SEC Proposes Family Office Definition

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The SEC's proposed rule under the Dodd-Frank Act defining which family offices will be exempt from regulation as investment advisers raises many questions requiring close attention.

In October 2010 the U.S. Securities and Exchange Commission (SEC) issued a rule proposal under the Investment Advisers Act of 1940 to define the term "family office" for purposes of a new statutory exemption from the definition of an investment adviser that will take effect July 21, 2011. The statutory exemption, established by section 409 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, implements a congressional judgment that family offices should not be regulated as investment advisers. It was needed because the Dodd-Frank Act repeals—also effective July 21, 2011—the so-called "private adviser exemption" from registration as an investment adviser under section 203(b)(3) of the Advisers Act, upon which many family offices have previously relied. This newsletter discusses the background of the proposed exemption, describes the proposed rule's definitions and notes a number of questions that have been raised concerning it.

Background

The private adviser exemption currently exempts from SEC registration (but not potentially applicable state investment advisory registration requirements) advisers that have had fewer than 15 clients during the preceding 12 months and that do not hold themselves out generally to the public as investment advisers. Family offices, which are utilized by wealthy families to manage their money and provide other services, generally do not hold themselves out to the public as providing investment advisory services and have frequently been able to utilize that exemption. Among other things, the SEC's rule that specifies how clients are to be counted (rule 203(b)(3)-1 under the Advisers Act) provides that a private investment fund is considered to be one client and that offering such a fund does not constitute "holding out."

Since the Advisers Act was enacted in 1940, approximately a dozen family offices that could not qualify to use the private adviser exemption have obtained exemptions from the SEC from the definition of an investment adviser. Those exemptions, obtained under section 202(a)(11) of the Advisers Act, are more complete than the private adviser exemption because if an entity is not within the definition of an investment adviser at all, it is also not subject to the Advisers Act's antifraud provisions, a number of which apply to unregistered as well as registered investment advisers. In addition, section 203A(b)(1)(B) of the Advisers Act exempts from state advisory regulation (but not antifraud protections) any entity that is exempted from the definition of an investment adviser under section 202(a)(11). Because the U.S. Congress inserted the new family office exemption in section 202(a)(11), an entity that qualifies as a family office under the rule as ultimately adopted will generally be exempt from regulation as an investment adviser at both federal and state levels.

Congress left it to the SEC to define the term "family office," directing the SEC to promulgate a definition that is "consistent with the [SEC's] previous exemptive policy," grandfathers the provision of advice to certain persons and "recognizes the range of organizational, management, and employment structures and arrangements employed by family offices." Proposed rule 202(a)(11)(G)-1 (at the end of the SEC's proposing release) attempts to comply with that mandate. The proposing release notes that family offices that do not fit within the rule's definitions as ultimately adopted will remain free to apply for a separate exemption; however, in the interim such an office would presumably be required to register as an investment adviser before section 409 of the Dodd-Frank Act takes effect July 21, 2011.

The Proposed Definition

Consistent with the exemptions that have been granted to family offices, the proposed rule would exempt only single-family offices (and their directors, partners, trustees and employees acting within the scope of their position or employment) that are wholly owned and controlled by family members and do not hold themselves out to the public as investment advisers. An office's permitted clients would be confined to "family clients," consisting of:

- Family members, including the founders of the family office, their lineal descendants (including by adoption and stepchildren) and lineal descendants' spouses and spousal equivalents (*i.e.*, a cohabitant occupying a relationship generally equivalent to a spouse), as well as the parents and siblings of the founders, their lineal descendants and lineal descendants' spouses and spousal equivalents (using the same definitions)
- Certain key employees
- Charitable foundations, organizations and trusts funded exclusively by family members
- Trusts and estates existing solely for the benefit of family clients
- Entities wholly owned and controlled (directly or indirectly) exclusively by family clients and operated solely for their benefit (provided that if such an entity is an investment fund, it must not be required to register as an investment company under the Investment Company Act of 1940)
- Former family members (former spouses, spousal equivalents or stepchildren), but only with respect to assets advised when family membership ceased (provided that advised assets may include investments—such as commitments to a private equity fund—that the former family member was contractually obligated to make when family membership ceased)
- Former key employees (subject to the same restriction as former family members)

If a person who is not a family client became a client of a family office as a result of the death of, or some other kind of involuntary transfer from, a family member or key employee, the family office could continue to provide advice to that person for four months following the transfer of assets resulting from the involuntary event.

The proposed rule also contains a provision implementing the statutorily required grandfathering provision, which would allow family offices that were not registered or required to be registered as investment advisers on January 1, 2010, also to advise:

- Officers, directors or employees who were receiving advice before that date and are accredited investors (as defined in Regulation D under the Securities Act of 1933), apparently regardless of whether such a person would qualify as a key employee
- Any company owned and controlled exclusively by family members, apparently regardless of whether such a company is operated solely for the benefit of family members
- A registered investment adviser that co-invests with the family office under specified circumstances.

Advice to grandfathered clients, however, will be subject to certain of the Advisers Act's antifraud provisions.

Questions and Comments

Comments on the proposed rule are due by November 18, 2010 (although the SEC will typically consider comments submitted reasonably quickly after the prescribed due date). We expect comments and questions to be lodged with respect to many issues, including:

- Why should advice to former family members be confined to assets managed by the family office when family membership ceases?
- Why should trusts that have been established by family members be disqualified simply because their beneficiaries are not family members? At a minimum, shouldn't such a trust qualify if it was established primarily for the benefit of family members?
- The four-month period that would be allowed for the management of involuntarily transferred assets is not sufficient. (This would be particularly the case with respect to an estate whose beneficiaries are not exclusively family members.)
- The rule would define a "founder" as a natural person and his or her spouse for whose benefit the family office was established and any subsequent spouse of such individuals. How would this work if there were multiple founders?
- Does it make sense not to allow advice to downstream family-controlled entities that are not wholly owned by family members?

- What would constitute family “control” is not clear in a number of circumstances. For instance, if a family office is owned in whole or in part by a trust, whose beneficiaries are entirely family members, of which the trustee is private trust company controlled, but not wholly owned, by the family, would the family control the family office within the meaning of the proposed rule?
- The proposing release indicates that a relatively narrow definition, drawing on precedent in other SEC rules, would apply in determining who is a key employee—excluding, for example, lawyers for the family office and nonexecutive personnel who are not involved in asset management. Is such a narrow interpretation appropriate in this context?
- Can a family office advise a pension plan for the benefit of its employees if they are not all key employees?
- Should there be a cure period, allowing a family office to correct mistakes so that it does not lose the benefit of the exemption?
- Should there be a safe harbor that would allow some minimum number of non-family clients? Should the answer to that question differ if the family office does not earn a profit that is distributed to its family owners?
- If a family office utilizes an employee-leasing arrangement for the administration of its employment relationships, could employees subject to such an arrangement qualify as key employees?
- While there is nothing in the proposing release or the proposed rule indicating that the rule would not cover family offices with U.S. clients that are organized outside the United States, the rule’s applicability to non-U.S. family offices should be explicitly confirmed in the final promulgating release.

In addition, the proposing release itself seeks comments on many questions.