

August 29, 2019

VIA ELECTRONIC DELIVERY TO: RULE-COMMENTS@SEC.GOV

Jill M. Peterson
Assistant Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: SEC Release No. 34-86558; File No. SR-FINRA-2019-022

Dear Ms. Peterson:

Dechert¹ respectfully submits this letter in response to the request for comments by the Securities and Exchange Commission (“SEC” or “Commission”) on the proposed changes to FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) (the “Proposed Amendments”) and FINRA Rule 5131 (New Issue Allocations and Distributions).² Our comments focus on FINRA’s proposed revised definition of “family investment vehicle” in paragraph (i)(4) of FINRA Rule 5130 and its inconsistency with the definition of “family office” in Rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940, as amended (the “Advisers Act”) (the “Family Office Rule”). While the scope of our comments is limited, we applaud FINRA for continuing to take steps to modernize Rules 5130 and 5131, and appreciate the opportunity to submit these comments.³

¹ Dechert LLP is an international law firm with a wide-ranging financial services practice that serves clients in the United States and worldwide. Our clients include, among others, a wide variety of broker-dealers, investment advisers, registered and unregistered investment companies (including mutual funds, closed-end funds and business development companies), private funds and other institutional investors.

² Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Amend FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) and FINRA Rule 5131 (New Issue Allocations and Distributions), Release No. 34-86558 (Aug. 2, 2019), 84 FR 39029 (Aug. 8, 2019), *available at* <https://www.govinfo.gov/content/pkg/FR-2019-08-08/pdf/2019-16942.pdf>. [hereinafter Proposing Release]

³ While this letter is submitted at the behest of one of our family office clients, the comments expressed herein reflect our own views and not necessarily the views of all of our clients.

As discussed below, we support the expansion of the definition of “family investment vehicle” to include entities whose beneficial owners include “family client[s],” as defined in Advisers Act Rule 202(a)(11)(G)-1(d)(4), and “family member[s],” as defined in defined in Advisers Act Rule 202(a)(11)(G)-1(d)(6), as well as “immediate family member[s],” as defined in FINRA Rule 5130(i)(5). Unlike the SEC’s treatment of family offices for purposes of the Advisers Act, however, FINRA proposes to exclude from the definition of family investment vehicle those entities “where the beneficial owners of such an entity include family clients” unless the “person who has the sole authority to buy or sell securities for such an entity is an ‘immediate family member’ . . . or a ‘family member’ ” (the “Sole Authority Requirement”).⁴ The effect of the Sole Authority Requirement is that the Proposed Amendments will not achieve FINRA’s stated goal of harmonizing FINRA Rule 5130 and the Family Office Rule and will not provide meaningful relief from being deemed “restricted persons” for persons who have authority to buy or sell securities for family offices.⁵

I. The Definition of “Family Investment Vehicle” Should Be Consistent with the Definition of “Family Office” Under the Advisers Act

In 2000, NASD Regulation, FINRA’s predecessor, excluded “family investment vehicles” from the definition of “portfolio manager” in NASD Rule 2790 “because family investment vehicles are often established for tax and estate planning purposes and do not manage money for unrelated persons.”⁶

When initially proposing to exclude family investment vehicles from the definition of “portfolio manager,” NASD Regulation stated that it was

⁴ Proposing Release, 84 FR at 39030.

⁵ FINRA Rule 5130(i)(10) defines “restricted persons” to include FINRA members and other broker-dealers, broker-dealer personnel, certain owners of broker-dealers, finders and fiduciaries, and portfolio managers. “Portfolio manager” is defined in FINRA Rule 5130(i)(10)(D) to include “[a]ny person who has authority to buy or sell securities for a bank, savings and loan institution, insurance company, investment company, investment advisor or collective investment account . . . and [a]n immediate family member of [such] a person who materially supports, or receives material support from, such person.”

⁶ Proposing Release, 84 FR at 39030, *quoting* Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Trading in Hot Equity Offerings, Release No. 34-42325, File No. SR-NASD-99-60 (Jan. 10, 2000), 5 FR 2656 (Jan. 18, 2000) at 2660, *available at* <https://www.finra.org/sites/default/files/RuleFiling/p000136.pdf>.

. . . *developing a distinction between directing investments of one's own money and other peoples' money.* This concept is addressed in the proposed rule's definition of 'collective investment account' which is defined as 'any hedge fund, investment partnership, investment corporation, *or any other collective investment vehicle that manages assets of other persons.*' *The proposed rule clarifies that a collective investment account shall not include any entity in which the decision to buy or sell securities is made jointly by each of the persons investing in the entity or by a member of their immediate family.* NASD Regulation does not believe that participation in an investment club, where, for example, ten people contribute their own money and make decisions as a group, is the type of activity that should preclude a person from purchasing hot issues. Likewise, NASD Regulation also does not believe that establishing and managing a family partnership should preclude a person from purchasing hot issues. Family partnerships are often established for tax and estate planning purposes and, *because they do not involve managing other peoples' money, they do not implicate the concerns addressed by the proposed rule.*⁷ (Emphasis added.)

