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SEC Adopts Final Definition of "Family Offices" Exempt From Investment Advisers Act

September 19, 2011

On June 22, 2011, the Securities and Exchange Commission (SEC) adopted its final rule (the Family Office Rule) under the Investment Advisers Act of 1940 (the Advisers Act) defining the term "family office" for purposes of the Advisers Act exemption of family offices from the definition of an "investment adviser."[1] The Family Office Rule took effect August 29, 2011.

Congress inserted the family office exemption into the Advisers Act as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), leaving it to the SEC to specify the family offices that would qualify for the exemption. A qualifying family office is altogether exempt from regulation by the SEC and cannot be required to register as an investment adviser by a state, but is subject to state antifraud regulation. Under the Family Office Rule a family office includes any type of qualifying entity that provides investment advice to a single family (as defined by the SEC), including traditional family offices and private trust companies.

A family office that does not meet the new definition may reorganize to meet its requirements. If a family office has been validly relying, and continues to validly rely, on the now-expired "private adviser exemption" (described below) and does not qualify, or reorganize to qualify, for the new exemption, it may be required to register with the SEC by March 30, 2012, unless it (i) qualifies for a different exemption under the Advisers Act, (ii) relies on relief granted by the SEC in an existing or newly obtained exemptive order or (iii) qualifies to be grandfathered as a family office under a narrow provision of the Family Office Rule specifically required by the Dodd-Frank Act (described further below). Depending on its level of assets under management and the investment advisory laws of the state where a family office is located or provides advice, a family office that does not meet the new definition may instead be required to register (either currently or in the future) as an investment adviser in one or more states.[2]

Background. Many wealthy families have created and utilized family offices, private trust companies and similar entities to manage their investments and provide fiduciary and other services. Most did not register with the SEC in reliance upon the "private adviser exemption" previously set forth in Section 203(b)(3)of the Advisers Act.[3] However, the Dodd-Frank Act repealed the private adviser exemption, effective July 21, 2011. In its place, the Dodd-Frank Act established several new exemptions and exclusions, including an exclusion from the definition of investment adviser for family offices.[4] The Family Office Rule defines and implements that exclusion.

Family office exclusion. Under the Family Office Rule, a family office is a "company" (*i.e.*, any kind of entity) that (1) provides investment advice only to "family clients," (2) is wholly owned by family clients and controlled (directly or indirectly) exclusively by "family members" and/or "family entities" and (3) does not hold itself out to the public as an investment adviser. We explain these requirements below.

Family clients. Family clients include the following persons:

- **Family member.** "Family member" includes all lineal descendants[5] of a designated common ancestor (living or deceased) and their spouses or spousal equivalents,[6] within 10 generations from that common ancestor. The common ancestor is not required to be the individual who originally created the family's wealth.

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[1] *Family Offices*, Investment Advisers Act Release No. 3220 (June 22, 2011), promulgating Advisers Act rule 202(a)(11)(G)-1. The Family Office Rule reflects substantial revisions to the SEC's proposed rule, based on numerous comment letters from the public. See *Family Offices*, Investment Advisers Act Release No. 3098 (October 12, 2010).

[2] A description of the manner in which federal and state investment advisory registration requirements interact is beyond the scope of this white paper. We would be pleased to provide such a description to interested clients.

[3] The private adviser exemption exempted from registration with the SEC (although not from the Advisers Act's antifraud provisions) an entity that did not hold itself out to the public as an investment adviser and had fewer than 15 clients during the preceding 12 months. Because a pooled investment vehicle generally qualified as a single client, even a family with many members could frequently take advantage of the private adviser exemption by offering family members the ability to invest through private investment funds organized by the family's family office. The private adviser exemption did not provide an exemption from state registration requirements.

[4] Section 202(a)(11)(G) of the Advisers Act.

[5] "Lineal descendants" include adopted children, step-children, foster children and any individual who was a minor when another family member became that individual's legal guardian.

