

**SEC ADOPTS RULE DEFINING “FAMILY OFFICE”
FOR PURPOSES OF EXCLUSION FROM THE ADVISERS ACT**

In one of its first actions to finalize rules designed to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), the Securities and Exchange Commission (the “SEC”) on June 22, 2011 adopted Rule 202(a)(11)(G)-1 (the “Rule”)¹ under the Investment Advisers Act of 1940 (the “Advisers Act”). The Rule constitutes the “family office exclusion” from the definition of “investment adviser” contained in the Advisers Act. The Rule is broader in a number of significant respects than the rule as originally proposed by the SEC in October of last year (the “Proposed Rule”)² and should provide many families the ability to operate their family offices outside the scope of the Advisers Act. In adopting the Rule, however, the SEC did not incorporate many comments it received in response to the Proposed Rule, with the result that many existing family offices, particularly multi-family offices, may need to substantially alter their operations to rely on the Rule’s exclusion or seek an individual exemption from the definition of investment adviser under the Advisers Act. Set out below is background information regarding the application of the Advisers Act to a family office, followed by a discussion of the provisions of the Rule.

Background

A “family office,” which the SEC has described as an “entit[y] established by [a] wealthy famil[y] to manage [its] wealth and provide other services to family members,” can meet the definition of “investment adviser” set out in Section 202(a)(11) of the Advisers Act.”³ If it does, the entity must register under and operate subject to the provisions of the Advisers Act, unless the entity qualifies for an exclusion from the definition of investment adviser or an exemption from registration under the Advisers Act and is not precluded from registering under the Advisers Act. According to the SEC, family offices have historically sought to rely on the “private adviser exemption” from registration set out in Section 203(b)(3) of the Advisers Act or sought individual exemptive relief from the SEC to operate outside of the scope of the Advisers Act. Prior to the enactment of the Dodd-Frank Act, the private adviser exemption exempted an entity meeting the definition of investment adviser from the requirement to register under the Advisers Act if, among other things, the entity 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. In addition, the SEC issued exemptive orders to certain family offices for which the private adviser

¹ See Investment Advisers Act Release No. 3220, June 22, 2011 (the “Release”). The Rule is enacted under Section 202(a)(11)(G) of the Advisers Act as required by Section 409 of the Dodd-Frank Act.

² The SEC released the Proposed Rule in Investment Advisers Act Release No. 3098, October 12, 2010.

³ Subject to certain exclusions, an “investment adviser” is: any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. Advisers Act, Section 202(a)(11).

exemption was otherwise unavailable.⁴ These SEC exemptive orders generally found that certain family offices were not investment advisers within the meaning of Section 202(a)(11) of the Advisers Act and were not required to register under the Advisers Act.

The Dodd-Frank Act rescinds, effective as of July 21, 2011, the private adviser exemption. As a result, a family office that currently relies on the private adviser exemption will, absent an exemptive order from the SEC, be required to register as an investment adviser under the Advisers Act no later than March 30, 2012, unless it qualifies as a “family office” excluded from the registration requirement, as described below. Family offices that satisfy the requirements of the Rule described below are not required to register under the Advisers Act because “[d]isputes among family members concerning the operation of [a] family office could . . . be resolved within the family unit or, if necessary, through state courts under laws designed to govern family disputes” and, as such, are “not the sort of arrangement that the Advisers Act was designed to regulate.”⁵

The Operation of the Family Office Exclusion

Section 202(a)(11)(G) of the Advisers Act, as amended by the Dodd-Frank Act, provides for an exclusion from the Advisers Act definition of investment adviser for “family offices” as defined by the SEC. Under the Dodd-Frank Act, the definition adopted by the SEC must be “consistent with the previous exemptive policy” of the SEC and recognize “the range of organizational, management, and employment structures and arrangements employed by family offices.” Under the Rule, an entity will qualify as a “family office” excluded from the definition of investment adviser (and, thus, from the requirement to register under the Advisers Act) if: (1) the entity has no clients other than “family clients”; (2) the entity is wholly owned by family clients and exclusively controlled (directly or indirectly) by “family members” or “family entities”; and (3) the entity does not hold itself out to the public as an investment adviser. Each of these three elements of the Rule is discussed more fully below.

