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The SEC's Proposed Rule Regarding the Family Offices Exemption

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On July 21, 2010, Congress enacted the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (Dodd-Frank Act). Title IV of the Dodd-Frank Act is primarily concerned with changes to investment adviser registration under the Investment Advisers Act of 1940 (Advisers Act). While Title IV notably restricts the most common investment adviser exemption, Section 203(b)(3), it creates other exemptions, including, without limitation, an exemption that will apply to any "family office," as defined by rule, regulation or order of the Securities and Exchange Commission (SEC). On October 12, 2010, the SEC proposed a rule (which is not yet final) that would provide further guidance on the "family office" exemption. This article first discusses the exemption, and then proceeds to explain the SEC's proposed Rule 202(a)(11)(G)-1.

Dodd-Frank Act

The Dodd-Frank Act adds an exclusion from the definition of "investment adviser" in Section 202(a)(11) that will apply to any family office, as defined by rule, regulation or order of the SEC.[1] However, the Dodd-Frank Act expressly notes that these rules, regulations and orders that define the term "family office" must provide for an exemption that (1) is consistent with the previous exemptive policy of the SEC, and reflected in exemption orders for family offices in effect on the date of enactment of the Dodd-Frank Act, and the grandfathering provisions in (3) discussed below; (2) recognizes the range of organizational, management and employment structures and arrangements employed by family offices; and (3) does not exclude any person who was not registered or required to be registered under the Advisers Act on January 1, 2010 from the definition of the term "family office" solely because such person provides investment advice to, and was engaged before January 1, 2010 in providing investment advice to (A) 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;" (B) any company owned exclusively and controlled by members of the family of the family office, or as the SEC may prescribe by rule; and (C) any investment adviser registered under the Advisers Act that provides investment advice 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 represent, in the aggregate, not more than 5 percent of the value of the total assets as to which the family office provides investment advice.[2]

Furthermore, the Dodd-Frank Act adds that to the extent any investment advisers are grandfathered under the term "family office" by operation of (3) above, the SEC may treat them as "investment

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advisers" for anti-fraud purposes under Section 206(1), (2) and (4) of the Advisers Act.[3]

Overview of Proposed Rule

The SEC has proposed to adopt Rule 202(a)(11)(G)-1 under the Advisers Act, which would exclude "family offices" from the definition of "investment adviser" under the Advisers Act.[4] As a consequence, "family offices" would not be subject to the Advisers Act.[5] The SEC release notes that the proposed rule would generally attempt to follow prior policy, but that the proposed rule would not match the "exact representations, conditions or terms contained in every exemptive order . . . ." The release notes that its core policy reflects the lack of need to apply the Advisers Act to the typical single family office. "Accordingly, most of the conditions of the proposed rule (like [SEC] exemptive orders) operate to restrict the structure and operation of a family office relying on the rule to activities unlikely to involve commercial advisory activities, while permitting traditional family office activities involving charities, tax planning, and pooled investing."[6] The SEC noted that under the rule, in the absence of an exemption, family offices could seek exemptive orders or register under the Advisers Act. It should also be noted that the SEC formerly incorporated the grandfather provision in the Dodd-Frank Act described above.

The proposed rule has three general conditions for a family office to be considered an excluded "family office." We discuss the conditions and explain the effect of the proposed rule on existing SEC exemptive orders below.

General Conditions to Meet Proposed Rule's Requirements

Condition #1 – Excluded Family Offices Must Have Only "Family Clients"

Excluded "family offices" would be permitted only to have "family clients" as advisory clients.[7] The term "family clients" is explained below.

Family Clients

"Family clients" would generally include "family members," "key employees," charities established and funded exclusively by family members or former family members, trusts or estates existing for the sole benefit of family clients, and entities wholly owned and controlled exclusively by, and operated for the sole benefit of, family clients (provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of "investment company" under the Investment Company Act of 1940), and, under certain circumstances, former family members and former key employees. Further explanation of these terms is discussed below.

Family Member

The definition of "family member" is important because several concepts related to the definition of "family clients" hinge on the meaning of "family member."

The SEC proposed to define the term "family member" to include the "founder" and his or her spouse or spousal equivalent for whose benefit the family office was established and any of their subsequent spouses or spousal equivalents, their parents, their lineal descendants (including by adoption and stepchildren), and such lineal descendants' spouses or spousal equivalents.[8] Spousal equivalent is defined as a cohabitant occupying a relationship generally equivalent to that of a spouse.[9] The SEC's proposed definition of "family member" also would include siblings of the founders of the family office, their spouses or spousal equivalents, their lineal descendants (including by adoption and stepchildren), and such lineal descendants' spouses or spousal equivalents.[10] The SEC stated that family offices that add other families would not fall within the "family member" condition and analogized this type of "family office" to a typical commercial investment adviser.

Key Employees

The SEC also proposed to treat as "family clients" certain key employees of the family office so that they may receive investment advice from and participate in investment opportunities provided by the family office. The proposed rule would permit the family office to provide investment advice to any natural person (including persons who hold joint and community property with their spouse or other similar shared ownership interest with that person's spouse or spousal equivalent) who is an executive officer, director, trustee, general partner, or person serving a similar capacity of the family office, or any other employee of the family office (other than an employee performing solely clerical, secretarial, or administrative functions) who, in connection with his or her regular duties, participates in the investment activities of the family office; provided that such employee has been performing such functions and duties for or on behalf of the family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months.[11] Similar to the SEC's treatment of family members under the proposed rule, key employees would be able to structure their investments through trusts and other entities, subject to the conditions relating to control and ownership described above.

