

The Family Office Rule

—An Exclusion from the Investment Advisers Act for Single Family Offices

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The logo for Lee & Stone LLP is displayed within a dark teal square. The text "LEE &" is positioned above a horizontal line, and "STONE" is positioned below it. The letters "LLP" are in a smaller font size to the right of "STONE".

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October 26, 2011

Overview

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- Exemption vs. Exclusion
- Family Office Definition
 - ▣ Must be Single Family Office
 - ▣ Family Clients
 - Common Ancestor within 10 generations
 - Key Employees
 - Family Entities
 - ▣ Ownership and Control
 - ▣ Holding Out

Investment Advisers Act of 1940

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- Applies only to “investment advisers”
- Section 202(a)(11) – defines investment adviser as a person who is
 - ▣ Engaged in the business of:
 - providing investment advice
 - for compensation

Investment Advisers Act of 1940

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- ▣ Elements construed broadly:
 - **Advice:** relating to securities
 - Portfolio Management
 - Asset allocation advice
 - Selection of outside advisors
 - **Compensation:** any economic benefit
 - Fees
 - Expense reimbursement
 - Overhead sharing

Investment Advisers Act

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- Before *Dodd Frank*: private adviser exemption to registration
 - Fewer than 15 Clients and no public advertising
 - Most entities count as one client
 - Other provisions of Act still apply
 - Anti-fraud
 - SEC and State jurisdiction

Definition of Investment Adviser

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- Section 202 (a) (11) excludes certain categories:
 - Certain bank holding companies
 - Includes regulated private trust companies
 - Other persons not within the intent of the definition, as the SEC may designate by rule or order
 - Family offices may apply for exemptive order from the SEC

Investment Advisers Act (cont.)

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- Dodd Frank – Game Changer
 - Eliminates private adviser exemption
 - Adds Family Office Exclusion: Section 202(a)(11)(G)
 - SEC to define
 - Consistent with past SEC exemptive policy

Family Office Exclusion

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- Big upside for those that qualify as “Family Office”
 - Not an “investment adviser”
 - Advisers Act does not apply
 - No registration (no disclosure, books and records, anti-fraud, etc.)
 - State Law is Pre-empted under NSMIA (Section 203A(b)(1)(B) of the Act)
 - State cannot require registration, licensing or qualification
 - Regardless of assets
- Some downside nonetheless:
 - If fail structure test, need to register with SEC by March 2012 (if over \$100mm/\$150mm) or look hard at the state rules (if under)
 - If already over 15 clients, need to register immediately

Family Office- Definition

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- Rule 202(a)(11)(G)-1 defines a “family office” as a **company** that:
 - (1) Has no clients other than “**family clients**”
 - (2) Is **wholly owned** by family clients (may include certain key employees)
 - (3) Is **wholly controlled by** family members or family entities
 - (4) Does not hold itself out to the public as an investment adviser

