Investment Funds Alert

SEC Adopts Rules Defining Investment Adviser Exclusion for Family Offices

July 19, 2011

On June 22, 2011, the Securities and Exchange Commission (SEC) adopted several rules to clarify the registration requirements of the Investment Advisers Act of 1940 (the "Advisers Act") as amended by the Dodd-Frank Wall Street Reform Protection Act (the "Dodd-Frank Act"). One of the rules further defines the exclusion added by the Dodd-Frank Act from the definition of "investment adviser" for persons that only advise family members.

Prior to the passage of the Dodd-Frank Act, many family offices did not register under the Advisers Act in reliance on the exemption for advisers to fewer than 15 clients or on exemptive orders from the SEC. Although the Dodd-Frank Act removed the 15-client exemption, it also added the new exclusion for "family offices," as defined by SEC rule. The family office rule codifies many of the aspects of the SEC's previous exemptive orders for single-family offices, but will be broader than the exemptive orders and will better fit with current family office practice.

In general, the family office rule defines a family office as a company that (i) provides advice about securities only to "family clients" (as defined below), (ii) is wholly owned by family clients, (iii) is exclusively controlled directly or indirectly by "family members" and (iv) does not hold itself out to the public as an investment adviser. The new rule will include transition periods for persons that become former family clients or family members and will 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 do not satisfy the requirements of the new rule.

The family office rule will become effective August 29, 2011.

Who is included in the definition of "family member"?

The final rule broadens the definition of a "family member" to include all lineal descendants of a common ancestor (who may be living or deceased) as well as current and former spouses or spousal equivalents of those descendants, provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members. All children by adoption, stepchildren and persons who were minors when another family member became the person's legal guardian are also considered family members. Unlike the proposal, the final rule does not reference a founder of the family office and instead allows a potential family office to reach back in the family tree to specify a common ancestor.

If a family expands past 10 generations, can a family office use a different common ancestor?

Yes, a potential family office may change the common ancestor. A change to the common ancestor would permit a family office to provide advice to additional generations of family members, but the family office would be required either to exclude family members who do not fit within the revised family tree or to register as an investment adviser. For an example of the effect of switching a common ancestor included in the SEC's adopting release,[1] click here.

How is "family client" defined?

"Family client" is a broader term that includes family members and also (i) "key employees"; (ii) nonprofit organizations, charitable foundations, charitable organizations or certain charitable trusts established and funded by family clients; (iii) trusts or estates for the sole benefit of family clients; (iv) 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 (v) subject to restrictions set forth below, former family members and former key employees.

Which types of employees will qualify as "key employees" who are treated as family clients?

The definition of "key employees" under the new rule is substantially similar to that of "knowledgeable employee" included in Rule 3c-5 under the Investment Company Act of 1940.[2] Spouses or spousal equivalents holding a joint interest with key employees are also permitted to receive advice as family clients.

Once an employee retires or a person is no longer a member of a family (due to divorce or death), may he or she be treated as a family client who is permitted to receive investment advice?

A person who becomes a former family member, including a former spouse or stepchild (such as through divorce), is permitted to continue to receive investment advice through the family office. A former key employee, however, is prohibited from receiving investment advice after the date that the person becomes a former key employee, except for advice regarding (i) additional investments that the former key employee was contractually obligated to make before such date or (ii) an existing family office-advised investment.

Will the estate of a family client be able to continue receiving investment advice after the death of a family client or other involuntary transfer?

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 one year following the legal transfer of title to the relevant assets. After that one-year period, the family office will be required to cease to provide investment advice, or the adviser would not satisfy the conditions of the exclusion.

Will a family office that would not satisfy the definition in the SEC rule because it provides advice to a nonprofit organization, charitable foundation or other charitable organization that accepts funds from persons other than family clients be required to register as an investment adviser?

Yes, but any company that provides investment advice to those nonqualifying charitable organizations on July 21, 2011, may, so long as the company satisfies all of the other requirements of being a family office, rely on the family office rule during a transition period, if (i) the charitable organization does not receive contributions from persons other than family members after August 31, 2011 (or December 31, 2011, to fulfill previous obligations) and (ii) the family office ceases providing investment advice to the nonqualifying charitable organization by December 31, 2013.

What if a potential family office does not satisfy all of the requirements of the family office exclusion as defined by the SEC, but has acted as a family office since before the passage of the Dodd-Frank Act?

As required by the Dodd-Frank Act, the family office rule grandfathers certain advisory relationships so long as they commenced prior to January 1, 2010. The grandfathered advisory relationships include advice to (i) officers, directors or employees of the adviser, if they are accredited investors who invested with the family office prior to

[1] Family Offices, Advisers Act Release No. 3225 (June 22, 2011), http://www.sec.gov/rules/final/2011/ia-3220.pdf
[2] Rule 3c-5 permits knowledgeable employees to be deemed "qualified purchasers" or excluded from the beneficial owner determination.

January 1, 2010, (ii) any company exclusively owned and controlled by one or more family members or (iii) an investment adviser registered under the Advisers Act that provides advice to, and identifies investment opportunities for, the family office and invests with the family office on substantially the same terms as the family office so long as the assets regarding 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 regarding which the family office advises.[3]

Will an investment adviser that is eligible to use the Family Office Exemption have to register under state law?

No. In contrast 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 a family office is excluded from being an investment adviser 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 satisfy the definition of a family office under the family office rule will also not be required to register with any state securities authority.

If a person wishes to change its client base to fit within the "family office" definition, will it be required to register on July 21, 2011?

The SEC delayed until March 30, 2012 the date that an investment adviser currently relying on the "fewer than 15 clients" exemption in Section 203(b)(3) of the Advisers Act will be required to register, so long as the adviser continues to satisfy the previous requirements of Section 203(b)(3), and it primarily advises members of a single family. It should be noted, however, that some states that incorporate the "fewer than 15 clients" exemption in Section 203(b)(3) of the Advisers Act in their state securities statues or regulations have not adopted a similar transition period for their statutes or regulations and may, therefore, require registration with the relevant state by July 21, 2011, if the adviser is not SEC-registered and does not currently fit within the "family office" exclusion.

RELATED ALERTS

On the same day that SEC adopted the family office definition, the SEC also adopted rules relating to exemptions from investment adviser registration added by the Dodd-Frank Act and changes to the assets under management calculation in Form ADV. For further information, please see Akin Gump alerts titled, "SEC Adopts Exemptions for Advisers to Certain Private Funds and Venture Capital Funds and Delays Registration" and "SEC Adopts Rules Clarifying Registration Exemption for 'Foreign Private Advisers'."

[3] Investment advisers relying on the grandfathering under (iii) will still be an investment adviser (but not a registered investment adviser) for purposes of Section 206(1), (2) and (4).

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