



*A Boutique Law Firm for the Investment Community*

CLIENT ALERT

**July 5, 2011**

## **SEC Issues Final Family Office Rule**

The SEC has finally adopted its long awaited rule defining “family offices” for purposes of the Investment Advisers Act.<sup>1</sup> Under the new rule, most single family offices will be excluded from the definition of “investment adviser” and therefore will not be required to register with the SEC. This client alert is intended to inform you of the final rule adopted by the SEC as well as the likely practical effects on family offices that do not qualify as a single family office under the new rule.

### **Background**

Historically, family offices have avoided registration under the Advisers Act by either taking advantage of the “private adviser” exemption or applying for a special exemptive order from the SEC. Prior to adoption of the Dodd-Frank Act, family offices that advised less than 15 “clients” were able to rely on the private adviser exemption. Other family offices either registered with the SEC or applied for an exemptive order, both of which were expensive and time consuming. Exemptive orders have been granted in the past based on the rationale that a single family managing its own wealth does not need the protections of the Advisers Act. Congress instructed the SEC to use the same rationale in defining single family offices for purposes of the Advisers Act.

The Dodd-Frank Act repeals the “private adviser” exemption effective July 22, 2011.<sup>2</sup> Nevertheless, Congress recognized that family offices that have traditionally relied on the private adviser exemption still should be able to privately manage their own wealth without being subject to regulation by the SEC. Therefore, Congress created a specific exclusion from

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<sup>1</sup> On June 22, 2011, the Securities and Exchange Commission (the “SEC”) adopted rule 202(a)(11)(G)-1 (the “Family Office Rule”) to define “family office” for purposes of the Investment Advisers Act of 1940 (the “Advisers Act”).

<sup>2</sup> Section 403 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Advisers that do not qualify for another exemption will need to file for registration by mid February of 2012.

the Advisers Act for “family offices.”<sup>3</sup> Nevertheless, Congress left it to the SEC to define “family office.”

The SEC initially proposed a definition in October of last year. As many of you may remember, Lee & Stone convened a conference of family offices in November 2010 to discuss the proposed rule, and received a number of helpful suggestions from our clients and friends. We wrote a comment letter to the SEC addressing many of the concerns raised, and followed up with a discussion with the staff of the SEC. We are pleased to report that the SEC took our concerns and proposed solutions seriously and our comment letter was cited by the SEC in several key places in its final release of the Family Office Rule. While we did not get everything we asked for, the SEC did adopt many of our suggestions.<sup>4</sup>

### **Why this matters**

The definition of family office under the Advisers Act is important because if an office fails to meet it, that office will have to

- register with the SEC;
- apply for an exemptive order;
- find another exemption; or
- restructure its operations.

### **Family Office Defined**

The new rule has three basic requirements:

1. Family offices may only provide investment advice to “family clients;”
2. Family offices must be wholly owned by family clients and exclusively controlled by family members and/or family entities; and
3. Family offices may not hold themselves out to the public as investment advisers.

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<sup>3</sup> Section 409 of the Dodd-Frank Act adds Section 202(a)(11)(G) of the Advisers Act, which provides that any family office, as defined by the SEC, is not an investment adviser, and therefore is exempt from regulation by the SEC or any state as an investment adviser.

<sup>4</sup> SEC Release No. IA-3220; File No. S7-25-10

## **Family Clients Only**

### **Family offices may only provide investment advice to family clients.**

The SEC defines **family clients** to include:

- Current and former family members;<sup>5</sup>
- Key employees;
- Charities and non-profits exclusively funded by family clients;<sup>6</sup>
- Estates of family members and key employees;
- Certain trusts;<sup>7</sup> and
- Companies owned exclusively by—and operated for the sole benefit of—family clients.

The SEC defines **family member** to include all lineal descendants of a common ancestor (living or deceased), including current and former spouses or spousal equivalents of those descendants. The common ancestor may be no more than 10 generations removed from the youngest generation of the family members being advised by the family office. This definition includes adopted children, foster children and stepchildren. Ex-spouses and other former family members such as former stepchildren may continue to be clients of the family office after the divorce or other event that caused them to no longer be family members.

Families may choose which **common ancestor** (living or deceased) to use to define “family members.” The family office may also change this designation over time to change along with the family members served by the office. Keep in mind, however, that choosing an ancestor from further back, generationally speaking, results in an office that can serve more current collateral family members but fewer future lineal members (due to the 10 generation limit). Conversely, choosing a more recent ancestor will result in an office that can serve more future lineal members at the expense of current collateral family members.

