

SEC PROPOSES RULE DEFINING “FAMILY OFFICE”

In response to the Dodd-Frank Act,¹ the Securities and Exchange Commission has proposed new Rule 202(a)(11)(G)-1 under the Investment Advisers Act of 1940 to define a “family office.”² The Dodd-Frank Act amended the Advisers Act to provide an exclusion from the definition of an “investment adviser” for a “family office,” but directed the SEC to define the term “family office.” The proposed rule complies with that directive, and largely codifies prior exemptive orders issued by the SEC to family offices. A family office meeting the requirements of the proposed rule would not be subject to any of the provisions of the Advisers Act.

Background

Many family offices that otherwise come within the definition of an investment adviser (by virtue of providing advice about securities for compensation) have to date relied upon the “private adviser exemption” under Section 203(b) of the Advisers Act. That Section exempted a person that met the definition of investment adviser from registration under the Advisers Act if, among other things, the person advised 14 or fewer clients during the preceding 12-month period and did not hold itself out generally to the public as an investment adviser. Over the years, the SEC has also issued to certain family offices for which the exemption under Section 203(b) was unavailable exemptive orders holding that the family offices are not investment advisers within the meaning of Section 202(a)(11) of the Advisers Act. As of July 21, 2011, the Dodd-Frank Act rescinds the private adviser exemption, and thus many family offices that currently can rely upon that exemption would, absent an exemptive order, be required to register under the Advisers Act but for the specific relief added to the Advisers Act for family offices.

The Three-Part Test

Under the proposed rule, three conditions would have to be satisfied for a family office to be considered as such for purposes of the exclusion:

¹ The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). Please see our previous client memorandum, *The Dodd-Frank Act Overhauls the Regulation of Private Fund Managers and Other Money Managers*.

² *See Family Offices*, Investment Advisers Act Release No. 3098 (October 12, 2010) (the “Release”), available at <http://www.sec.gov/rules/proposed.shtml>.

1. ***No clients other than “family clients.”*** Only a “family client” may be a client of the family office. This would include family members;³ key employees of the family office;⁴ charitable foundations, charitable organizations or charitable trusts, in each case established and funded exclusively by family members; trusts or estates existing for the sole benefit of family clients; entities wholly owned or controlled (directly or indirectly) by, and operated for the sole benefit of, family clients;⁵ and under certain limited circumstances, former family members (i.e., former spouses, spousal equivalents and stepchildren) and former key employees.⁶ An investment adviser relying on the proposed rule could continue to provide advice to a transferee that receives assets in a transfer only if the transferee is a family client. In the event of an involuntary transfer to a person that is not a family client, an adviser relying on the proposed rule would have four months to transition the management of the transferee client’s assets to another adviser.⁷

2. ***Wholly owned and controlled (directly or indirectly) by family members.*** A family office under the proposed rule would have to be wholly owned and controlled, either directly or indirectly, by family members. The SEC indicated that part of its rationale for this requirement is to distinguish family offices from “family-run offices” that may provide advice to other clients and families but at the same time operate similar to a typical investment adviser that would be registered under the Advisers Act.

³ The proposed rule defines a “family member” to mean: (i) the founders, their lineal descendants (including by adoption and stepchildren), and such lineal descendants’ spouses or spousal equivalents; (ii) the parents of the founders; and (iii) the siblings of the founders and such siblings’ spouses or spousal equivalents and their lineal descendants (including by adoption and stepchildren) and such lineal descendants’ spouses or spousal equivalents.

⁴ A “key employee” is defined in the proposed rule to mean: any natural person (including any person who holds a joint, community property, 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 in a similar capacity of the family office or any employee of the family office (other than an employee performing solely clerical, secretarial, or administrative functions with regard to the family office) who, in connection with his or her regular functions or 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.

⁵ Control is defined in the proposed rule 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. If the entity is a pooled investment vehicle, it must be excepted from the definition of “investment company” under the Investment Company Act of 1940.

⁶ Former family members and former key employees would not, however, be permitted to make any new investments through the family office other than in limited circumstances.

⁷ The proposed rule does not specify whether a person whose assets are managed by a family office without compensation must still be a “family client.” Rule 203(b)(3)-1(b)(4) under the Advisers Act currently provides that such a person need not be counted as a client for purposes of the 14 or fewer client test of the private adviser exemption.

3. ***Does not hold itself out to the public as an investment adviser.*** A family office seeking to rely on the proposed rule would not be able to hold itself out to the public as an investment adviser. According to the SEC, a family office that holds itself out to the public as an investment adviser can be regarded as seeking traditional advisory relationships with non-family clients, which would be inconsistent with the basis on which the SEC has in the past provided exemptive orders to family offices.

Grandfathering Provision

As required by the Dodd-Frank Act, the proposed rule contains a grandfathering provision that includes in the definition of family office any person or entity that was not registered or required to be registered as an investment adviser under the Advisers Act on January 1, 2010 solely because the person provided investment advice, and was engaged before January 1, 2010 in providing investment advice, to certain natural persons and entities associated with a family office, including certain registered investment advisers that identified investment opportunities for the family office and invested in those opportunities on substantially the same terms as the family office, but did 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 five percent of the value of the total assets as to which the family office provides investment advice. A person or entity that is a family office solely as a result of the grandfathering provision would be deemed to be an investment adviser for purposes of the antifraud provisions of the Advisers Act.

State Law Preemption

Family offices that qualify for the proposed rule would also not be subject to registration as investment advisers under state securities laws. The exclusion provided under the Dodd-Frank Act is an exclusion from the definition of investment adviser under Section 202(a)(11) of the Advisers Act, and as such is covered by the preemption of state registration requirements in Section 203A(b)(1)(B) of that Act.

Previously Issued SEC Exemptive Orders

The SEC is not proposing to rescind exemptive orders that it has issued to family offices under Section 202(a)(11)(G) of the Advisers Act declaring them not to be investment advisers within the meaning of the Advisers Act even if the relief granted is broader than the terms of the proposed rule, but is seeking comment on that proposal.

Comment Period

The SEC has provided a relatively short comment period, seeking comments on the proposed rule on or before November 18, 2010.

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October 15, 2010

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