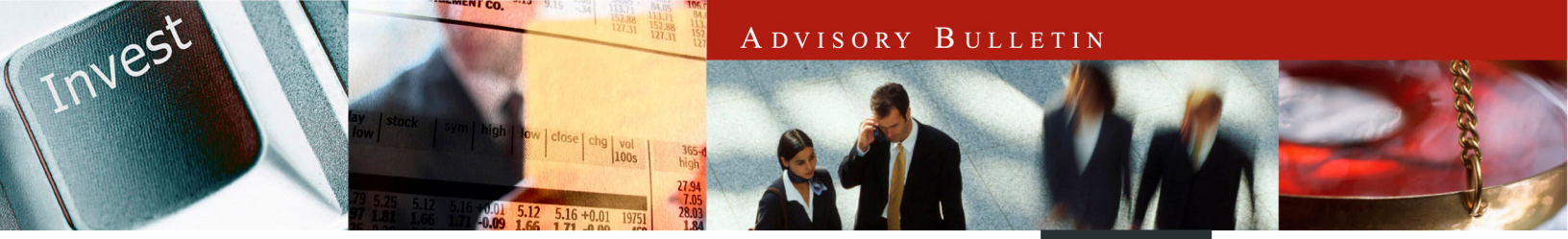

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INVESTMENT MANAGEMENT UPDATE

SEC Proposes Rule Defining "Family Office" Exclusion Under Investment Advisers Act

On October 12, the Securities and Exchange Commission (SEC) proposed Rule 202(a)(11)(G)-1 ("Proposed Rule") under the Investment Advisers Act of 1940, as amended ("Advisers Act").[1] The purpose of the Proposed Rule is to comply with the provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[2] requiring the SEC to define family offices that would be excluded from the definition of an investment adviser for purposes of the Advisers Act.

Prior to the Dodd-Frank Act, many family offices relied upon the exemption set forth in Section 203(b)(3) of the Advisers Act to avoid registering as investment advisers. Among other provisions, the Dodd-Frank Act largely repeals the so-called "private adviser exemption" effective July 11, 2011. As a result, many entities that currently rely on the exemption, including private fund managers, will be required to register. However, the Dodd-Frank Act creates several new exemptions from registration under the Advisers Act, including an exemption for "family offices" as defined by the SEC.[3]

GENERAL CONDITIONS

The Proposed Rule has three general conditions. Any family office seeking to rely on the Proposed Rule to avoid registration under the Advisers Act must: provide advice about securities only to certain family members and key employees; be wholly owned and controlled by members of the same family; and refrain from holding itself out to the public as an investment adviser. The conditions set forth in the Proposed Rule generally track those contained in prior exemptive orders issued to family offices by the SEC. As the SEC noted in the Proposing Release, the prior exemptive orders issued, as well as the conditions of the Proposed Rule, are designed to distinguish a family office from a "family run office" that, "although owned and controlled by a single family, provides advice to a broader group of clients and much more resembles the business model common among many smaller investment adviser firms that are registered with the… [SEC] or state regulatory authorities."[4] In the view of the SEC, excluding family offices from the definition of an investment adviser is appropriate, at least in part, because the interests of the family members are fully aligned with one another and a family office is not the sort of arrangement that the Advisers Act was designed to regulate.[5]

PERMISSIBLE CLIENTS

In order to rely on the Proposed Rule, a family office cannot have any investment advisory clients other than "family clients," which the Proposed Rule defines as:

> any family member; any key employee; any charitable foundation, charitable organization, or charitable trust, in each case established and funded exclusively by one or more family members or former family members; any trust or estate existing for the sole benefit of one or more family clients; any…entity wholly owned and controlled (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more family clients, provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of an "investment company" under the Investment Company Act of 1940; any former family member…; or any former key employee…[6]