Family Clients

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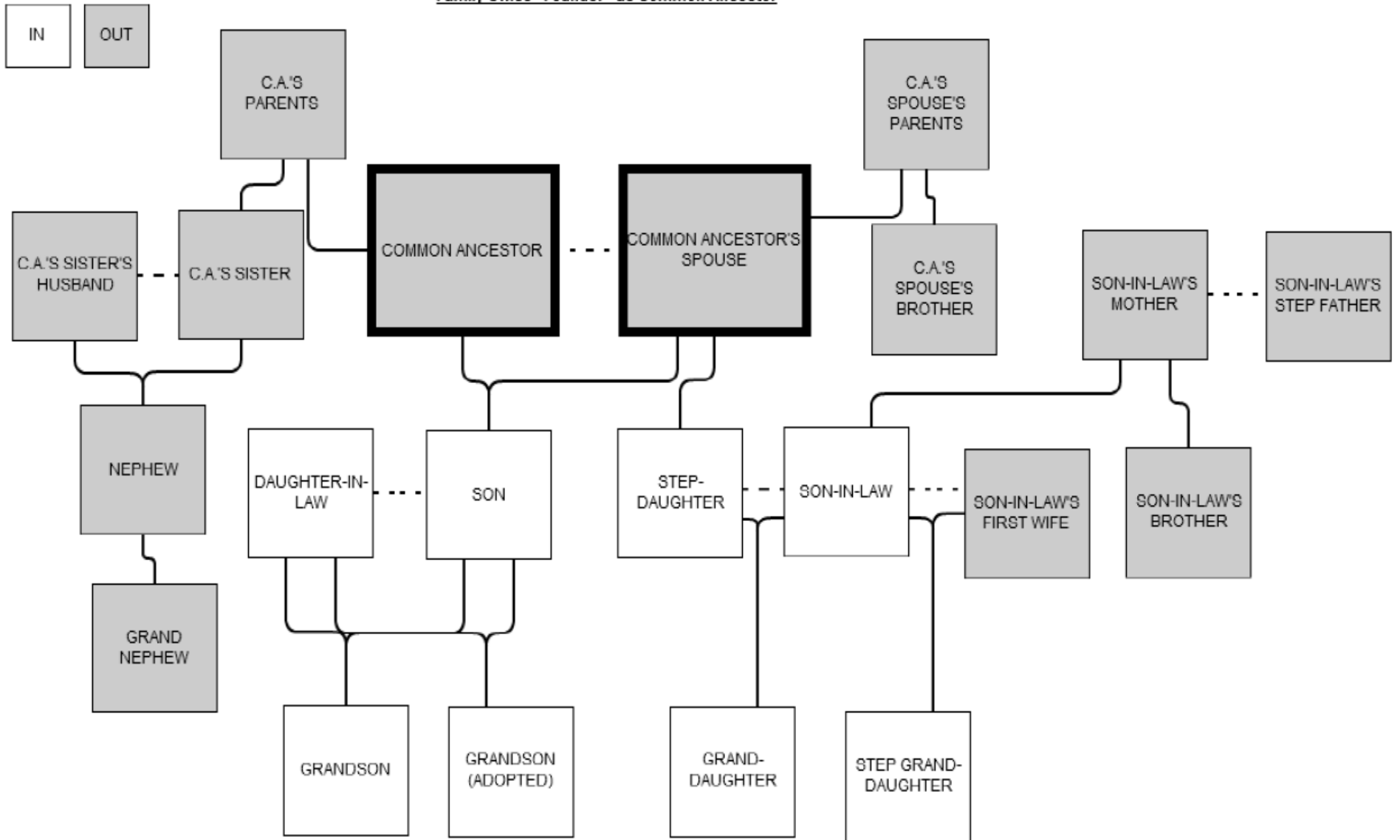
- Both family members and certain key employees are considered Family Clients
- Family members are defined by reference to degree of lineal kinship to a designated “common ancestor”
 - Designated common ancestor may be living or dead
 - Includes:
 - Lineal descendants up to 10 generations removed from common ancestor
 - Current and former spouses of lineal descendants
 - Spousal equivalents
 - Adopted children, Stepchildren and Foster children
 - Persons who were minors when family member became their legal guardian

