

## SEC Finalizes Dodd-Frank Rules Affecting Investment Advisers: The SEC Adopted a Rule To Define 'Family Offices' That Will Be Excluded From the Definition of an Investment Adviser Under the Investment Advisers Act of 1940 (the "Advisers Act")

Author: Stacey C. Palmer, Counsel, Pittsburgh

**Publication Date: July 25, 2011**

### What is new with family offices?

The Dodd-Frank Act creates a new exclusion from the Advisers Act in Section 202(a)(11)(G) under which "family offices" are not investment advisers subject to the Advisers Act.<sup>1</sup> Historically, family offices that fell outside the private adviser exemption have sought and obtained from the Securities and Exchange Commission ("SEC") orders under the Advisers Act declaring those offices not to be investment advisers within the intent of Section 202(a)(11) of the Advisers Act.<sup>2</sup>

### Background

Family offices, as defined by Rule 202(a)(11)(G)-1 (the "Rule") under the Advisers Act, are excluded from the Act's definition of "investment adviser," and thus, are not subject to any provisions of the Advisers Act.<sup>3</sup> With some variations and modification, the scope of the Rule is generally consistent with the conditions of exemptive orders previously issued by the SEC.<sup>4</sup> The SEC has typically provided an exclusion for family offices because family offices are viewed as not the sort of arrangement that the Advisers Act was designed to regulate.<sup>5</sup> The SEC believes that disputes among family members concerning the operation of the family office could be resolved within the family unit or, if necessary, through state courts under laws designed to govern family disputes.<sup>6</sup> It is important to note that the failure of a family office to be able to meet the conditions of the Rule will not preclude the family office from providing advisory services to family members; rather, the family office will need to register under the Advisers Act (unless another exemption is available) or seek an exemptive order from the Commission.<sup>7</sup>

### How do I know if my family office is excluded from the definition of an investment adviser?

The Rule contains three conditions that a family office must meet in order to be excluded from the definition of an investment adviser:

- The family office must provide advice about securities only to certain "family clients."
- Family clients must wholly own the family office. Family members and/or family entities must control the family office.
- A family office must not hold itself out to the public as an investment adviser.<sup>8</sup>

Further, the Rule grandfathers family offices that have historically provided advice to certain natural persons and entities who do not qualify as "family clients," so long as that advice was being given prior to January 1, 2010.<sup>9</sup>

### What is a family client?

A family office excluded from the Advisers Act is limited to an office that advises only "family clients."<sup>10</sup> Family clients include current and former family members; certain key employees of the family office (and, under certain circumstances, former employees); charities funded exclusively by family clients; estates of current and former family members or key employees; trusts existing for the sole current benefit of family clients or, if both family clients and charitable and nonprofit organizations are the sole current beneficiaries, trusts

funded solely by family clients; revocable trusts funded solely by family clients; certain key employee trusts; and companies wholly owned exclusively by, and operated for the sole benefit of, family clients (with certain exceptions).<sup>11</sup>

## **What is a family member?**

A family member includes all lineal descendants of a common ancestor (who may be living or deceased and who may be designated and re-designated from time to time), as well as current and former spouses or spousal equivalents of those descendants, provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members.<sup>12</sup> All children by adoption and current and former stepchildren also are considered family members.<sup>13</sup> Further included are foster children and persons who were minors when another family member became their legal guardian.<sup>14</sup>

## **Can the family office provide investment advice to employees of the family office?**

Yes and no. Certain key employees of the family office, their estates and certain entities through which key employees may invest, are treated as family clients so that they may receive investment advice from, and participate in investment opportunities provided by, the family office.<sup>15</sup> The Rule specifically permits the family office to provide investment advice to any natural person (including the key employee's spouse or spousal equivalent who holds a joint, community property or other similar shared ownership interest with that key employee) who is (i) an executive officer, director, trustee, general partner, or person serving in a similar capacity at the family office or its affiliated family office, or (ii) any other employee of the family office or its affiliated family office (other than an employee performing solely clerical, secretarial or administrative functions) who, in connection with his or her regular functions or duties, participates in the investment activities of the family office or affiliated family office, provided that such employee has been performing such functions or duties for or on behalf of the family office, or substantially similar functions for or on behalf of another company, for at least 12 months.<sup>16</sup> The Rule prohibits key employees from making additional investments through the family office upon the end of the key employees' employment by the family office, but does not require former key employees to liquidate or transfer investments held through the family office.<sup>17</sup>

