Investment Funds Alert

SEC Proposes "Family Office" Definition For Exclusion Under Advisers Act

October 29, 2010

Prior to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), many family offices did not register under the Investment Advisers Act of 1940 (the "Advisers Act") in reliance on the exemption for advisers to fewer than 15 clients. Although the Dodd-Frank Act removed this exemption, it also added a new exclusion for "family offices" to be defined by Securities and Exchange Commission (SEC) rule from being considered an "investment adviser" subject to regulation under the Advisers Act. On October 12, 2010, the SEC proposed a new rule setting forth its definition of "family office". Much of the proposed family office rule would be a codification of the SEC's previous exemptive orders for single-family offices, but the proposed rule would also address some issues not addressed in the previous exemptive orders.

In general, the proposed family office rule would define a family office as a company that (1) provides advice about securities only to "family clients" (as defined below), (2) is wholly owned and controlled directly or indirectly by "family members" and (3) does not hold itself out to the public as an investment adviser. The proposed rule would include transition periods for persons that become former family clients or family members and would also include grandfathering provisions for unregistered investment advisers that were exempt from registration on January 1, 2010, and that provided advice to certain clients that would not satisfy the requirements of the proposed rule.

The SEC is soliciting comments through November 18, 2010.

Family Clients and Family Members

As stated above, one of the conditions of being a family office under the proposed family office rule would be that the investment adviser be wholly owned and controlled by family members; another condition would require that the adviser have only provided investment advice to family clients. Understanding the scope of these definitions is key to understanding whether an exemption would be available. "Family members" are defined to include (1) the person founding a family office, (2) his or her spouse or spousal equivalent, (3) any subsequent spouse of the founder or his or her spouse (together with (1) and (2), the "Founders"), (4) the lineal descendants of the Founders (including by adoption and stepchildren), (5) those lineal descendants' spouses or spousal equivalents, (6) the parents of the Founders and (7) the siblings of the Founders, (8) those siblings' spouses or spousal equivalents, (9) the lineal descendants of those siblings (including by adoption and stepchildren) and (10) the spouses or spousal equivalents of those lineal descendants. "Family client" would be a broader term that would include family members and also include (1) "key employees," (2) charitable foundations, organizations or trusts established and funded by family members or former family members, (3) trusts or estates for the sole benefit of family clients, (4) any entity (other than a nonexempt investment company) that family clients directly or indirectly exclusively own and control and for whose sole benefit the entity is operated and (5) subject to restrictions set forth below, former family members and former key employees.

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Key Employees

The definition of "key employees" under the proposed rule is substantially similar to that included in Rule 205-3 under the Advisers Act, which defines which persons may be charged incentive fees. As stated above, key employees could not be owners of the entity providing advice, but may co-invest in client entities along with family members.

Former Family Members and Former Key Employees

Persons who become former family members, including former spouses or stepchildren (such as through divorce), and former key employees are able to continue receiving investment advice for assets under management with the family prior to becoming a former family member or former key employee. Those former family members and former key employees would not be able to receive investment advice after the date that they became former family members or key employees except for advice regarding additional investments that the former family member or former key employee was contractually obligated to make before such date and that relate to an existing family-office advised investment.

Involuntary Transfers and Transition Periods

If a person becomes a family client due to an involuntary transfer, such as due to the death of a family member or a key employee, a transferee would be deemed to be a family client for a period of four months. After that four-month period, the family office would be required to cease to provide investment advice, or the adviser would not satisfy the conditions of the proposed rule.

Grandfathering

As required by the Dodd-Frank Act, the proposed family office rule would grandfather certain advisory relationships (so long as they were commenced prior to January 1, 2010) and certain subadvisory relationships. The grandfathered advisory relationships include advice to (1) officers, directors or employees of the adviser, if they are accredited investors and (2) any company exclusively owned and controlled by one or more family members.

Preemption of State Law

As opposed to the exemptions added by the Dodd-Frank Act, such as the exemption for advisers to venture capital funds, the United States Congress excluded family offices from the definition of an "investment adviser" in Section 202(a)(11) of the Advisers Act. As family offices are excluded from being investment advisers under that definition, the exclusion is captured by the preemption provision in Section 203A of the Advisers Act, which prohibits any state from "requiring the registration, licensing, or qualification as an investment adviser or supervised person of an investment adviser. . . that is not registered under section 203 because that person is excepted from the definition of an investment adviser under section 202(a)(11) ." Therefore, persons that would satisfy the definition of a family office under the proposed rule would also not be required to register with any state securities authority.

Conclusion

The SEC's proposed family office rule would codify many of the factors in many of its previous exemptive orders, such as limitations on the owners of a family office, clients of a family office and the family office's ability to hold itself out as an investment adviser. The proposed rule would also slightly expand the scope of its previous orders to capture spousal equivalents and stepchildren, who were not always previously included.

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The proposed rule does not, however, cover every situation previously addressed by exemptive orders. If a family office previously received an exemptive order, it may continue to rely on the exemptive order. Also, if a family adviser provides advice to clients that are beyond the scope of the proposed family office rule, but are connected to the family, it may still request an exemptive order from the SEC.

For a link to the SEC's proposing release, click here.

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