Family Clients

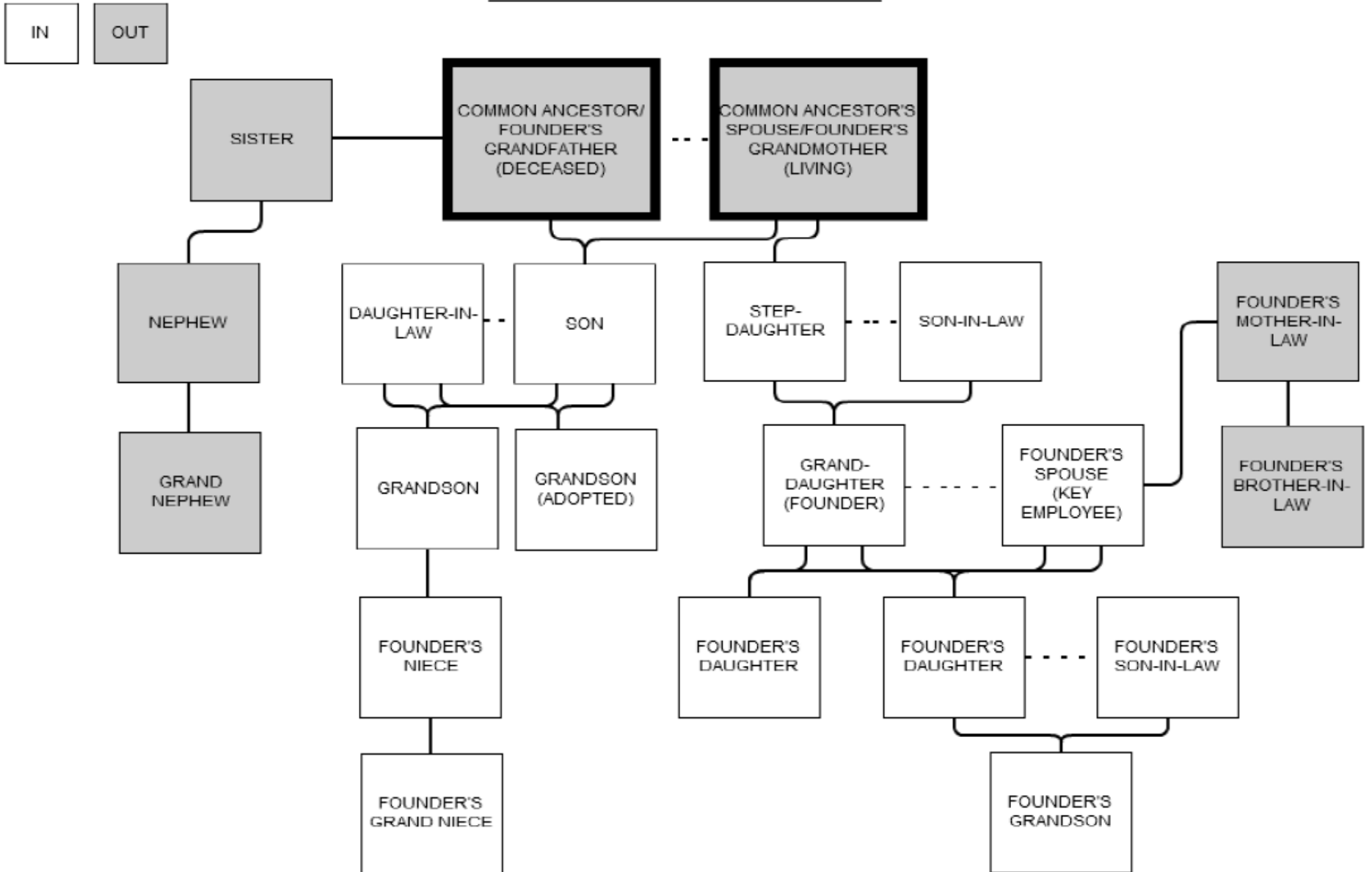
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- 10-generation limit between oldest and youngest generation
- Designation may be made and changed without any notice or filing
- Practical effect: the further up from current members, the more included collateral members but fewer future lineal members

Family Office "Founder" as Common Ancestor



"Founder's" Grandfather as Common Ancestor



“Family Clients” include Key Employees

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- Key Employees:
 - Executive officer, director, trustee, general partner or person in similar capacity for family office or its affiliated family office
 - Employees (not executive officers) who have participated in investment activities of family office or affiliated family office (or similar duties for another company) for at least 12 months
 - Excludes employees who are solely clerical, secretarial or administrative
 - Includes community property or other shared ownership with key employee’s spouse
- Post Employment
 - Can keep existing investments
 - No new investments

