Akerman Practice Update

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SEC Adopts Final Rule for Family Office Exemption

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On June 22, 2011, the Securities and Exchange Commission ("SEC") approved a final rule ("Family Office Rule") defining "family offices" that will be excluded from the definition of an investment adviser under the Investment Advisers Act of 1940 ("Advisers Act") and thus will not be subject to regulation under the Advisers Act. The implementation of the Family Office Rule stems from the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

On October 12, 2010, the SEC issued its proposing release for the Family Office Rule. The SEC received more than 90 comment letters on the proposed rule and made a number of changes in the final rule. The final Family Office Rule significantly expands the family members and entities that may seek advice from a family office and still qualify for the "family office" exclusion from registration. The full text of the Family Office Rule, which is Rule 202(A)(11)(g)-1 of the Advisers Act, is available at www.sec.gov/rules/final/2011/ia-3220.pdf.

Background

Family offices are typically established by wealthy families to manage their assets and provide other services to family members, such as portfolio management, tax, accounting and estate planning services. The SEC estimates that there are 2,500 to 3,000 family offices, generally servicing families with at least $100 million of investable assets. Family offices generally meet the definition of an

investment adviser under the Advisers Act because they are in the business of providing advice about securities for compensation.

Most family offices have relied on the "private investment adviser" exemption from registration for an adviser that had fewer than 15 clients during the preceding 12 months and does not hold itself out to the public as an investment adviser. The Dodd-Frank Act removed the private adviser exemption, with the stated goal of enabling the SEC to regulate hedge funds and other private fund advisers. With this change, however, the Dodd-Frank Act added a "family office" exclusion from the definition of "investment adviser." Section 409 of Dodd-Frank Act directs the SEC to define the term "family office" consistently with previous exemptive policy of the SEC and in a manner that recognizes "the range of organizational, management and employment structure and arrangements employed by family offices."

A summary of the resulting Family Office Rule appears below.

Family Office Rule

The Family Office Rule requires a family office to satisfy three conditions in order to avoid registration as an investment adviser under the Advisers Act. A "family office" is any company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their position or employment) that:

(i) has no clients other than "family clients" (as defined),
(ii) is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more "family members" (as defined) and/or family entities, and
(iii) does not hold itself out to the public as an investment adviser.

In order to meet these conditions, a family office must limit its investment advisory services to "family clients," which include:

Family Members

The definition of "Family Members" is all lineal descendants, including adopted, step and foster children, of a common ancestor, who may be living or deceased, and such lineal descendant's spouses or spousal equivalents, provided that the common ancestor is no more than 10 generations removed from the youngest generation. The family selects a common ancestor to define the family, whether or not such ancestor created the wealth being managed. The family can redesignate the common ancestor over time and no formal documentation or procedure is required when designating or redesignating the common ancestor. As older generations pass away, a family office may want to chose a new common ancestor in order to better serve the needs of the younger generation.

Former Family Members

"Former Family Members" are defined as a spouse, spousal equivalent or stepchild who was a family member but is no longer a family member due to a divorce or other similar event.

Key Employees

Certain key employees can be considered family clients and will be able to participate in the investment opportunities provided by the family office and receive investment advice from the family office. A key employee is defined as any natural person (including any key employee's spouse or spousal equivalent who holds a joint, community property interest with that key employee) who is (i) an executive officer, director, trustee, general partner or a person who serves in a similar capacity of the family office or its affiliated family office or (ii) any other employee of the family office or its affiliated family office who participates in the investment activities of the family office or affiliated family office in connection with that employee's regular duties (other than performing solely clerical or similar duties) and has been performing such duties for the family office or affiliated

family office (or substantially similar duties for another company) for at least 12 months. Trusts established by key employees which meet certain conditions will also qualify as family clients.

Foundations and Other Charities

Foundations, non-profits and other charitable organizations are family clients, if they are funded exclusively by one or more other family clients. Because some family offices currently advise non-profit or charitable organizations which have accepted funding from non-family clients, the Family Office Rule includes a transition period until December 31, 2013, before family offices have to modify such advisory arrangements or restructure the organization to comply with this exclusion. In order for a family office to rely on this transition period, the non-profit or charitable organization advised by such family office must spend or transfer the non-family money so that none of it is "currently held" by the organization as of December 31, 2013. Furthermore, the non-profit or charitable organization cannot accept additional funding from any non-family clients after August 31, 2011, except for any funding received prior to December 31, 2013 pursuant to a pledge made prior to August 31, 2011.