## **Will a family office lose its exemption in the event of an involuntary transfer of assets to a person who is not a family client?**

No. Under the rule, a family office may continue to provide advice with respect to assets following an involuntary transfer to a person who is not a family client for a transition period of up to one year.<sup>18</sup>

## **If a family office currently advises charitable or nonprofit organizations that have accepted funding from non-family clients, what happens?**

In order to maintain its exemption under the Rule, in this case, the family office will need to transition such advisory arrangements or restructure the charitable or nonprofit organization by December 31, 2013.<sup>19</sup> In order to rely on this transition period, the nonprofit or charitable organization advised by the family office must not accept any additional funding from non-family clients after August 31, 2011, except that during the transition period, the nonprofit or charitable organization may accept funding provided in fulfillment of any pledge made prior to August 31, 2011.<sup>20</sup>

## **What if a family office was relying on the private adviser exemption but does not qualify for the family office exclusion?**

The Rule provides that family offices currently exempt from registration under the Advisers Act in reliance on the private adviser exemption that do not meet the new family office exclusion are not required to register with the SEC as investment advisers until March 30, 2012.<sup>21</sup>

1. Section 409 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").
2. Family Offices, SEC Release No. IA-3220 (June 22, 2011) [76 FR 37983, 37983-84 (June 29, 2011)] ("Adopting Release").
3. Adopting Release, at 37984.
4. Adopting Release, at 37984.
5. Adopting Release, at 37984 (citing Family Offices, SEC Release No. IA-3098 (Oct. 12, 2010) [75 FR 63753 (Oct. 18, 2010)] ("Proposing Release").
6. Adopting Release, at 37984.
7. Adopting Release, at 37984.
8. Rule 202(a)(11)(G)-1(b)(1)-(3). See also Adopting Release, at 37984.
9. Rule 202(a)(11)(G)-1(c).
10. Rule 202(a)(11)(G)-1(b)(1). See also Adopting Release at 37948.
11. Adopting Release at 37984.
12. Adopting Release at 37984. See also Rule 202(a)(11)(G)-1(d)(6) and (7).
13. Adopting Release at 37984. See also Rule 202(a)(11)(G)-1(d)(6).
14. Adopting Release at 37984. See also Rule 202(a)(11)(G)-1(d)(6).
15. Adopting Release at 37988. See also Rule 202(a)(11)(G)-1(d)(8).
16. Adopting Release at 37988-89. See also Rule 202(a)(11)(G)-1(d)(8).
17. Adopting Release at 37990. See also Rule 202(a)(11)(G)-1(d)(4)(iv).
18. Adopting Release at 37986. See also Rule 202(a)(11)(G)-1(b)(1).
19. Adopting Release at 37988. See also Rule 202(a)(11)(G)-1(e)(1).
20. Adopting Release at 37988. See also Rule 202(a)(11)(G)-1(e)(1).
21. Adopting Release at 37992. See also Rule 202(a)(11)(G)-1(e)(2).

## About Reed Smith

Reed Smith is a global relationship law firm with more than 1,600 lawyers in 23 offices throughout the United States, Europe, Asia and the Middle East.

The information contained herein is intended to be a general guide only and not to be comprehensive, nor to provide legal advice. You should not rely on the information contained herein as if it were legal or other professional advice.

The business carried on from offices in the United States and Germany is carried on by Reed Smith LLP of Delaware, USA; from the other offices is carried on by Reed Smith LLP of England; but in Hong Kong, the business is carried on by Reed Smith Richards Butler. A list of all Partners and employed attorneys as well as their court admissions can be inspected at the website <http://www.reedsmith.com/>.

© Reed Smith LLP 2011. All rights reserved.