Multiple revisions to this proposed rule followed, and the term "family investment partnership" evolved into "family investment vehicle" in recognition that it was "too restrictive and fails to recognize" the multiple vehicles that families use to invest their money.⁸ Commenters previously sought to expand the definition of family investment vehicle to include "long-term family employees," but those efforts were rejected by NASD Regulation's staff because, among other reasons: (i) "any concerns about the application of the proposed rule change in these limited

⁷ *Id.* When the SEC adopted the Family Office Rule, it similarly noted that the family office "exclusion is limited to family offices that provide advice about securities only to certain 'family clients.'" Family Offices, Release No. IA-3220 (June 22, 2011), 76 FR 37983 (June 29, 2011) at 37984, *available at* <https://www.govinfo.gov/content/pkg/FR-2011-06-29/pdf/2011-16117.pdf>. [hereinafter Family Office Adopting Release]

⁸ NASD Letter re: File No. SR-NASD-99-60 Restrictions on the Purchase and Sale of Initial Equity Public Offerings Amendment No. 3 (Mar. 19, 2001) at 8 (discussing comments received regarding the definition of "family partnership"), *available at* <https://www.finra.org/sites/default/files/RuleFiling/p000150.pdf>.

situations is best addressed through the exemptive process on a case-by-case basis”;⁹ and (ii) “permitting nonfamily persons into the exemption for family investment vehicles could open the exemption to abuse.”¹⁰

Notwithstanding NASD Regulation’s reluctance to include any employees within the family investment vehicle exemption from the definition of portfolio manager, the SEC included key employees¹¹ and other non-family members as “family clients” for purposes of the family office exemption from the definition of “investment adviser” when it adopted the Family Office Rule in 2011.¹²

The Advisers Act’s treatment of key employees as permissible family clients is based on their knowledge of and participation in the investment process.¹³ The Family Office Rule also includes

⁹ NASD Letter re: File No. SR-NASD-99-60 Restrictions on the Purchase and Sale of Initial Equity Public Offerings Amendment No. 3 (Mar. 19, 2001) at 8 (discussing comments received regarding the definition of “family partnership”), *available at* <https://www.finra.org/sites/default/files/RuleFiling/p000150.pdf>. Interestingly, the SEC staff granted several no-action letters to various entities that sought treatment as a family office at that time. Family Office Adopting Release, 76 FR at 37984 n.6.

¹⁰ NASD Letter re: File No. SR-NASD-1999-60 Restrictions on the Purchase and Sale of Initial Equity Public Offerings Amendment No. 5 (Oct. 22, 2003) at 11 (discussing miscellaneous issues raised by commenters), *available at* <https://www.finra.org/sites/default/files/RuleFiling/p000156.pdf>.

¹¹ For purposes of the Family Office Rule, a “key employee” of a family office is any: (i) executive officer, director, trustee, general partner or person serving in a similar capacity, or any employee (not performing solely clerical, secretarial or administrative functions); (ii) that participates in the investment activities in connection with their regular functions; and (iii) has been performing such function for at least twelve months for this office, an affiliate family office or another company. Advisers Act Rule 202(a)(11)(G)-1(d)(8). The definition of key employee also includes the key employee’s spouse meaning any spouse (*i.e.*, current, former, or cohabitating person in an equivalent relationship) that held a shared ownership interest (*e.g.*, joint or community property) with the key employee at the time of contribution to the investment entity, such as a trust.

¹² Generally, to qualify as a family office, the entity must: (1) only serve family clients with some exceptions for involuntary transfers from a family member or key employee; (2) be wholly owned by family clients and exclusively controlled by family members and/or family entities; (3) not hold itself out to the public as an investment adviser. Advisers Act Rule 202(a)(11)(G)-1. We note, however, that, the SEC staff declined to extend the definition of family client to include “long-term employees of the family” that are not also knowledgeable employees because there was “no basis on which to conclude that they can protect themselves.” Family Office Adopting Release, 76 FR at 37989.

