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SEC Adopts Final Definition of "Family Offices"

On June 22, 2011, the U.S. Securities and Exchange Commission (the "SEC") adopted a final rule under the Investment Advisers Act of 1940, as amended (the "Advisers Act")[1] under which family offices will be excluded from the definition of an investment adviser, and thus, will not be required to register under the Advisers Act. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") repealed the "private adviser exemption"[2] contained in Section 203(b)(3) of the Advisers Act, upon which many family offices had relied in order to avoid SEC registration as an investment adviser. However, the Dodd-Frank Act also provided a specific exclusion for family offices, as defined by the SEC, from the definition of an investment adviser.[3] The Family Offices Adopting Release adopts final Rule 202(a)(11)(G)-1 under the Advisers Act defining the term "family offices" (the "Final Rule") and provides certain interpretive guidance related thereto. The Final Rule will be effective 60 days after its publication in the Federal Register.

In order to qualify for the exclusion, a family office must fulfill three general conditions, each of which is discussed in more detail below: (i) the family office may provide securities advice only to certain "family clients;" (ii) the family clients must wholly own the family office and family members and/or family entities must wholly control the family office; and (iii) the family office must not hold itself out to the general public as an investment adviser.

Family Clients. Family offices making use of the exclusion may only provide investment advice to "family clients." Under the Final Rule, family clients include current and former family members, certain employees of the family office, charities funded exclusively by family clients, estates of current and former family members or key employees, trusts existing for the sole benefit of family clients or, if both family clients and charitable and non-profit organizations are the sole current beneficiaries, trusts funded solely by family clients, revocable trusts funded solely by family clients, certain key employee trusts and companies wholly owned exclusively by, and operated for the sole benefit of, family clients (with certain exceptions).

- **Family members**. Family members include all lineal descendants of a common ancestor (whether living or deceased), as well as current or former spouses or spousal equivalents of those descendants; provided, that the common ancestor is no more than 10 generations removed from the youngest generation of the family. All children by adoption

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1 See SEC Release No. IA-3220 entitled "Family Offices" (June 22, 2011) at http://www.sec.gov/rules/final/2011/ia-3220.pdf (the "Family Offices Adopting Release").

2 Generally, an investment adviser who, during the course of the preceding 12 months, had fewer than 15 clients and neither holds itself out generally to the public as an investment adviser nor acts as an adviser to a registered investment company or business development company.

3 Section 202(a)(11)(G) of the Advisers Act.

and current or former stepchildren are considered family members as well. In order to serve younger generations, the Final Rule permits families to change their common ancestor without formal documentation. The definition has now been expanded to include foster children and individuals who were minors when a family member became their legal guardian. Former family members (*i.e.*, former spouses, spousal equivalents and stepchildren) are also treated as family members under the Final Rule.

- **Involuntary Transfers**. The Final Rule permits family offices to manage involuntary transfers of assets (*e.g.*, a bequest to a friend who is not a family member) for a one year transition period. Following this transition period, the family office must divest itself of such assets or register as an investment adviser under the Advisers Act.

- **Family Trusts and Estates**. The Final Rule treats any **irrevocable trust** in which one or more family clients are the only *current* beneficiaries as family clients. In addition to family members, the family office may also advise an irrevocable trust funded exclusively by one or more family clients, in which the current beneficiaries, in addition to other family clients, are non-profit organizations, charitable foundations, charitable trusts or other charitable organizations. The Final Rule also permits the family office to advise a **revocable trust** so long as one or more family clients are the sole grantors, regardless of whether the beneficiaries of the trust are family clients. With respect to **estates,** the Final Rule considers an estate of a family member, former family member, key employee or former key employees, even if the estate will be distributed to non-family clients, a family client.

