Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS JUNE 24, 2011

SEC Adopts “Family Office” Definition for Purposes of Advisers Act Exclusion

The Securities and Exchange Commission (“SEC”) recently adopted a new rule under the Investment Advisers Act of 1940 (“Advisers Act”) defining “family offices” for purposes of a family office exclusion from the definition of “investment adviser” under the Advisers Act. As described in our October 15, 2010, Client Alert (available at: http://www.chapman.com/media/news/media.877.pdf), the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) created the family office exclusion and required that the SEC adopt a rule defining “family office” for this purpose. Among other things, those meeting the definition of “family office” under new Advisers Act Rule 202(a)(11)(G)-1 would not be required to register with the SEC under the Advisers Act. The SEC release related to the new rule is available at http://www.sec.gov/rules/final/2011/ia-3220.pdf.

What is a Family Office?

Family offices are generally entities established by wealthy families to manage their finances and provide related services to family members, such as managing securities portfolios, providing personalized financial, tax, and estate planning advice, providing accounting services, and directing charitable giving, in each case to members of a family. The SEC believes that family offices generally meet the definition of “investment adviser” under the Advisers Act because family offices are often in the business of providing advice about securities for compensation.

Why is the New Rule Necessary?

Section 203(b)(3) of the Advisers Act currently exempts from registration investment advisers that have fewer than fifteen clients and who do not hold themselves out generally to the public as investment advisers or act as investment advisers to a registered investment company or business development company. The Dodd-Frank Act deletes this exemption effective July 21, 2011. While the primary purpose of eliminating Section 203(b)(3) is to require advisers to hedge funds and private equity funds to register under the Advisers Act, it will also affect family offices, which have often relied on this exemption. Some family offices have obtained orders from the SEC declaring them not to be investment advisers within the intent of the “investment adviser” definition under the Advisers Act. To prevent typical family offices from being treated as investment advisers under the Advisers Act after the Dodd-Frank Act changes, the Dodd-Frank Act created a new exclusion from the definition of “investment adviser” for family offices as defined by rule, regulation, or order of the SEC. The Dodd-Frank Act also requires that any SEC “family office” definition must provide for an exemption that is consistent with the previous SEC family office exemptive orders and recognizes the range of organizational, management, and employment structures and arrangements employed by family offices. The Dodd-Frank Act also requires that the SEC definition grandfather certain family offices.

Comments Received

The SEC received approximately 90 comments on the proposed rule. The SEC rejected the suggestions of many to adopt a broader exemption than the current rule in order to accommodate typical family office structures not reflected in prior exemptive orders. The SEC believed that such expansion would not befit the purpose of the exclusion or the legislative instructions presented by the Dodd-Frank Act. Other comments requested exceptions in

various aspects of the rule to allow individuals or entities with no family relations to receive investment advice from a family office without the protections of the Advisers Act. The final rule addresses some of these concerns, as described below.

Family Office Definition

The rule provides that a "family office" would not be considered to be an investment adviser for purpose of the Advisers Act. The proposed rule defines a "family office" as a company that (1) has no clients other than family clients; (2) is wholly owned and controlled (directly or indirectly) by family members; and (3) does not hold itself out to the public as an investment adviser.

1. Has no clients other than family clients

The rule defines "family clients" to include current and former family members, certain key employees of the family office, charities established and funded exclusively by current or former family members, trusts or estates existing for the sole benefit of family clients, and most entities owned and controlled exclusively by, and operated for the sole benefit of, family clients. The proposed definition of "family member" was expanded in the final rule to include all lineal descendants of a common ancestor as well as current and former spouses (or spousal equivalent), provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members. Children by adoption and current and former stepchildren are considered "family members" under the rule.

The proposed definition referred to the "founder" of the family office, implying that the founder is the initial generator of the family's wealth and is an individual or a couple. In response to several comments, the adopted rule permits a family to choose a common ancestor (living or deceased) and define family members by reference to the degree of lineal kinship to such relative. The SEC believes this approach avoids any assumptions regarding the source of the family's wealth and any inconsistent treatment of extended family members. The 10 generation limit would constrain the scope of persons considered family members while accommodating the typical number of generations served by most family offices.