Family Members

The Proposed Rule provides a fairly expansive definition of who is considered to be a family member for purposes of the Proposed Rule. Generally, the definition would include an "individual and his or her spouse or spousal equivalent for whose benefit the family office was established and any of their subsequent spouses or spousal equivalents, their parents, their lineal descendants and such lineal descendents' spouses or spousal equivalents."[7] Although adopted children are included in the definition of a family member, the SEC has requested comment on whether or not stepchildren also should be included.[8] In addition to requesting general comments on the definition of family member under the Proposed Rule, the SEC also has requested comments as to whether the definition of family member under the Proposed Rule should include siblings of the founders of the family office, their spouses or spousal equivalents, their lineal descendants (including by adoption and stepchildren) and such lineal descendants' spouses or spousal equivalents.[9]

The Proposing Release notes that, although the SEC is aware of some family offices having combined operations with other families in an attempt to achieve certain economies of scale, the Proposed Rule would not apply to such multi-family offices.[10] Although the Proposing Release points out that the SEC has never issued an exemptive order to such multi-family offices, the Proposing Release nonetheless seeks comments as to whether the Proposed Rule should extend to multi-family offices and, if so, on what basis the SEC should distinguish between a multi-family commercial office and a family office more closely resembling those operating under prior exemptive orders.[11]

Recipients of Involuntary Transfer

In the event of an involuntary transfer, such as a transfer of assets of a family member to a non-family member by operation of the family member's will following their death, the Proposed Rule would permit the family office to continue advising such assets for a period of four months following the involuntary transfer.[12] During the four-month transition period, the SEC would expect the family office to "transition the transferred assets to another investment adviser, seek exemptive relief from the …[SEC], or otherwise restructure its activity to comply with the Advisers Act."[13]

Former Family Members

Under the Proposed Rule, former family members (e.g., former spouses and spousal equivalents) are permitted to retain investments in the family office that existed at the time they became a former family member.[14] However, the Proposed Rule would prevent any former family member from making new investments, aside from additional investments that the former family member was contractually obligated to make, through the family office once they became a former family member.[15] The Proposed Rule seeks to limit adverse tax consequences while at the same recognizing that former family members no longer are a part of the family controlling the family office, and thus would not, in the view of the SEC, be afforded the benefit of the protections that accompany membership in the family running the family office.[16]

Family Trusts, Charitable Organizations and Other Family Members

The Proposed Rule would permit a family office to structure its investments using typical investment structures. Thus, the family office may treat the following entities as a "family client" for purposes of the Proposed Rule:

1. Any charitable foundation, charitable organization or charitable trust established and funded exclusively by one or more family members or former family members;
2. Any trust or estate existing for the sole benefit of one or more family clients; or
3. Any limited liability company, partnership, corporation or other entity wholly owned and controlled (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more family clients; provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of "investment company" under the Investment Company Act of 1940.[17]

Key Employees

The Proposed Rule would extend to certain "key employees" of a family office and would permit such employees to receive investment advice from the family office and to otherwise participate in investment opportunities provided by the family office. The principal motivation behind including key employees in the definition of a family client is to permit the family office to create an appropriate compensation and incentive structure for skilled investment professionals such that the interests of the employee are better aligned with the interests of the family members served by the family office.[18]

However, the definition of a key employee is fairly narrow. In particular, paragraph (d)(6) of the Proposed Rule would permit the family office to provide investment advice to any natural person (including persons who hold joint and community property with their spouse) who is:

> (i) an executive officer, director, trustee, general partner, or person serving a similar capacity of the family office, or (ii) any other employee of the family office (other than an employee performing solely clerical, secretarial, or administrative functions) who, in connection with his or her regular duties, has participated in the investment activities of the family office, or similar functions or duties for or on behalf of another company, for at least twelve months.

The scope of the definition is intended to cover only those employees who are likely to be in a position or have a level of knowledge and experience in financial matters sufficient to be able to evaluate the risks and take steps to protect themselves without the protections afforded either by the Advisers Act or, in the view of the SEC, family membership.[19] Similar to the treatment afforded to former family members, key employees who cease to be employed by the family office would not be required to liquidate or transfer investments held through the family office upon the termination of their employment, but any such terminated employee would not be permitted to make additional investments through the family office other than those additional investments that the former employee was contractually obligated to make.[20]

The SEC seeks comment on a range of issues related to the definition of family client, including the scope of the definition. However, as the Proposing Release notes, "as a family office extends its provision of investment advice beyond family members, it increasingly resembles a more typical commercial investment advisory business, and not a family managing its own wealth."[21] Thus, the definition of family client under the Proposed Rule, in the view of the SEC, should be quite narrowly tailored.

