Katten

FAMILY OFFICES ADVISORY

Family Offices Receive Increased Regulatory Scrutiny

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The recent defaults by Archegos caused several large broker-dealers to incur significant losses. Archegos represented that it operated as a single-family office, which made it exempt from many provisions of the federal securities and commodities laws.[1] Questions have arisen about whether Archegos properly qualified for the family office exemption and whether, in any case, the exemption is too broad. For example:

- On April 7, 2021, Senator Sherrod Brown, the Chairman of the Senate Banking Committee, wrote to several brokers that traded with Archegos asking them to identify the services they provide to family offices and how they review family offices before accepting them as clients.[2]
- On May 6, 2021, in testimony before the House Financial Services Committee, SEC Chairman Gensler noted the Archegos situation.[3]
- The Securities and Exchange Commission (SEC) has identified "Amendments to the Family Office Rule" as one of its regulatory priorities for 2021.[4]
- On May 1, 2021, CFTC Commissioner Berkowitz issued a statement that "[t]he Archegos failure highlights the importance of strengthening the Commodity Futures Trading Commission's (CFTC) oversight of [family offices] . . . ."[5]

Family offices are investment firms that solely manage the money of a single family and that of the family office's key employees. The Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) granted the SEC broad rule-making authority to exempt family offices from the Investment Advisers Act of 1940. Section 202(a)(11)(G) of the Investment Advisers Act exempts from the definition of an investment adviser, and therefore from all of the requirements of that Act, "any family office, as defined by rule, regulation, or order of the Commission." In June 2011, the SEC adopted Rule 202(a)(11)(G)-1 defining a family office for purposes of this exemption. Under this Rule, a family office is excluded from the investment adviser definition if it: (1) manages the wealth and other affairs of a single family, (2) provides investment advice only to family clients, (3) is wholly-owned by family clients and exclusively controlled by family members and/or certain family entities, and (4) does

1 Rather than trading in individual securities, Archegos allegedly obtained economic exposure to securities by entering into total return swaps with brokers. These positions were allegedly not reported by Archegos because total return swaps are exempt from many reporting requirements. Under current rules, this would be the case regardless of whether Archegos was an exempt family office or a registered investment adviser. On May 6, 2021, in testimony before the House Financial Services Committee, SEC Chairman Gensler noted that: "At the core of that story was Archegos' use of total return swaps based on underlying stocks, and significant exposure that the prime brokers had to the family office. Under Dodd-Frank, Congress gave the SEC rulemaking authority to extend beneficial ownership reporting requirements to total return swaps and other security-based swaps. Among other things, I've asked staff to consider recommendations for the Commission about whether to include total return swaps and other security-based swaps under new disclosure requirements, and if so how."

2 https://www.brown.senate.gov/newsroom/press/release/brown-presses-banks-answers-trades-recent-market-turmoil

3 https://www.sec.gov/news/testimony/gensler-testimony-20210505

4 https://www.federalregister.gov/documents/2021/03/31/2021-04360/regulatory-flexibility-agenda

5 https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement040121

not hold itself out to the public as an investment adviser. Neither the total assets under management by the family office, nor the nature of those assets (such as the amount of leverage utilized or the exposure of counterparties to its positions), nor the number of family members participating in it are disqualifying factors for the exemption. As noted above, it would appear that the Dodd-Frank Act gives the SEC broad authority to expand or restrict this definition, and the SEC is currently considering doing so.

Effective January 9, 2020, the CFTC adopted rule amendments that codified prior CFTC no-action letters exempting operators and advisors to family offices, as defined in the SEC Rule summarized above, from the obligations to register as commodity pool operators (CPOs) and commodity trading advisors.[6] These exemptions are self-effectuating, forgoing the notice filing obligations typically associated with other CPO exemptions. Moreover, family offices are exempted from the condition, which applies to other exempt CPOs (with limited exceptions), that the exempt firm's principals not be subject to certain statutory disqualifications. As noted above, CFTC Commissioner Berkowitz has urged the CFTC to review these exemptions.

Looking Forward at the Family Office Exemption

Review of the family office exemption could be addressed in several ways. First, Congress could repeal or limit the family office exemption. No legislation has been introduced to accomplish this, and it appears that any possible legislative action is not imminent. Rather, it is more likely that the SEC and/or the CFTC will change their regulations to redefine the family office exemption. Existing legislation appears to grant the Commissions broad statutory authority to redefine the family office exemption more restrictively — or even, in the case of the CFTC, to eliminate it completely. Significant changes to current regulations could significantly restrict the availability of the exemption for many family offices.

Although any proposed regulations will afford the public with the opportunity to provide comments, given the importance of current exemptions to family offices, it may be prudent for family offices to begin a dialogue now with the regulators on any proposed changes to existing rules.

6 See CFTC Rules 4.13(a)(6) (17 C.F.R. § 4.13(a)(6)) and 4.14(a)(11) (17 C.F.R. § 4.13(a)(6)).

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