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SECURITIES ALERT

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SEC Adopts Rule Defining "Family Offices" Under the Investment Advisers Act of 1940

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Background

On June 22, 2011, the Securities and Exchange Commission ("SEC") approved a new rule to define "family offices" that are to be excluded from the Investment Advisers Act of 1940. The rulemaking stems from the Dodd-Frank Wall Street Reform and Consumer Protection Act.

"Family offices" are entities established by wealthy families to manage their wealth and provide other services to family members, such as tax and estate planning services. Historically, family offices have not been required to register with the SEC under the Advisers Act because of an exemption provided to investment advisers with fewer than 15 clients.

The Dodd-Frank Act removed that exemption so the SEC can regulate hedge fund and other private fund advisers. However, Dodd-Frank also included a new provision requiring the SEC to define "family offices" in order to exempt them from regulation under the Advisers Act.

The new rules adopted by the SEC enable those managing their own family's financial portfolios to determine whether their "family offices" can continue to be excluded from the Investment Advisers Act.

Family Office

Family offices typically are considered to be investment advisers under the Advisers Act because of the investment advisory services that they provide. As such, they are subject to the registration requirements set forth in that Act. Historically, however, most family offices have been structured to take advantage of an exemption from registration for firms that advise less than 15 clients and meet certain other conditions. If a family office did not meet this exemption, it would have to seek an SEC order exempting it from such regulation.

The Dodd-Frank Act repeals the 15-client exemption to enable the SEC to regulate hedge fund and other private fund advisers. But, the Dodd-Frank Act includes a new provision requiring the SEC to define family offices in order to exempt them from regulation under the Advisers Act.

A family office will be excluded from the Advisers Act that:

- Provides investment advice only to "family clients," as defined by the rule.
- Is wholly owned by family clients and is exclusively controlled by family members and/or family entities, as defined by the rule.
- Does not hold itself out to the public as an investment adviser.

Family Clients

A family office can advise the following family members and employees:

- *Family Members.* Family members include all lineal descendants (including by adoption, stepchildren, foster children, and in some cases, by legal guardianship) of a common ancestor (who is no more than 10 generations removed from the youngest generation of family members), and such lineal descendants' spouses or spousal equivalents.

- *Key employees.* Key employees include:
  - Executive officers, directors, trustees, general partners, or persons serving in a similar capacity

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for the family office or its affiliated family office.

- Any other employee of the family office or its affiliated family office (other than a clerical or secretarial employee) who, in connection with his or her regular duties, has participated in the investment activities of the family office or affiliated family office, or similar functions or duties for another company, for at least 12 months.

- *Other family clients.* Other family clients generally include:
  - Any nonprofit or charitable organization funded exclusively by family clients.*
  - Any estate of a family member, former family member, key employee, or subject to certain conditions, a former key employee.
  - Certain family client trusts.
  - Any company wholly-owned by and operated for the sole benefit of family clients.

* A family office that presently advises a nonprofit or charity that at some point in its past has received non-family funds may still be allowed to advise the nonprofit or charity while claiming the family office exclusion. To come within the family office exclusion, a family office has a transition period of until December 31, 2013 to comply with the condition that the office cannot advise a nonprofit or charity that is funded other than by family clients. Furthermore, although the final rule does not permit any nonprofit or charity that the family office advises to accept additional non-family funding after August 31, 2011, the nonprofit or charity is permitted to accept funding during the transition period that is made in fulfillment of a pledge that a non-family donor made before August 31, 2011.

Registration If Exclusion Not Met

Family offices will have to register with the SEC under the Advisers Act or with applicable state securities authorities, or obtain an SEC exemptive order, if they do not meet the terms of the exclusion by March 30, 2012.

Grandfathering Provision

The Dodd-Frank Act requires that the SEC not preclude certain family offices not registered or required to be registered under the Advisers Act on January 1, 2010 from meeting the new exclusion solely because they provide investment advice to certain clients (primarily "natural persons" who are officers, directors, or employees of the family office and who are also "accredited investors" and invested with the family office prior to January 1, 2010). The adopted rule incorporates this grandfathering provision. ◆

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