The proposed rule would have allowed a family office to continue to advise a non-family client for four months following a transfer of assets resulting from an involuntary event, such as a bequest to a friend, that would otherwise cause the family office to lose its exclusion. This transition period was extended to one year in the final rule.

The types of trusts that may be treated as a family client was expanded in response to several comments that the proposed rule failed to account for aspects of trust and estate planning. The expansions generally accommodate common estate planning and charitable giving plans and do not suggest that the family office engages in commercial enterprise. Under the rule, any non-profit or charitable foundation, organization, or trust funded exclusively by one or more other family clients is treated as a family client. Because some family offices currently advise non-profit or charitable organizations and have accepted funding from non-family clients, the rule includes a transition period of until December 31, 2013, before family offices have to modify such advisory arrangements or restructure the organization to comply with this aspect of the exclusion. Similarly, the rule also treats as a family client any company, including a pooled investment vehicle, that is wholly owned (directly or indirectly) by one or more family clients and operated solely for the benefit of such family clients.

Finally, the adopted rule treats certain key employees as family clients so that they may receive investment advice from, and participate in investment opportunities provided by, the family office. Such key employee must be a natural person (including his or her spouse or spousal equivalent who holds a shared ownership interest with the key employee) who (i) is an executive officer, director, trustee, general partner, or person serving in a similar capacity or (ii) any other employee who, in connection with his or her regular duties (other than solely clerical or administrative), participates in the investment activities of the family office and has done so for at least one year. In addition, because key employees are "family clients" under the rule, they may receive indirect investment advice through the family office by their investment in family office-advised private funds, charitable organizations, and other family entities. The final rule modifies the proposed rule by including knowledgeable employees of an affiliated family office in the definition of "key employee," including a definition for "executive officer" which mirrors that used in Advisers Act Rule 205-3 and Rule 3c-5 of the Investment Company Act of 1940, and by clarifying that family clients include trusts of which the key employee generally is the sole contributor and authorized to make decisions.

2. Wholly owned and controlled (directly or indirectly) by family members

To qualify for the exclusion from regulation under the Advisers Act, the rule requires that the family office must be wholly owned by family clients and exclusively controlled (directly or indirectly) by one or more family members or family entities. The final rule expands who may own the family office from “family members” to “family clients”. Like the proposed rule, however, “control” of the family office must remain (directly or indirectly) with family members and their related entities. The rule defines “control” as the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company.

3. Does not hold itself out to the public as an investment adviser

As proposed, the final rule prohibits a family office relying on the rule from holding itself out to the public as an investment adviser. The SEC included this condition to make the family office exclusion unavailable for family offices seeking to enter into typical advisory relationships with non-family clients. These relationships and activities are inconsistent with the basis for excluding “family offices” from the investment adviser definition.

The rule also makes clear that the exclusion provided by the rule does not extend to family offices serving multiple families.

Grandfathering of Certain Family Offices

The Dodd-Frank Act requires that any proposed definition of “family office” not exclude any person who was not registered or required to be registered under the Advisers Act on January 1, 2010, solely because that person provides investment advice to certain specified family office clients to whom the person was engaged in providing investment advice before January 1, 2010. Accordingly, the rule provides that the “family office” definition does not exclude any such person who provides investment advice to the following clients:

- 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;

- Any company owned exclusively and controlled by family members; or

- Any registered investment adviser who 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 five percent of the total value of the total assets as to which the family office provides investment advice, provided that such a family office would be deemed an investment adviser for purposes of paragraphs (1), (2), and (4) of Section 206 of the Advisers Act (the primary antifraud provisions of the Advisers Act).

When Will the Rule be Effective?

The new rule will be effective 60 days after its publication in the Federal Register. However, the SEC agreed with several commenters that the time period between the adoption of this rule and the repeal of the private adviser exemption from registration contained in Section 203(b)(3) of the Advisers Act (effective July 21, 2011) may not be sufficient for family offices to conduct an evaluation, restructure, or register. Accordingly, the rule provides that family offices currently exempt in reliance on the private adviser exemption and that do not meet the new family office exclusion are not required to register with the SEC as investment advisers until March 30, 2012. All family offices currently operating under existing exemptive orders may continue to rely on them as they will not be rescinded.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at chapman.com.

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