Key Employees- Issues

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- ❑ Employees not involved in investment process (other than executive officers)
 - Grandfather provisions would permit existing employees if
 - accredited
 - invested as of 1/1/10
- ❑ Family or family business employees not employed in formal capacity by family office are not eligible family clients
- ❑ 12 month standard for non-management investment employees
- ❑ A trust established by a key employee is an eligible family client if:
 - each trustee or other person authorized to make decisions with respect to the trust is a key employee
 - each grantor of the trust is also a key employee

Family Entities

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- Non-Profit and Charitable Organizations
 - Established and funded exclusively by family clients
 - Cannot accept outside donations after August 31, 2011
 - Have until December 31, 2013 to restructure
- Family Trusts
 - Irrevocable:
 - if family clients are sole beneficiaries; or
 - Funded exclusively by family clients and beneficiaries are family clients and non-profits
 - Revocable: only if family clients are sole grantors, regardless of beneficiaries
- Pooled investment vehicles (Family Limited Partnerships)
 - Wholly owned by family clients
 - Operated for sole benefit of family clients

Other Co-Investors

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- Grandfather provision for RIA Co-investor
 - Extremely Limited Application (Blanche Lincoln exception)
 - Registered investment advisers that provide reciprocal advice to family office
 - May co-invest in opportunities referred to family office
 - Must be client of family office as of 1/1/10
 - Assets of client cannot exceed 5% of total family office assets
- Co-Investors not paying compensation (Club Deals)
 - Issue on reimbursement of expenses
 - Cannot share in overhead expenses

Other “Family Client” Issues

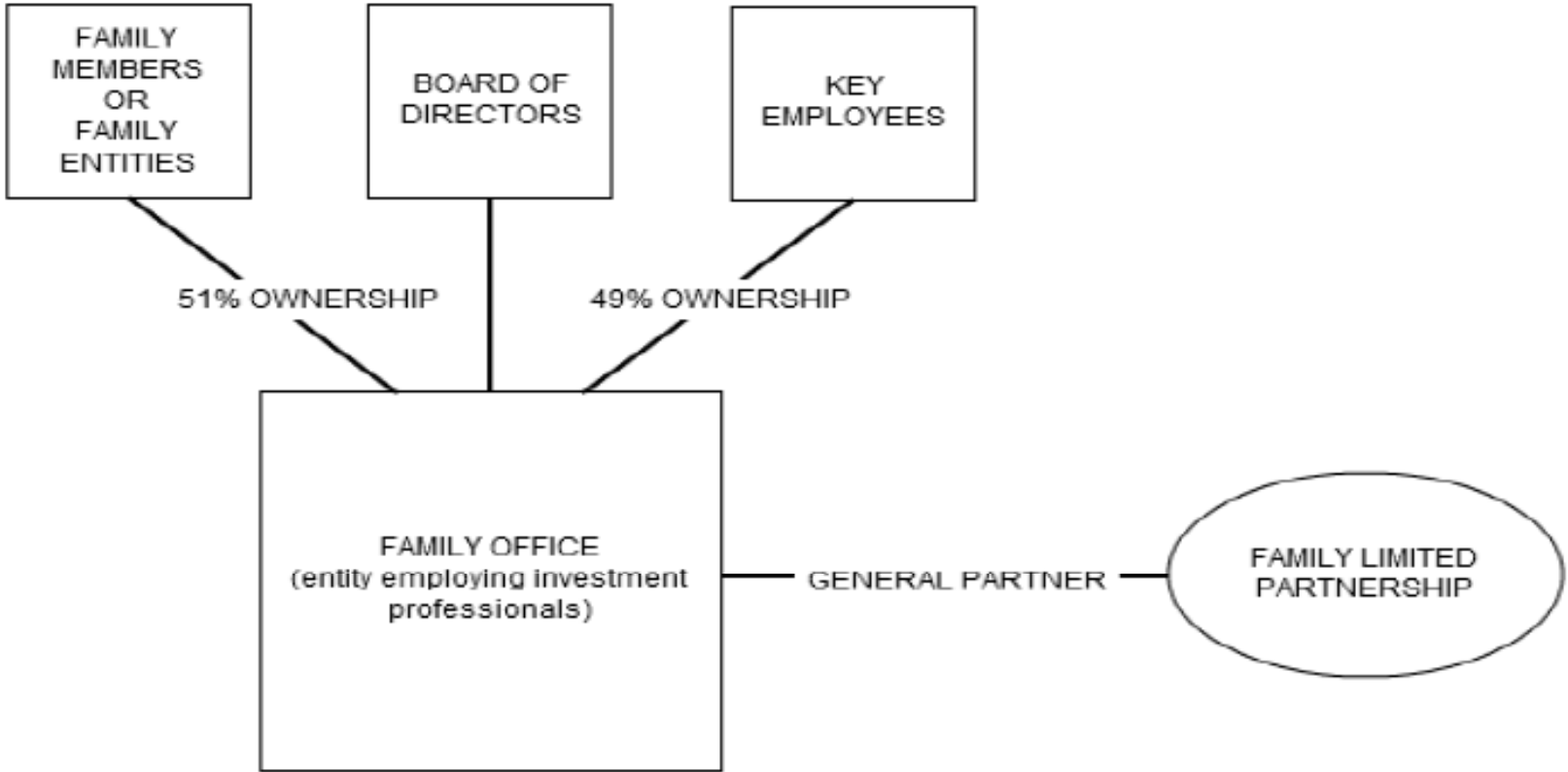
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- Involuntary Transfers (e.g., bequest to a charity or other non family member): 12 months to transition out
 - Period begins to run at completion of title transfer of assets resulting from involuntary transfer
- Former family members are treated as family members
 - ex-spouse of family member
 - Former step-children
 - avoids adverse tax consequences