¹³ In the Family Office Adopting Release, the SEC recognized the special position of key employees. Family Office Adopting Release, 76 FR at 37990-91. In particular, the Commission noted that

guardrails with respect to key employees including: (i) tying a knowledgeable employee's ability to make additional investments to their continued employment; (ii) defining a key employee to include a spouse only if property is held jointly (unless the spouse separately qualifies as a family client); (iii) a grace period following the death of a family member or key employee or other involuntary transfer event, where the transferee is deemed to be a family client for one year following the "transfer of legal title to the assets" for purposes of the Family Office Rule; and (iv) defining permissible legal entities (*e.g.*, trusts, estates, companies, charitable organizations, and other entities).¹⁴

FINRA, however, takes the view that a family investment vehicle beneficially owned by a family client should be treated differently than a family investment vehicle owned exclusively by immediate family members and/or family members. This is because "FINRA believes that it is necessary to impose this condition to safeguard against the abuses the rule is designed to address and to ensure that, for purposes of Rule 5130, the person who has the authority to buy or sell securities for the account is more closely aligned with the family than with key employees or others associated with the family office."¹⁵ Nevertheless, FINRA does not provide any support for the proposition that the interests of managers of family offices are not aligned with the interests of the family members.

"[c]ommenters [to proposed Advisers Act Rule 202(a)(11)(G)-1] also pointed out that many family offices permit their employees to own equity interest in family offices as an incentive to attract and retain talented employees, and urged [the SEC] not to prohibit such arrangements." *Id.* The Family Office Adopting Release determined that key employees could own a non-controlling stake as part of their incentive package, and "that while family clients may own the family office, family members and family entities (*i.e.*, their wholly owned companies or family trusts) must control the family office." *Id.* See also *Key Employee Trusts Under the Family Office Rule*, SEC Investment Management Guidance Update, No. 2014-13 (Dec. 2014), available at <https://www.sec.gov/investment/im-guidance-2014-13.pdf>. (To enable family offices to attract and retain investment professionals, family clients also include certain non-family members, such as "key employees," those employees whose position and experience should enable them to protect themselves, and investment entities that may be used by key employees to invest in opportunities connected to the family office.)

¹⁴ Advisers Act Rule 202(a)(11)(G)-1(d)(4)-(5).

¹⁵ Proposing Release, 84 FR at 39030.

II. The Proposed Revised Definition of “Family Investment Vehicle” Is Functionally the Same as the Existing Definition

The inclusion of the Sole Authority Requirement in the Proposed Amendments will result in an amended version of Rule 5130 that will effectively be the same as the existing rule with respect to the treatment of family offices. This is because the requirement that an immediate family member or family member authorize every purchase and sale does not reflect that one of the primary purposes of establishing a family office is the hiring of investment professionals to help the family manage its assets.¹⁶

As such, while a condition of eligibility as a “family office” under the Family Office Rule is that the entity must be “wholly owned by family clients and . . . exclusively controlled (directly or indirectly) by one or more family members and/or family entities,” the Family Office Rule allows for non-family member ownership in the family office, non-family member beneficial ownership in its investment vehicles and investment authority to be delegated to a non-family member.¹⁷ As noted above, in many cases, family offices allow these non-family members to participate in ownership of the family office and as beneficial owners in the family investment vehicle(s) to incentivize outside investment professionals to work for family offices.

By contrast, under the proposed (and current) versions of Rule 5130, any family office or family investment vehicle that allows for non-family member ownership and the delegation of investment authority to a non-family member will be an account that is at least partially beneficially owned by a restricted person because the account cannot qualify as a family investment vehicle.

The inclusion of the Sole Authority Requirement ignores that the beneficial owners of family office entities routinely include non-family members and investment authority is typically delegated to a non-family member. In addition, persons that are not immediate family members or family members often are appointed as trustees over a trust that exclusively benefits the family. The proposed definition of family investment office would also exclude family offices that make investment decisions through an investment committee, even if the investment committee is made up entirely of immediate family members, because there would not be a person with “sole

¹⁶ As noted by the SEC in the Family Office Adopting Release, the exclusion of family offices from the definition of investment adviser was intended to allow family offices “to attract highly skilled investment professionals who may not otherwise be attracted to work at a family office.” Family Office Adopting Release, 76 FR at 37990.

¹⁷ Advisers Act Rule 202(a)(11)(G)-1(b)(2). Under the Proposed Amendments, such arrangements would preclude an entity from meeting the revised definition of family investment vehicle and the family investment vehicle would still be considered a “restricted person” under FINRA Rule 5130.

investment authority.” For the reasons discussed above, the Proposed Amendments do not address the inconsistencies between current Rule 5130 and the Family Office Rule.

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We appreciate the opportunity to comment on the Proposed Amendments. Please contact K. Susan Grafton at [REDACTED], or Ashley N. Rodriguez at [REDACTED] if you have any questions regarding our comments.

Sincerely,

/s/ Dechert LLP

Dechert LLP