Charitable Foundations, Charitable Organizations and Charitable Trusts

The SEC also proposed to treat as a "family client" any charitable foundation, charitable organization, or charitable trust established and funded exclusively by one or more family members[12] and any trust or estate existing for the sole benefit of one or more family clients.[13]

Companies

The SEC would also treat as a "family client" any limited liability company, partnership, corporation, or other entity wholly owned and controlled (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more family clients; provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of "investment company" under the Investment Company Act of 1940.[14] Under proposed Rule 202(a)(11)(G)-1(d)(1), "control" would be defined as the power to exercise a controlling influence over the management or policies of an entity, unless such power is solely the result of being an officer of such entity.

Former Family Members

The SEC proposed permitting former family members, *i.e.*, former spouses, spousal equivalents and stepchildren, to retain any investments held through the family office at the time they became a former family member.[15] However, the SEC proposed to limit former family members from making any new investments through the family office; provided that the proposed rule would permit the family office to provide investment advice with respect to additional investments that the former spouse or spousal equivalent was contractually obligated to make, and that relate to a family-office advised investment existing prior to the time the person became a former spouse or spousal equivalent (*e.g.*, if the individual has a previously existing capital commitment to a private fund advised by the family office).[16]

Former Key Employees

Upon the end of key employees' employment by the family office, key employees (including their trusts and controlled entities) would not be permitted to make additional investments through the family office, except that a former key employee shall be permitted to receive investment advice from the family office with respect to additional investments that the former key employee was contractually obligated to make, and that relate to a family-office advised investment existing, in each case prior to the time the person became a former key employee.[17] Similar to the SEC's proposed treatment of former spouses,

spousal equivalents, and stepchildren, the SEC's proposed rule would not require former key employees to liquidate or transfer investments held through the family office at the time their employment ends.

Effect of Involuntary Transfers on "Family Client" Status

The SEC noted that involuntary transfers could jeopardize the family offices exclusion if the involuntary transaction is to a person that is not a "family client." The proposed rule would permit the family office to continue to advise such a client without violating the terms of the exclusion for four months following the transfer of assets resulting from the involuntary event, which should allow a family office to orderly transition that client's assets to another investment adviser, seek exemptive relief, or otherwise restructure its activities to comply with the Advisers Act.[18]

Condition #2 – Family Office Must Be Wholly Owned and Controlled by Family Members

The SEC proposed that to operate under the proposed exclusion from the Advisers Act the family office be wholly owned and controlled, either directly or indirectly, by family members.[19]

Condition #3 – Family Offices Cannot Hold Themselves Out to the Public as an Investment Adviser

The SEC proposed to prohibit a family office relying on the rule from holding itself out to the public as an investment adviser.[20] The release does not explain in detail what would constitute holding oneself out as an investment adviser. Most likely, this would be interpreted consistent with the "holding out" provision of Section 203(b)(3) as it existed prior to enactment of the Dodd-Frank Act. While no clear guidelines existed, the SEC often interpreted "holding out" broadly to include the following: (1) advertising related to investment advisory services; (2) maintaining a list as an investment adviser in a telephone or building directory; (3) letting it be known by word of mouth or otherwise that the person will accept new investment advisory clients; (4) using letterhead or business cards referring to investment advisory activities; or (5) participation in a "mini-account" or similar investment advisory programs.[21]

To the extent family offices use the world wide web to provide information about services, it is likely that they would be considered to be holding themselves out as investment advisers. Such family offices would need to consider using password protected websites, or, alternatively, possibly using disclaimers that they are not "investment advisers" and do not offer services to the general public.[22]

Effect of Proposed Rule on Prior Exemptive Orders

The SEC noted that it is not proposing to rescind the orders it has issued to family offices. Family offices currently operating under these orders could continue to rely on those orders or, if they meet the conditions of proposed Rule 202(a)(11)(G)-1, they could rely on the rule.

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[1] Dodd-Frank Act, Section 409.
[2] *Id*.
[3] *Id*.
[4] Proposed Advisers Act Rule 202(a)(11)(G)-1(a).
[5] SEC Release No. IA-3098 (Oct. 12, 2010).
[6] *Id*.
[7] Proposed Advisers Act Rule 202(a)(11)(G)-1(b)(1).
[8] Proposed Advisers Act Rule 202(a)(11)(G)-1(d)(3).
[9] *See* proposed Advisers Act Rule 202(a)(11)(G)-1(d)(7).
[10] Proposed Advisers Act Rule 202(a)(11)(G)-1(d)(3).
[11] Proposed Advisers Act Rule 202(a)(11)(G)-1(d)(6).
[12] Proposed Advisers Act Rule 202(a)(11)(G)-1(d)(2)(iii).
[13] Proposed Advisers Act Rule 202(a)(11)(G)-1(d)(2)(iv).
[14] Proposed Advisers Act Rule 202(a)(11)(G)-1(d)(2)(v).
[15] Proposed Advisers Act Rule 202(a)(11)(G)-1(d)(2)(vi), and (d)(4).
[16] Proposed Advisers Act Rule 202(a)(11)(G)-1(d)(2)(vi).
[17] Proposed Advisers Act Rule 202(a)(11)(G)-1(d)(2)(vii).
[18] Proposed Advisers Act Rule 202(a)(11)(G)-1(b)(1).
[19] Proposed Advisers Act Rule 202(a)(11)(G)-1(b)(2).
[20] Proposed Advisers Act Rule 202(a)(11)(G)-1(b)(3).
[21] Thomas P. Lemke and Gerald T. Lins, Regulation of Investment Advisers, § 1:36.
[22] *Id*.