No Clients Other Than “Family Clients”

An entity seeking to be an excluded family office under the Rule may not advise any client other than a “family client.” Under the Rule, a family client is defined to include (1) any “family member” (as defined below); (2) any former family member;⁶ (3) any key employee (as defined

⁴ The SEC has a long history of granting such exemptions, albeit quite slowly. In an ominous sounding footnote, the SEC said when adopting the Rule “[w]e are troubled by comment letters . . . that appear to acknowledge that [some advisers] were operating as unregistered investment advisers, although they were not eligible for the private adviser exemption and had not obtained an exemptive order from us. We note that an adviser may not ‘rely’ on exemptive orders issued to other persons.” *See* footnote 6 of the Release.

⁵ *See* Release, at 4-5.

⁶ The Rule permits a family office to provide investment advice to a “former family member,” which is defined to include: a spouse, spousal equivalent, or stepchild that was a family member but is no longer a family member due to a divorce or other similar event. Rule 202(a)(11)(G)-1(d)(7). Under the Proposed Rule, a family office would not have been permitted to provide investment advice to a former spouse except with respect to investments existing at the time the person became a former spouse. *See* Release, at 12.

below); (4) any former key employee;⁷ (5) any non-profit organization, charitable foundation, charitable trust (including charitable lead trusts and charitable remainder trusts whose only current beneficiaries are other family clients and charitable or non-profit organizations), or other charitable organization that satisfies certain requirements (as described below); (6) any estate of a family member, former family member, key employee, or former key employee;⁸ (7) any irrevocable trust in which one or more other family clients are the only current beneficiaries;⁹ (8) any irrevocable trust funded exclusively by one or more other family clients in which other family clients and non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations are the only current beneficiaries; (9) any revocable trust of which one or more other family clients are the sole grantors;¹⁰ (10) any trust of which each trustee (or other person authorized to make decisions with respect to the trust) is a key employee and each settlor (or other person who has contributed assets to the trust) is a key employee or the key employee's current and/or former spouse or spousal equivalent who, at the time of contribution, holds a joint, community property, or other similar shared ownership interest with the key employee; and (11) any company wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more other family clients; provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of "investment company" under the Investment Company Act of 1940.

Family Member. The Rule defines "family member" as all lineal descendants¹¹ of a common ancestor (who may be living or deceased), and such lineal descendants' spouses or spousal equivalents. The common ancestor, however, can be no more than 10 generations removed from

⁷ The Rule permits a family office to continue to provide investment advice with respect to investments made by a former key employee prior to the end of such individual's employment (and with respect to investments that the former key employee became contractually obligated to make prior to the end of such individual's employment). A former key employee cannot, however, make additional investments after the end of such individual's employment, other than pursuant to a contractual obligation entered into prior to the end of such individual's employment. The Rule does not require a former key employee to liquidate or transfer such individual's investments held through the family office as a criterion for the family office to rely on the Rule's exclusion. *See* Release, at 29.

⁸ The estate of a former key employee is subject to the limitations described in footnote 7.

⁹ Under the Rule, a family office can provide investment advice to an irrevocable trust that is funded in whole or in part by non-family clients if the *current* beneficiaries of the irrevocable trust are family clients. In adopting the Rule, the SEC noted that a contingent beneficiary is not a *current* beneficiary. *See* Release, at 15. The Rule provides for a one year transition period if a contingent beneficiary becomes an actual beneficiary (*i.e.*, a current beneficiary) who is not permitted to be advised by a family office. Rule 202(a)(11)(G)-1(b)(1). *See* "Involuntary Transfers" below for a further discussion of the one year transition period in connection with involuntary transfers to non-family clients.

¹⁰ Under the Rule, the beneficiaries of a revocable trust need not be family clients. In taking this position, the SEC noted that "the contingent nature of any beneficiary's expectation that it will benefit from the [revocable] trust's assets supports disregarding a revocable trust's beneficiaries under the exclusion." *See* Release, at 17.

¹¹ Lineal descendants, for these purposes, include lineal descendants by adoption, stepchildren, foster children, and individuals that were a minor when another family member became a legal guardian of that individual. Rule 202(a)(11)(G)-1(d)(6).

the youngest generation of family members. The “common ancestor” concept was not part of the Proposed Rule, and it broadens the reach of the Rule by providing in effect that a family can determine to a significant extent the family members who can be advised by the family office.¹² The family office may designate a common ancestor and provide investment advice to the family members of the common ancestor (and to certain other persons and entities).