- **Non-profit organizations, charitable foundations, charitable trusts or other charitable organizations**. Non-profit organizations, charitable foundations, charitable trusts or other charitable organizations, if funded *exclusively* by one or more family clients, will be treated by the rule as a family client.[4]

- **Key Employee**. The Final Rule treats a key employee who is either (i) an executive officer, director, trustee, general partner, or performing a similar function at the family office, or (ii) any employee who participates in the investment activities of the family office, as a family client.[5] This provision does not apply to employees performing "solely clerical, secretarial or administrative functions." Key employees may also receive investment advice indirectly via the family office's investment activities in charitable and non-profit organizations.[6] At the end of the key employee's employment, the employee will no longer be permitted to make additional investments through the family office; however, the employee will not be compelled to liquidate or transfer his existing investment out of the family office.

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[4] This provision includes charitable lead trusts and charitable remainder trusts whose only current beneficiaries are other family clients and charitable or non-profit organizations.

[5] The rule applies to any key employee's spouse or spousal equivalent that holds a joint, community property or other similar shared ownership interest with that key employee.

[6] A family office may also advise a family trust established by a key employee, *but only if* the key employee is the sole person making the investment decision.

Control. In order to qualify as a family office, the office must "be wholly owned by family clients, and exclusively controlled, directly or indirectly, by one or more family members or family entities."[7] The SEC employed the word "exclusively" to underscore that control of the family office cannot be shared with individuals or companies that are not family members or family entities under the Final Rule. Key employees may own a non-controlling stake in the family office, *e.g.*, a part of an incentive compensation package, but the office must be ultimately controlled by family members and their related entities.

Holding Out. This condition provides that family offices may not hold themselves out to the general public as investment advisers without registering under the Advisers Act. The family office should not conduct itself in a manner suggesting to the general public that it is seeking to enter into typical advisory relationships with non-family clients. Investment advisers who expect to de-register in reliance on the Final Rule are not prohibited from relying on the exclusion solely because they held themselves out to the public while they were registered as investment advisers under the Advisers Act.

Transition Provisions. The SEC noted that the time period between the adoption of the Final Rule and the repeal of the private adviser exemption (effective July 21, 2011) may not be sufficient for every family office to conduct an evaluation, restructure or register. Accordingly, the Final Rule provides that any office providing investment advice primarily to members of a single family on July 21, 2011 and that is not registered under the Advisers Act in reliance on the private adviser exemption is exempt from registering with the SEC until March 30, 2012, provided that such office, during the course of the preceding 12 months, has had fewer than 15 clients and neither holds itself out generally to the public as an investment adviser nor acts as an adviser to a registered investment company or business development company. ***Because initial applications for registration can take up to 45 days to be approved by the SEC, investment advisers relying on this transition provision should file a complete Form ADV (Parts 1 and 2) with the SEC no later than February 14, 2012.*** All family offices currently operating under existing exemptive orders may continue to rely on them as they will not be rescinded.

In addition, for family offices advising non-profit or charitable organizations that have accepted funding from non-family clients, the SEC has provided a transition period extending until December 31, 2013 for the family office to divest itself of such funds or register as an investment adviser under the Advisers Act. To rely on this transition period, a non-profit or charitable organization advised by the family office must not accept any additional funding from any non-family clients after August 31, 2011, except that during the transition period the non-profit or charitable organization may accept funding provided in fulfillment of any pledge made prior to August 31, 2011.

Grandfathering Provision. 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:

- 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,

[7] Note that in this case, family entities do not include key employees or their trusts.

2010 and are accredited investors, as defined in Regulation D under the Securities Act of 1933, as amended;

- any company owned exclusively and controlled by one or more family members; and
- any SEC-registered investment adviser that provides investment advice to the family office and who identifies investment opportunities to the family office, and co-invests in those opportunities with the family office on substantially the same terms, provided that 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, and, provided, further that such a family office would be deemed an investment adviser for purposes of the antifraud provisions of the Advisers Act (paragraphs (1), (2), and (4) of Section 206 of the Advisers Act).

Multiple Families. Family offices may not serve multiple families. The family office is meant to serve the financial needs of one particular family, and must remain distinguishable from a regular financial investment firm which serves multiple clients, each with conflicting financial goals. The SEC believes that allowing a family office to advise multiple families would remove that distinction.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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