[6] "Spousal equivalent" means a cohabitant in a relationship generally equivalent to a spousal relationship.

The family office later may designate a different common ancestor to maintain qualification as a family office, but such a change would alter the individuals who would then qualify as family members.

- **Former family member.** A "former family member" includes a spouse, spousal equivalent or step-child who was a family member but is no longer a family member (due to divorce or a "similar event"). Former family members can continue to invest through the family office because they remain family clients. However, a family office cannot provide investment advisory services to the spouse (or spousal equivalent) or subsequently born children of a family member's former spouse or spousal equivalent, and the ability of a family office to advise a former stepchild's spouse (or spousal equivalent) and descendants is currently ambiguous.[7]

- **Key employee.** "Key employee" means:

  - An individual who is an executive officer,[8] director, trustee or general partner of the family office, or an employee of the family office who participates in the investment activities of the family office as part of his or her regular functions or duties if he or she has been performing those duties for at least 12 months at the family office or another entity. The definition includes a person serving in a similar capacity for an affiliated family office[9] and a key employee's spouse or spousal equivalent who owns a joint community property or other similar ownership interest with the key employee.

  - The definition of key employee excludes not only persons performing solely clerical, secretarial or administrative functions but also employees who are not executive officers but perform important functions that do not include participation in the family office's investment activities (for instance, an internal counsel who is not an executive officer).

- **Former key employee.** A "former key employee" remains a family client, *but* the family office generally may provide investment advice only as to assets that the family office was advising immediately prior to the end of such individual's employment.[10]

- **Charitable organizations or trusts.** If funded *exclusively* by one or more family clients, any non-profit organization, charitable foundation, charitable trust (including charitable lead trust and/or charitable remainder trust if the current beneficiaries only include other family clients and charitable or non-profit organizations) or other charitable organization.

  If a family office currently advises non-profit or charitable organizations or trusts that have accepted non-family client funding, the SEC has provided a transition period for such an organization or trust to remain a family client if it spends or distributes the non-family-client funding or transitions to other investment advisory arrangements by December 31, 2013. To rely on this transition rule, the organization or trust must not have accepted any additional funding from 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 a pledge made prior to August 31, 2011.

- **Estates of family clients.** Any estate of a family member, former family member, key employee or former key employee (limited to the former key employee's assets described above), for the entire period of the estate's administration. The identity of the estate's beneficiaries is ignored for this purpose.

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[7] On a strict reading of the Family Office Rule, a family office's provision of investment advisory services to a former stepchild's spouse (or spousal equivalent) or descendants is arguably not permitted; however, senior members of the SEC staff have stated orally that this result was not intended and that it may be cured by subsequent staff interpretations.

[8] An "executive officer" is the family office's president, a vice president in charge of a principal business unit, division or function (such as administration or finance), any other officer who performs a policy-making function or any other person who performs similar policy-making functions.

[9] An affiliated family office is an entity wholly owned by family clients of another family office and controlled (directly or indirectly) by one or more family members of that other family office and/or family entities affiliated with the other family office and that only serves the family clients of the other family office.

[10] The family office also may advise as to investments that a former key employee was contractually obligated to make pursuant to agreements in effect before he or she ceased to be a key employee.

- **Trusts created by or for family clients.** A trust meeting one of the following criteria:

  - An irrevocable trust of which family clients are the sole current beneficiaries, regardless of the identity of the settlor[s] of the trust. Contingent beneficiaries are ignored for this purpose.

  - An irrevocable trust funded exclusively by one or more family clients and that solely includes family clients, non-profit organizations, charitable foundations, charitable trusts or other charitable organizations as the current beneficiaries. Contingent beneficiaries are ignored for this purpose.

  - A revocable trust created solely by family clients. The beneficiaries are not relevant until the trust becomes irrevocable, when it must qualify as a permissible irrevocable trust described above.

  - A trust of which each trustee, person authorized to make decisions with respect to the trust and person who funded the trust is a key employee (or the key employee's current or former spouse (or spousal equivalent) holding a joint, community property or similar shared ownership interest in the contributed assets at the time of contribution).