A family office may change the person that it designates as the common ancestor, and is not required to submit any formal documentation to the SEC or follow any formal procedure in doing so. If, for example, a family designated a paternal grandfather (or paternal grandmother) as the common ancestor, the family office could provide investment advice to the paternal aunts and uncles (and their spouses, spousal equivalents, and lineal descendants), and could change this designation as necessary or desired (to include, for instance, later generations). The Rule appears not to afford a family that designates a paternal grandfather as the common ancestor the ability to advise maternal aunts and maternal uncles (or their spouses, spousal equivalents, and their lineal descendants) through the family office. Furthermore, for a family office to advise paternal grandparents, the family would have to designate a paternal great grandparent as the common ancestor.¹³

Key Employee. Under the Rule, a family office can provide investment advice to any key employee of the family office.¹⁴ The Rule expands the Proposed Rule to include within the definition of key employee any person who is a key employee of an affiliated family office. The SEC acknowledged that some families may establish multiple family offices for tax-planning purposes or for other reasons and that a family office should be permitted to provide investment advice to key employees of those affiliated family offices. The Rule does not, however, permit a family office (the “first family office”) to provide investment advice to *any* employees of *any* affiliated entity; rather, the employee must be a key employee of the affiliated entity and the affiliated entity must be a family office that (1) is wholly owned by family clients of the first

¹² The Proposed Rule did not include the “common ancestor” concept used in the Rule, and instead contemplated a family office centered around a “founder.” Under the Proposed Rule, the family office could have provided investment advice to the founder’s lineal descendants, parents, and siblings (and lineal descendants of the founder’s siblings). In employing the common ancestor concept, the Rule enables a family office to provide investment advice to more family members than would have been the case under the Proposed Rule.

¹³ The common ancestor and his or her spouse or spousal equivalent are not included in the definition of family member. As a result, a family office seeking to rely on the Rule may not provide investment advice to the common ancestor or his or her spouse or spousal equivalent. This result can be avoided by designating a common ancestor from the immediately preceding generation.

¹⁴ The Rule defines “key employee” to mean: any natural person (including any key employee’s spouse or spouse equivalent who holds a joint, community property, or other similar shared ownership interest with that key employee) who is an executive officer, director, trustee, general partner, or person serving in a similar capacity of the family office or its affiliated family office or any employee of the family office or its affiliated 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 or affiliated family office, provided that such employee has been performing such functions and duties for or on behalf of the family office or affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months. Rule 202(a)(11)(G)-1(d)(8).

family office, (2) is controlled by family members of the first family office (or controlled by family entities affiliated with the first family office), and (3) has no clients other than family clients of the first family office.

Non-Profit Organization, Charitable Foundation, Charitable Trust, or Other Charitable Organization. Under the Rule, a family office can provide investment advice to any non-profit organization, charitable foundation, charitable trust (including charitable lead trusts and charitable remainder trusts whose only current beneficiaries are other family clients and charitable or non-profit organizations), or other charitable organization that is funded entirely by family clients.¹⁵ Although limiting the Rule in this manner, the SEC recognized that many existing family offices provide investment advice to non-profit and charitable organizations that have received funding from non-family clients, and provided in the Rule that a family office can continue to provide investment advice until December 31, 2013 to any non-profit or charitable organization that has received funding from non-family clients, *so long as* the organization does not accept additional funding from non-family clients after August 31, 2011 (other than funding subject to a pledge made prior to August 31, 2011 and to be fulfilled prior to December 31, 2013). After December 31, 2013, all non-profit and charitable organizations advised by a family office must hold funding exclusively from family clients. For purposes of determining whether a non-profit or charitable organization is funded by non-family clients, the organization may, according to the SEC, “offset any spending by the organization occurring at any time in the year of that non-family client contribution or any subsequent year against the non-family client contribution (*i.e.*, the organization may treat the non-family client contributions as the first funding spent).”¹⁶

Ownership and Control

An entity seeking to be an excluded family office under the Rule must be wholly owned by family clients and exclusively controlled (directly or indirectly) by one or more family members and/or family entities.¹⁷ Under the Proposed Rule, family members (and not other family clients, such as key employees) would have to have wholly owned the family office. The Rule broadens the category of individuals who can participate in the ownership of the family office so that, for example, a key employee who is not a family member can own a portion of the family office.

