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SEC Adopts Family Office Rule

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On June 22, the Securities and Exchange Commission (SEC) adopted a rule exempting from registration and regulation under the Investment Advisers Act of 1940 (Advisers Act) certain "family offices."[1] The rule implements Section 409 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Without the rule, many family offices would have been forced to register as investment advisers in light of the repeal of Section 203(b)(3) of the Advisers Act, the 14-client rule upon which many family offices relied for exemption from registration. While the SEC significantly expanded the rule from its proposed form, many of the definitions remain complicated, and given the widely varying structures of family offices, some offices may need to restructure their operations or terminate clients to avoid registration under the Advisers Act. Family offices that cannot meet the definition of "family office" are required to be registered with the SEC as investment advisers by March 30, 2012, unless they choose to seek exemptive relief from registration and regulation.

Family Members and Family Clients

A family office is an entity providing investment advisory services that meets each of the following criteria:

1. Its only clients are "family clients" (family members and certain alter ego family entities formed for tax, charitable, or estate planning purposes).[2]
2. It is wholly owned by family clients and exclusively controlled by "family members" or family entities.
3. It does not hold itself out to the public as an investment adviser.

"Family members" are all lineal descendants of a common ancestor, who may be living or deceased, as well as the descendants' current and former spouses or spousal equivalents, so long as the common ancestor is no more than 10 generations removed from the youngest generation of family members. The 10-generation limit means that the family will be able to choose a common ancestor and, as older generations pass away, may over time choose a new common ancestor in order to "shift down" to new

1. Investment Advisers Act Release No. 3220 (June 22, 2011). For additional information, see our June 23, 2010 LawFlash, "SEC Adopts Investment Adviser Rules Implementing the Dodd-Frank Act," available online at http://www.morganlewis.com/pubs/IMLF_SECAdoptsInvestmentAdviserRulesForDodd-FrankAct_23june11.pdf.

2. Multifamily offices are not within the scope of the rule.

generations.[3] The SEC received many comments that the family member definition was too narrow, and in response expanded the definition to include, for example, former spouses and adopted, foster, and stepchildren.

"Family clients" are current and former family members; certain key employees of the family offices and key employee trusts; certain trusts existing for the sole current benefit of family clients or for the sole current benefit of family clients and charitable and nonprofit entities; certain trusts funded solely by family clients; and certain companies wholly owned exclusively by, and operated for the sole benefit of, family clients. A family office will not lose its exclusion because a person who is not a family client receives assets as a result of an involuntary transfer from a family client, such as a bequest. The family office may continue to provide advice about these assets to the nonfamily client for a transition period of up to one year (up from four months in the proposed rule).

Family Trusts and Estates

A family client includes 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, including not only family-funded and created charities but also public charities.

Revocable trusts may be family clients so long as one or more family clients are the sole grantors, even if nonfamily members are beneficiaries. Further, estates of current or former family members or key employees may be family clients, so that their executors may receive advice from the family office.

Charitable and Nonprofit Entities

The final rule, like the proposed rule, treats a charitable or nonprofit entity as a family client only if it is funded exclusively by family members. The SEC dropped the requirement that the charity be *established* by family members or family clients, reasoning that the source of the funding is more important than the identity of the creator. A number of commenters had asked the SEC to permit a charity to remain a family office client so long as it accepted only a small amount of nonfamily donations and was controlled by family clients. The SEC was not persuaded by these arguments, even though the nonfamily assets, once donated, are not managed on behalf of the nonfamily donor. If a charity has received donations from nonfamily members in the past, it may still be a "family client" so long as it does not accept contributions from nonfamily members after August 31, 2011, unless the contributions are in fulfillment of a pledge, in which case the cutoff date is December 31, 2013. The adopting release notes that charitable and nonprofit entities, in order to remain family clients, must spend their nonfamily funds so that none of the entity's assets consist of nonfamily assets on December 31, 2013.

Other Family Entities

A family client includes any company, such as a pooled investment vehicle, that is wholly owned, directly or indirectly, by one or more family clients and operated for the sole benefit of family clients. The SEC did not require the family entity also to be controlled by family clients, as was proposed.

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3. The adopting release, available online at http://www.sec.gov/rules/final/2011/ia-3220.pdf, contains a useful chart illustrating this "shift down" to a new common ancestor.

Key Employees

"Key employees" may be clients of the family office. A "key employee" 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 affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months. The definition is substantially the same as the definition of "knowledgeable employee" in Rule 3c-5 under the Investment Company Act of 1940.

Trusts established by key employees whose beneficiaries are the key employee's lineal descendants or immediate family members also may be clients of the family office. Former key employees would not be required to liquidate or transfer their family office investments, but may not make new investments after their departure. The SEC added to the rule a definition of "executive officer," which is essentially the same as that found in Rule 3c-5, but declined to allow a key employee's spouse, spousal equivalent, and immediate family members to be considered key employees.

Grandfathering

Three types of clients are grandfathered as family clients so long as the family office was engaged to provide advice to the client before January 1, 2010. First, a family office may treat as a family client an officer, director, or employee of the family office who is an accredited investor. Second, any company owned exclusively and controlled by one or more family members may be a family client, even if it is not operated for the sole benefit of one or more family clients. Third, any investment adviser to the family office that is registered under the Advisers Act, identifies investment opportunities to the family office, and co-invests in those opportunities with the family office on substantially the same terms may be a family client, so long as the adviser's co-invested assets, in the aggregate, do not represent more than 5% of the value of the assets to which the family office provides advice. In this last case, the family office will be considered an investment adviser for purposes of the antifraud provisions of the Advisers Act (Sections 203(1), (2) and (4)).

Implications

Family offices that seek to rely on the new exemption should determine whether they have any nonfamily, non–key employee clients, and determine whether these clients can be advised through other arrangements, or whether the family office should register or seek exemptive relief from the SEC.

Additional Information

If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact the authors, **Monica Lea Parry** (202.739.5692; mparry@morganlewis.com), **Ethan W. Johnson** (305.415.3394; ejohnson@morganlewis.com), and **Trina C. Winkelmann** (202.739.5254; twinkelmann@morganlewis.com), or any of the following Morgan Lewis attorneys:

New York

Andrew J. Donohue	212.309.6160	adonohue@morganlewis.com

Philadelphia

Timothy W. Levin	215.963.5037	tlevin@morganlewis.com
John J. O'Brien	215.963.4969	jobrien@morganlewis.com

Washington, D.C.

Thomas S. Harman	202.739.5662	tharman@morganlewis.com

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