

SEC Staff Rationalizes Treatment of Institutional Family Offices under Regulation BI and Form CRS

By Wayne M. Aaron

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Overview – Much Needed Relief

Last month, the SEC staff provided much-needed no-action relief allowing broker-dealers, subject to certain conditions, to treat family offices as institutional, rather than retail, clients for purposes of Regulation BI and Form CRS.¹ Without the relief, family offices not managed by a registered professional were deemed “retail customers” for purposes of Regulation BI and “retail investors” under Form CRS even though broker-dealers traditionally service such family offices as institutional accounts given their sophistication and assets under management. As such, broker-dealers providing services to such family offices, particularly broker-dealers that did not otherwise service “retail customers,” faced the difficult choice of (a) developing a burdensome Regulation BI program that did not apply for most of its client base, solely to address the potential application to family office clients or (b) not servicing family office clients for fear that interactions with such clients might constitute a “recommendation” rendering the interaction subject to Regulation BI.² A similar analysis was required for determining whether to provide a relationship summary on Form CRS to a family office deemed a “retail investor” under Rule 17a-14 of the Securities Exchange Act of 1934, as amended.

The relief provided, to some extent, reinstates for applicable family offices (“Institutional Family Offices”) the status quo existing before the adoption of Regulation BI. Under the FINRA suitability requirements applicable to recommendations prior to Regulation BI’s adoption, family offices with assets under management of \$50 million or more were “institutional accounts” and, to the extent applicable, broker-dealers could satisfy the customer-specific suitability obligations through less onerous means. The no-action conditions are more comprehensive than the institutional suitability certification process that was common under FINRA suitability rules, but provide a clear framework for servicing Institutional Family Offices outside Regulation BI and for not having to prepare or send Form CRS to such accounts.

Relief Conditions

Under the no-action relief, a broker-dealer must satisfy four conditions:

1. The broker-dealer must have a reasonable basis to believe that one or more Institutional Family Office employees is experienced.

- Experience can be determined through a number of methods, such as length in the industry, examination qualifications (prior FINRA registrations or CFP/CFA examination), education or professional credentials, or the family office’s employment of non-family members.

¹ The no-action letter providing relief is available at <https://www.sec.gov/divisions/marketreg/mr-noaction/2020/sifma-122320-regbi.pdf>.

² The application of Regulation BI turns on whether a broker-dealer has provided a “recommendation.” That term, however, is construed broadly and can be triggered by any “call to action.” Determining that no recommendation has been given (and that Regulation BI does not apply on that basis) is not only fact specific, but also is subject to a regulator reaching a different conclusion.

- Generally, five years' experience will satisfy the requirement, but there could be instances where someone with less experience could meet the standard or where a broker-dealer might require more experience to form a reasonable belief.
- Any Institutional Family Office professional used to satisfy this requirement must not be subject to a statutory disqualification, under either the Exchange Act or the Adviser's Act.

A broker-dealer can document the basis for its reasonable belief either in a written representation from the Institutional Family Office or by memorializing an oral conversation obtaining the required information, absent any red flags that the information is not accurate or otherwise cannot be relied upon.

2. The Institutional Family Office must have assets under management of \$50 million or more.

As indicated above, this condition mirrors the standard that was applicable for institutional suitability under FINRA's suitability framework. This requirement also can be documented in a written representation or an oral representation subsequently documented, absent any red flags of inaccuracy or unreliability.

3. The broker-dealer has a reasonable basis to believe that the Independent Family Office is acting independently of the broker and is not relying on the broker-dealer for any recommendations.

To meet this requirement, the Institutional Family Office must acknowledge (in writing, electronically, or verbally) that:

- it is capable of evaluating investment risks independently, both in general and with regard to all transactions and investment strategies involving securities;
- it will exercise independent judgment in evaluating any of the broker-dealer's recommendations;
- it is a sophisticated investor knowledgeable and experienced with respect to the securities or investment strategies it trades or implements with the broker-dealer;
- its professionals responsible for investment decisions have not and will not accept compensation or items of value from the broker-dealer that would cause those professionals to act inconsistent with the best interest of the family client; and
- it meets the definition of a "family office" under the Advisers Act.

These representations are somewhat similar to, but slightly expand upon, the representations that were required for the Institutional Investor exemption to FINRA's suitability rule. Indeed, the first two representations mirror the requirements for the Institutional Investor Exemption under FINRA Rule 2111(b) and Interpretive Material .08 to that rule.³ The penultimate representation is directly aligned with the purpose of Regulation BI, in that it serves to confirm that personnel making investment decisions are acting in the best interest of the account. The final representation leverages off other interpretations of Regulation BI that considers a family office to be an institutional account if it is managed by a regulated professional. Essentially, the no-action relief treats managers of Institutional Family Offices as if they were regulated managers (and consequently outside the scope of Regulation BI and Form CRS) based on the fact that they are exempt from registration as regulated managers.

³ This is a helpful fact, as FINRA's suitability rule continues to apply to recommendations that are not subject to Regulation BI. See FINRA Rule 2111, Interpretive Material .08 ("This Rule shall not apply to recommendations subject to [Regulation BI]"). Thus, broker-dealers should memorialize receipt of these two representations to satisfy customer-specific suitability through the Institutional Investor Exemption set forth in FINRA Rule 2111(b) and Interpretive Material .07.

4. The broker-dealer implements policies and procedures to comply with the relief and maintains documentation of compliance.

It is nowadays common for the SEC and its staff to enforce rules and regulations by requiring the party subject to the rule or regulation to adopt, maintain, and enforce procedures reasonably designed to achieve compliance with the requirement. Indeed, Regulation BI contains such a “compliance obligation” in Rule 15c-1(a)(2)(iv).

To comply with this requirement, broker-dealers should set clear procedures to conduct the inquiries required by the no-action relief, to memorialize the required representations, and to maintain them for inspection. It may be appropriate to prepare checklists and/or form certifications that can be obtained and reviewed for red flags, consistent with the relief.

Conclusion

The Institutional Family Office no-action letter provides welcome relief not only for Institutional Family Offices, which might otherwise not have received the same coverage it received pre-Regulation BI under the FINRA suitability standard, but also for broker-dealers that were surprised to find in the course of Regulation BI implementation that such family offices otherwise came within Regulation BI and Form CRS.

Broker-dealers, particularly those servicing exclusively institutional customers and family offices should develop policies and procedures to implement the no-action relief and to obtain and implement the representations necessary to rely upon the relief.

If you have any questions regarding the topics discussed in this article, please contact **Wayne M. Aaron** at +1 (212) 407-7640 or any other member of Vedder Price’s Investment Services Group with whom you have worked.