¹⁵ Under the Proposed Rule, a family office could have provided investment advice to charitable organizations that are funded entirely by *family members*. Under the Rule, a family office can provide investment advice to charitable organizations (and non-profit organizations) that are funded entirely by *family clients*. This revision enables key employees (and other family clients) to contribute to charitable organizations and non-profit organizations that are advised by the family office. *See* Release, at 18.

¹⁶ The SEC also noted that “only the actual contributions to the non-profit or charitable organization need be examined for this purpose, and not any income, gains or losses relating to those contributions.” *See* footnote 66 of the Release.

¹⁷ The Rule defines “family entity” to mean: the trusts, estates, companies or other entities set forth in paragraphs (v), (vi), (vii), (viii), (ix), or (xi) of subsection (d)(4) of the Rule, but excluding key employees and their trusts from the definition of family client solely for purposes of this definition. Rule 202(a)(11)(G)-1(d)(5).

The Proposed Rule was broader than the Rule in one important respect, however. Under the Proposed Rule, the family office could be “controlled (directly or indirectly) by family members.” This provision would have enabled a non-family member (such as a key employee) to serve as a director of the family office, so long as the family office was still controlled by family members. The Rule, in contrast, requires that the family office be “exclusively controlled” by family members or family entities. As a result, a question is presented as to whether a key employee who is not a family member may serve as a director of a family office (although, given the definition of “control,”¹⁸ a key employee clearly is permitted to serve as an officer of the family office).

Holding Out to the Public

An entity seeking to be an excluded family office under the Rule may not hold itself out to the public as an investment adviser. The Rule is identical to the Proposed Rule in this regard.

Miscellaneous Matters

Grandfathering Provision

As required by the Dodd-Frank Act, the Rule contains a grandfathering provision that includes within the definition of family office any person who 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 (1) certain officers, directors, and employees of the family office who are accredited investors;¹⁹ (2) any company owned exclusively and controlled by one or more family members; or (3) any registered investment adviser that provides investment advice to the family office and who identifies investment opportunities to the family office, and invests in such transactions on substantially the same terms as the family office invests, but does 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 represents, in the aggregate, not more than 5 percent of the value of the total assets as to which the family office provides investment advice.²⁰ The grandfathering provision seems designed to apply to specific family offices in operation at the time of the passage of the Dodd-Frank Act and would appear to provide limited relief, if any, to family offices generally.

¹⁸ The Rule defines “control” to mean: the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company. Rule 202(a)(11)(G)-1(d)(2).

¹⁹ The term “accredited investor” is defined in Regulation D under the Securities Act of 1933.

²⁰ A family office that would not be a family office but for this grandfathering provision is still subject to most of the anti-fraud provisions in the Advisers Act. Rule 202(a)(11)(G)-1(c)(3).

Multi-Family Offices

In perhaps the most disappointing aspect of the Rule, the Rule's exclusion is not available to a family office providing investment advice to more than one family. In response to comments that the Rule should cover such multi-family offices, the SEC said that it did not believe the Rule could be drafted so as to meaningfully distinguish between multi-family offices and commercial advisory firms that provide investment advice to multiple families. The SEC also noted its view that multiple families advised by the same unregistered family office could be faced with potential conflicts of interest or disputes, but would not be afforded all of the protections of the Advisers Act or the necessary family relationships that serve as the policy basis for excluding single family offices from the Advisers Act. In a footnote of some consequence, the SEC added that if several families were to establish family offices and staff these family offices with "the same or substantially the same employees," then such family offices might be in violation of Section 208(d) of the Advisers Act and could not claim the family office exclusion provided by the Rule.²¹

Involuntary Transfers

Under the Rule, a family office can continue to provide investment advice to non-family clients who receive assets as a result of an involuntary transfer (such as a bequest) for a period of one year. Under the Proposed Rule, a family office would have been able to continue to provide investment advice to a non-family client for four months following an involuntary transfer. In response to numerous comments on the Proposed Rule, the SEC decided that a one year period is necessary to permit a family office to properly transition the non-family client's assets to another investment adviser. The one year period begins following the completion of the transfer of legal title to the assets resulting from the involuntary event.²²

State Law Preemption

The Rule 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 of the Advisers Act.²³ As a result, entities that qualify as family offices under the Rule would not

²¹ Section 208(d) provides that "[i]t shall be unlawful for any person indirectly, or through or by any other person, to do any act or thing which it would be unlawful for such person to do directly under the provisions of this title or any rule or regulation thereunder." Advisers Act, Section 208(d).