**Key employees** of a family office include:

1. executive officers, directors, trustees, general partners, or those in similar positions; and
2. other employees who participate in family office investment activities.<sup>8</sup>

Only natural persons may be key employees.

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<sup>5</sup> Former family members include ex-spouses and their children (former stepchildren of a family member).

<sup>6</sup> Family office-advised charities that have in the past accepted funds from anyone other than a family client have until December 31, 2013 to either spend those funds or lose the family office exemption. Also, such charities may not accept non-family client funds after August 31, 2011.

<sup>7</sup> Includes irrevocable trusts in which one or more family clients are the only current beneficiaries, and revocable trusts of which the sole grantors are family clients, regardless of the current beneficiaries.

<sup>8</sup> “Other employees” cannot be solely secretarial, clerical, or administrative in function and must have participated in the investment activities of the family office for at least a year.

Based in part on comments made by Lee & Stone, the SEC has expanded the definition of **family client trusts** to include revocable trusts of which a family client is the sole grantor, even if the current beneficiaries of the trust are not family clients. At our urging, the SEC recognized that the beneficiaries of a revocable trust should not matter until the trust becomes irrevocable, at which time the trust will have a one year transition period to find another investment adviser. Likewise, the SEC recognized that irrevocable trusts may have contingent beneficiaries that are not family clients. Again, if contingent beneficiaries that are not family clients become actual beneficiaries, the one year transition period will apply. This one year transition period for involuntary transfers is discussed in further detail in the next section of this alert.

### **Grandfathering and Transition Provisions**

A family office may continue to provide investment advice to employees that are not key employees who invested with the family office before January 1, 2010 if those employees are “accredited investors.”<sup>9</sup>

The new Family Office Rule will also allow a family office to continue to provide advice for a transition period in the case of involuntary transfers of assets to those who are not family clients. For example, upon the death of a family member, a non-family member may inherit an interest in a private fund advised by the family office. Following such an involuntary transfer, the family office may still provide advice regarding the asset for a transition period of up to a year.

### **Wholly Owned and Exclusively Operated**

**Family offices must be wholly owned by family clients and exclusively controlled by family members and/or family entities.**

An important change from the proposed rule is that key employees of a family office may have a minority equity interest in the office. As we pointed out to the SEC, a profit interest in the family office may serve as part of an important incentive compensation package to key employees. The SEC recognized this in the final Family Office Rule, while maintaining the requirement that the family office be controlled by family members and family entities.

### **No Holding Out**

**Family offices may not hold themselves out to the public as investments advisers.**

If a family office were to publicly hold itself out as an investment adviser, it would suggest that the family office seeks an advisory relationship with non-family clients. This runs counter to the purpose of the family office exemption and will negate the office’s use of the

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<sup>9</sup> A family office that advises grandfathered employees will be subject to certain anti-fraud provisions of the Advisers Act. Rule 202(a)(11)(G)-1(c)(3)

exemption. For example, family offices should be circumspect of having a web-site that is accessible by the public.

### **Multifamily Offices**

The SEC has determined that the Family Office Rule will not extend to multifamily offices. The SEC believes that to allow an office to manage the wealth of more than one family would not be consistent with the rationale for the family office exemption - a single family managing its own wealth does not need the protections of the Advisers Act.

### **Transition Period**

The Rule allows a transition period for family offices that do not meet the definition of a single family office under the new Family Office Rule, but only if they are currently relying on the private advisers exemption to the Advisers Act. Those family offices will have until March 30, 2012 to register with the SEC<sup>10</sup>. Family Offices with more than 14 clients will not be able to take advantage of the transition period and should consider whether the office needs to register or restructure immediately. This, of course, assumes that those offices do not qualify for another exemption.

### **Previously-Issued Exemptive Orders**

Exemptive orders issued to family offices prior to adoption of the Family Office Rule are not rescinded. Family offices may still operate under those exemptive orders if they choose to do so. It makes no difference if the exemptive order is broader or narrower in scope than the new rule. Family Offices that do not meet the definition of “family offices” may want to consider applying for an exemption with the SEC.

*Lee & Stone LLP is a boutique law firm focused on the investment community. Please call George Lee at 214-377-4852 if you have any questions on the family office rules.*

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<sup>10</sup> Family Offices that have less than \$100 million under management may need to register with one or more states rather than the SEC.