- **Family entities.** Any entity wholly owned by and operated for the sole benefit of family clients.[11]

Involuntary transfers: One-year grace period. The Family Office Rule provides that a person that otherwise is not a family client but receives assets due to an involuntary transfer (such as death) is deemed to be a family client for one year following completion of the transfer of legal title to assets resulting from the involuntary transfer. The SEC concluded that this period is necessary to facilitate the orderly transition of management of the transferred assets to a new investment adviser.

Ownership and control. A family office must be owned entirely by family clients and controlled[12] exclusively by one or more family members and/or family entities (entities that are family clients, excluding key employees and their trusts). As a result, key employees may own non-controlling interests in a family office, enabling a family office to attract and retain talented professionals.

Profits. A family office may be a profit-making enterprise.

Holding out to the public. A family office may not hold itself out to the public as an investment adviser. However, the SEC clarified that a family office currently registered as an investment adviser that de-registers in reliance on the Family Office Rule will not be prohibited from qualifying under the Family Office Rule solely because it held itself out to the public as an investment adviser while it was registered under the Advisers Act.

Exemption limited to single family offices. The Family Office Rule limits the definition of "family office" to family offices that advise only a single family. The SEC warned in the Family Office Rule promulgating release that the exclusion would not exempt a *de facto* multi-family office if several families attempt to circumvent the Family Office Rule by establishing separate family offices but staffing them with "the same or substantially the same employees."

Grandfathered companies. The Dodd-Frank Act required the SEC not to exclude from the definition of "family office" offices that were not registered or required to be registered under the Advisers Act on January 1, 2010, and would not meet all of the Family Office Rule's generally applicable requirements solely because those offices provide investment advice to certain persons.[13] A grandfathered family office meeting this narrow exclusion is not required to register as an investment adviser but,

[11] If the entity is a pooled investment vehicle, it must not be registered or required to register as an investment company under the Investment Company Act of 1940.

[12] "Control" means the power to exercise a controlling influence over the company's management or policies unless such power results solely from being a company officer.

[13] These include the following kinds of persons for whom a family office was engaged in providing advice before January 1, 2010: (i) individuals who, at the time of the applicable investment, were officers, directors or employees of the family office who invested with the family office before January 1, 2010 and are accredited investors under the Securities Act of 1933, Regulation D; (ii) any company owned exclusively and controlled by one or more family members; and (iii) any investment adviser registered under the Advisers Act that provides investment advice and identifies investment opportunities to the family office and invests in such transactions on substantially the same terms as the family office but does not invest in other funds advised by the family office, and whose assets as to which the family office directly or indirectly advises represents 5 percent or less of the total assets as to which the family office provides investment advice. Of course, the second, and to some extent the first, of these grandfathered categories of persons overlap with the definition of family clients under the Family Office Rule's generally applicable provisions.

unlike family offices meeting the Family Office Rule's generally applicable requirements, is subject to the anti-fraud provisions of the Advisers Act.

Exemptive orders. The SEC has in the past issued exemptive orders to approximately a dozen family offices. The SEC stated in its Family Office Rule promulgating release that a family office that is currently relying on such an order may continue to do so even if the order permits activities that are not covered by the Family Office Rule. A family office may also apply for an exemption for services and activities not covered by the Family Office Rule but, if not registered as an investment adviser, should not provide unexempted services unless and until such an exemption is granted.

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This white paper provides only a general description of the Family Office Rule and must not be relied upon as legal advice. For more information regarding the Family Office Rule, please contact your regular McDermott lawyer or:

Ryan M. Harding: +1 312 984 6483 rharding@mwe.com

Carol A. Harrington: +1 312 984 7794 charrington@mwe.com

Julie K. Kwon: +1 650 815 7439 jkwon@mwe.com

Edwin C. Laurenson: +1 212 547 5657 elaurenson@mwe.com