²² The SEC noted in a footnote when adopting the Rule that "if the involuntary transferee does not receive investment advice about securities for compensation from the family office, then the availability of the [Rule] would be unaffected." This footnote suggests that a family office could continue to provide investment advice *gratis* to involuntary transferees beyond the one year period. See footnote 47 of the Release.

²³ "No law of any State or political subdivision thereof requiring the registration, licensing, or qualification as an investment adviser or supervised person of an investment adviser shall apply to any person . . . that is not registered under section 203 because that person is excepted from the definition of an investment adviser under section 202(a)(11)." Advisers Act, Section 203A(b)(1)(B).

be subject to registration as investment advisers under the Advisers Act or under applicable state securities laws.

Previously Issued SEC Exemptive Orders

As described above, the SEC has issued exemptive orders to certain family offices, determining that those family offices were not investment advisers within the meaning of the Advisers Act. The SEC will not be rescinding any of the exemptive orders that it previously issued under the Advisers Act to those family offices even if the relief granted in the exemptive orders is broader than the terms of the Rule (*i.e.*, family offices that have received exemptive orders will not be required to register as investment advisers under the Advisers Act even if they do not satisfy the criteria set out in the Rule).²⁴

Effective Date of Rule

Under newly adopted Rule 203-1(e), an entity that, prior to July 21, 2011, is properly exempt from registering as an investment adviser under the Advisers Act in reliance upon the “private adviser exemption,”²⁵ but is unable to rely on the Rule²⁶ (or another exemption), is not required to register with the SEC until March 30, 2012.²⁷ To qualify for the delayed registration under Rule 203-1(e) the entity must have had fewer than 15 clients during the course of the preceding 12 months and must not have held itself out generally to the public as an investment adviser (or act as an adviser to a registered investment company or business development company).

Proposed Amendment

On June 16, 2011, Representative Hensarling (R-Texas) introduced H.R. 2225, legislation that would amend the Advisers Act to define “family office” in a manner that would include many advisers that are not covered by the Rule adopted by the SEC.²⁸ Included among those advisers are family offices that have no clients other than family clients and are (1) owned, directly or indirectly, by family clients, (2) controlled, directly or indirectly, by family clients, or (3) operated primarily for the benefit of family clients. H.R. 2225 defines “family client” to include, among other persons and entities, (a) any charitable foundation, charitable organization, charitable trust, or other non-profit organization established or controlled, directly or indirectly, by persons one or more of whom is a family client; and (b) any trust or estate funded exclusively

²⁴ See Release, at 36.

²⁵ Advisers Act, Section 203(b)(3).

²⁶ The Rule will become effective 60 days after the date it is published in the Federal Register. See Release, at 1.

²⁷ Rule 203-1(e). The SEC may require up to 45 days to approve initial registration applications. As a result, entities relying on Rule 203-1(e) should file a complete application (Part 1 and a brochure(s) meeting the requirements of Part 2 of Form ADV) no later than February 14, 2012 in order to be properly registered by March 30, 2012. See Investment Advisers Act Release No. 3221, June 22, 2011, at 94-95.

²⁸ The text of H.R. 2225 is available at <http://thomas.loc.gov/cgi-bin/query/z?c112:H.R.2225>.

by one or more family members or established primarily for the benefit of one or more family clients. H.R. 2225 was referred to the House Committee on Financial Services and has six co-sponsors. At this time, no similar bill has been introduced in the Senate, and it is unclear whether H.R. 2225 will move forward in the House of Representatives or ultimately be enacted.

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If you have any questions regarding this memorandum, please contact Barry P. Barbash (202-303-1201, bbarbash@willkie.com), Daniel Schloendorn (212-728-8265, dschloendorn@willkie.com), Timothy C. Harker (202-303-1138, tharker@willkie.com), or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, DC 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, DC telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

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