Ownership

- Family office “company”
 - ▣ required to be wholly owned by family clients and exclusively controlled—directly or indirectly—by family members (or family entities)
- SEC Policy: a family office is essentially a family managing its own wealth
 - ▣ fees/compensation accrue solely to family clients
 - ▣ advice is delivered by family controlled office to family clients
 - ▣ Cannot resemble commercial advisor
 - ▣ Familial relationship protects unsophisticated investors
 - Therefore, oversight is unnecessary where the relationship is present and can be relied upon
 - ▣ No multi-family offices

FAMILY OFFICE OWNERSHIP



Ownership - Issues

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- Identification of the “company”
 - Exemptive orders have focused on the entity/ individual(s) providing investment advisory services (i.e., those employing investment professionals)
 - Sole proprietorship not a “company”

- Substance of “ownership”
 - Compensation of employees- profits interests vs. voting control
 - Application down the chain (equity in subsidiary or entity under common control)

- Profit Generation
 - Prior orders have focused on family offices that solely cover costs
 - New rule permits profit generation by office

Holding Out as Advisor

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- Prohibition on holding oneself out as an investment advisor

- Issues:
 - Websites
 - Speaking engagements

Strategies- Restructure, Register or Respond

- Restructure
 - Eliminate non-family client owners
 - Eliminate non-family clients
 - Private Trust Company
 - Not an option for most family offices
 - Must be state regulated
- Register
 - SEC if over \$100 million (\$150 million if only advising private funds)
 - State if under \$100 million
- Respond
 - Apply for exemptive order
 - Expensive and time consuming

Other Important Issues

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- Family office exclusion does not extend to multi-family offices
- Multi-family offices relying on old private adviser exemption must register by March 30, 2012
- Family offices with SEC exemptive orders may still rely on them
 - ▣ Whether broader or narrower than new rule
- No end-run – can't share employees among unrelated family offices

Worth Mentioning

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- Registration takes time
 - Should begin strategizing, planning, and possibly registering sooner rather than later
 - Need to file with the SEC by February 14, 2012 to achieve March deadline