relevant to family offices is the bank and trust company exception, as some family offices have created "private trust companies" to fit within this exception. The two most important exemptions in the family office context are for family offices whose clients reside only in the state of the family office's principal office, and the private adviser exemption discussed above. Even if an exception or exemption does not apply, family offices may be able to obtain an order from the SEC exempting the family office from registration.

Whether a family office must register under the Advisers Act has been an issue for years, and neither the new hedge fund rule nor the no-action letter directly changes the analysis. The no-action letter should, however, serve to remind family offices of the potential application of the Advisers Act. The SEC's position is also an indication that no broad family office exemptions to the Advisers Act should be forthcoming.

## WHAT SHOULD FAMILY OFFICES DO?

Family offices that have not analyzed the Advisers Act should do so as soon as possible, and those that have done so should periodically review their activities, even if an exception or exemption has previously been determined to apply. The exceptions and exemptions can be complicated, and their application depends upon activities and facts that may change over time.

## LAWYER CONTACTS

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