Family Trusts and Estates

Certain family trusts also fall under the "family client" definition. The Family Office Rule treats as family clients all irrevocable trusts funded exclusively by one or more family clients, in which the only current beneficiaries, in addition to other family clients, are charitable and nonprofit entities. Revocable trusts are family clients only if the grantor is a family client, even if non-family members are beneficiaries, because of the extent of control the grantor exercises over such a trust. Estates are family clients if they are the estates of a family member, former family member, key employee, or, if conditions are satisfied, former key employee.

Other Family Entities

Any companies, including pooled investment vehicles (provided they are excepted from the definition of investment company under the Investment Company Act of 1940), wholly owned, directly or indirectly, by one or more family clients and operated for the sole benefit of family clients are also treated as family clients under the Family Office Rule. The SEC did not require that the family entity also be controlled by family clients, which was contained in the proposed rule.

Involuntary Transfers

If a person who is not a family client becomes a client as a result of the death of a family member or other involuntary transfer from a family member or key employee, that person shall be deemed to be a family client for purposes of the Family Office Rule for twelve months following the transfer of assets resulting from the involuntary event. The SEC believes this twelve month transition period provides the family office with sufficient time to orderly transition that client's assets to another investment adviser or otherwise restructure its activities to comply with the Advisers Act.

Additional Requirements for Reliance on the Family Office Rule

A family office is exempt from registration under the Advisers Act only if it is wholly-owned by family clients and exclusively controlled (directly or indirectly) by one or more family members and/or family entities. In the final rule, the SEC expanded the permissible owners of a family office from "family members" to "family clients." This new ownership definition will permit key employees to own a non-controlling stake in the family office and will be an important incentive for family offices to attract and retain talented employees. "Control" means the power to exercise a controlling influence over the management or policies of a company, unless such power is the solely the result of being an officer of such company.

Finally, the Family Office Rules prohibit a family office relying on this exemption

from holding itself out to the public as an investment adviser.

The SEC declined to extend the Family Office Rule to family offices serving multiple families due to a concern that multi-family offices more closely resemble commercial investment advisers.

"Grandfathering" Provisions

Three types of clients are grandfathered as family clients so long as the family office provides and was engaged to provide investment advice to these clients before January 1, 2010. These clients are (i) natural persons, who at the time of their investment were officers, directors or employees of the family office, who invested with the family office before January 1, 2010 and are accredited investors, (ii) any company owned exclusively and controlled by family members, and (iii) a registered investment adviser that identifies investment opportunities to the family office and co-invests in those opportunities with the family office on substantially the same terms as a family client, as long as the adviser's co-investment assets, in the aggregate, do not represent more than 5% of the value of the assets to which the family office provides advice.

Family office that previously received exemptive orders from the SEC will be able to continue operating under such orders or, if they meet the conditions for a "family office," they can rely on the Family Office Rule. In the final release, the SEC noted that existing SEC exemptive orders for family offices may be slightly broader in some areas than the Family Office Rule, while narrower in other areas.

Transition Period and Effective Date

The Family Office Rule will be effective on August 29, 2011, which is 60 days after its publication in the Federal Register. However, the SEC has provided a transition period ending on March 30, 2012 for family offices currently exempt from registration under the Advisers Act in reliance on the private adviser exemption (which was repealed on July 21, 2011) in order to allow such family offices time to evaluate whether they meet the new family office exclusion and, if not to either restructure or register under the Advisers Act by the March 30, 2012 deadline. Additionally, if the only issue that disqualifies a family office from relying on the exemption is having accepted donations from a charitable entity from non-family members, the family office will have until December 31, 2013 to take corrective action.

This Practice Alert is intended only as a summary of the Family Office Rule and is not intended to constitute comprehensive legal advice and readers should not act upon the information contained herein without seeking the advice of legal counsel.

For more information please contact a member of our Corporate practice.

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