Ownership and Control

In order to rely on the Proposed Rule, a family office must be wholly owned and controlled, either directly or indirectly, by family members. This criteria is consistent with the conditions set forth in prior exemptive orders as well as the stated desire of the SEC to "distinguish family offices from family-run offices that may provide advice to other people, as well as other families, and operates as a more typical investment adviser."[22]

In addition to the ownership structure of the family office, the SEC also noted that family offices that have received exemptive relief in the past generally have represented that they did not operate for the purpose of generating a profit and charged fees designed to just cover their costs.[23] Since any profits generated by a family office would accrue to the benefit of the family member owners, the Proposed Rule does not contain a specific condition regarding whether or not the family office generates a profit.[24]

Prohibition on Holding Out

A family office seeking to rely on the Proposed Rule is prohibited from holding itself out to the public as an investment adviser. Given that the scope of permissible clients that a family office may

have effectively is limited to family members, it seems logical that a family office would not have a need to advertise or otherwise seek to attract third parties as clients.[25] Furthermore, the prohibition on holding out to the public is consistent with prior exemptive orders issued by the SEC.[26]

GRANDFATHERING PROVISIONS

The Proposed Rule would allow a family office that as of January 1, 2010 was not registered as an investment adviser or otherwise required to be so registered, and that otherwise satisfies the definition of a family office as set forth in the Proposed Rule, to rely on the exclusion even though the family office may have provided investment advice to certain persons that fall outside of the definition of a family client under the Proposed Rule. In particular, providing advice to the following persons would be permissible under the grandfathering provisions of the Proposed Rule:

1. Natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office who have invested with the family office before January 1, 2010 and are accredited investors, as defined in Regulation D under the Securities Act of 1933;
2. Any company owned exclusively and controlled by one or more family members; or
3. Any investment adviser registered under the Act that provides investment advice to the family office and who identifies investment opportunities to the family office, and invests in such transactions on substantially the same terms as the family office invests, but does not invest in other funds advised by the family office, and whose assets as to which the family office directly or indirectly provides investment advice represents, in the aggregate, not more than 5 percent of the value of the total assets as to which the family office provides investment advice…[27]

FOR MORE INFORMATION

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[1] Family Offices, Rel. No. IA-3098 (Oct. 12, 2010) ("Proposing Release"). A copy of the Proposing Release can be found at http://sec.gov/rules/proposed/2010/ia-3098.pdf.

[2] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[3] Section 407 of the Dodd-Frank Act also creates a new exemption from registration under the Advisers Act for investment advisers who provide advice solely to one or more venture capital funds. As is the case with family offices, the Dodd-Frank Act requires that the SEC promulgate a definition for the term "venture capital fund." Although the Dodd-Frank Act did not set a deadline for the SEC to define family office, the SEC must establish a definition for a venture capital fund within one year of the enactment of the Dodd-Frank Act.

[4] The Proposing Release, *supra* n. 1 at 5.

[5] *Id*. at 4-5.

[6] Proposed Rule 202(a)(11)(G)-1(d)(2)(i-vii).

[7] The Proposing Release, *supra* n. 1 at 9.

[8] *Id*. at 11.

[9] *Id*. at 13.

[10] *Id*. at 14.

[11] *Id.*

[12] Proposed Rule 202(a)(11)(G)-1(b)(1).

[13] The Proposing Release, *supra* n. 1 at 15.

[14] Proposed Rule 202(a)(11)(G)-1(d)(2)(iv).

[15] *Id*.

[16] The Proposing Release, *supra* n. 1 at 17.

[17] Proposed Rule 202(a)(11)(G)-1(d)(2)(iii-v).

[18] The Proposing Release, *supra* n. 1 at 17.

[19] *Id*. at 20.

[20] *Id*. at 21.

[21] *Id*. at 22.

[22] *Id*. at 23.

[23] *Id*.

[24] *Id*. at 24.

[25] *Id*.

[26] *Id*. at 25.

[27] Proposed Rule 202(a)(11)(G)-1(c)(1-3).