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A legal update from Dechert's Financial Services Group

SEC Proposes Family Office Rule

The U.S. Securities and Exchange Commission (the "SEC") on October 12, 2010 proposed a new rule, Rule 202(a)(11)(G)-1, under the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act"), defining the term "family office" for purposes of the exclusion from the definition of "investment adviser" provided by Section 202(a)(11)(G) of the Advisers Act, which was added to the Advisers Act by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1] The proposed rule represents the SEC's first step toward adopting the required rules to fully implement Dodd-Frank's provisions affecting private fund managers and other currently unregistered investment advisers.[2]

Family offices meeting the definition in the rule as eventually adopted would be excluded from the definition of the term investment adviser for purposes of the Advisers Act and would not be subject to any of the requirements of the Advisers Act or the rules thereunder (including the registration provisions). Conversely, family offices that do not meet the definition in the rule would be required to register with the SEC, or one or more state securities regulators, as investment advisers and to comply with the Advisers Act and the rules thereunder, unless they meet the requirements of an exemption from registration or are able to rely on exemptive relief.

Family Offices Excluded from the Definition of Investment Adviser

Under the proposed rule, a family office would be excluded from the definition of an investment adviser under the Advisers Act if it:

- has no clients other than ***family clients*** (subject to a limited exception discussed below);
- is wholly owned and controlled (directly or indirectly) by ***family members***; and
- does not hold itself out to the public as an investment adviser.

Permitted Family Clients

Under the proposed rule, a family office's clients must be limited to:

- ***family members***;
- ***key employees***;
- charitable foundations, charitable organizations, or charitable trusts, in each case established and funded exclusively by one or more family members or former family members;
- trusts or estates existing for the sole benefit of one or more family clients; any limited liability company, partnership, corporation, or other entity wholly owned and controlled (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more family clients, provided that if any such entity is a

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1 *Family Offices*, SEC Rel. No. IA-3098 (Oct. 12, 2010).

2 Family offices that are currently registered but that meet the terms of Rule 202(a)(11)(G)-1 would be able to withdraw from registration upon the effectiveness of the rule.

pooled investment vehicle, it is excepted from the definition of "investment company" under the U.S. Investment Company Act of 1940;

- ***former family members*** (subject to the conditions discussed below); or
- ***former key employees*** (subject to the conditions discussed below).

A family office may choose not to have clients in any one or more of these categories in its discretion. A family office that provides investment advice to other types of clients not on the list above or to multiple families would not be able to rely on the exclusion, and would have to (a) register as an investment adviser, (b) qualify for an exemption, or (c) apply for and receive specific exemptive relief. The SEC has not proposed repealing exemptive relief it has previously issued, so family offices that currently rely on existing exemptive relief could chose to continue to comply with the conditions of such relief rather than relying on the new rule.

Family Members and Former Family Members

For purposes of the proposed rule, the term "family member" means:

- the natural person and his or her spouse or spousal equivalent (i.e., a cohabitant occupying a relationship generally equivalent to that of a spouse) for whose benefit the family office was established and any subsequent spouse of such individuals (the "founders");
- the lineal descendants of the founders (including by adoption and stepchildren), and such lineal descendants' spouses or spousal equivalents;
- the parents of the founders; and
- 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.

The SEC crafted most of this list of family members from the specific requests for exemptive relief it had previously granted, but it added stepchildren, parents of the founders and spousal equivalents to craft a rule of general applicability. Absent from this list of family members, however, are aunts, uncles and cousins of the founders, for example.

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 would be considered a "former family member" under the proposed rule. However, if the founders divorce, both spouses would apparently remain family members as a result of the definition of founder and, accordingly, all the family members from both sides of that marriage would apparently also remain family members despite the divorce of the founders.

Former family members would be permitted to be considered family clients provided that from and after becoming a former family member the individual does not receive investment advice from the family office (or invest additional assets with a family office-advised trust, foundation or entity) other than with respect to assets advised (directly or indirectly) by the family office immediately prior to the time that the individual became a former family member. Notwithstanding the above, the family office would be permitted to provide investment advice to a former family member with respect to additional investments that the former family member was contractually obligated to make, and that relate to a family-office advised investment existing, in each case, prior to the time the person became a former family member.

Key Employees and Former Key Employees

In order to permit family offices to provide incentives to attract talented investment professionals, the SEC has proposed that certain "key employees" of the family office be permitted to be included as "family clients."[3]

[3] However, key employees would not be considered "family members" and, as a result, would not be permitted to have an equity interest in the family office itself. This prohibition would limit a family office's ability to provide the full range of incentive compensation options that other types of registered investment advisers may be able to offer. The proposing release notes that "[r]equiring that the family office be wholly owned by family members alleviates any concern that we may otherwise have about the profit structure . . . because any profits generated . . . only accrue to family members" but also requests comment as to whether minor ownership stakes should be permitted for non-family members.

Under the proposed rule, the term "key employee" includes:

- any executive officer, director, trustee, general partner, or other person serving in a similar capacity of the family office, and
- 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.

This definition is based on the "knowledgeable employee standard" of Rule 205-3(d)(iii) under the Advisers Act, which specifies the types of clients that may be charged performance fees.

As with former family members, former key employees may be considered family clients provided that upon the end of such individual's employment by the family office, the former key employee does not receive investment advice from the family office (or invest additional assets with a family office-advised trust, foundation or entity) other than with respect to assets advised (directly or indirectly) by the family office immediately prior to the end of such individual's employment. Notwithstanding the above, the family office would be permitted to provide investment advice to a former key employee with respect to additional investments that the former key employee was contractually obligated to make, and that relate to a family-office advised investment existing, in each case, prior to the time the person became a former key employee.

Involuntary Transfers from a Family Client

If a person that is not a family client becomes a client of the family office as a result of the death of a family member or key employee or other involuntary transfer from a family member or key employee, that person could be treated as a family client for up to four months following the transfer of assets resulting from the involuntary event. However, if after four months that transferee is still a client of the family office, the family office would no longer be able to rely on the exclusion provided by the proposed rule. This provision is intended to allow for the orderly transition of management services with respect to transferred assets.

Grandfathering Required Under Dodd-Frank

The proposed rule also contains the grandfathering provisions required by Dodd-Frank. Accordingly, the SEC has proposed that the definition of family office shall not exclude any person who was not registered or required to be registered under the Advisers Act on January 1, 2010, solely because such person provides investment advice to, and was engaged before January 1, 2010 in providing investment advice to, the categories of persons and entities set out in Section 409(b)(3) of Dodd-Frank.

Grandfathered family offices would not be not required to register as an investment adviser but would be subject to certain anti-fraud provisions of the Advisers Act.

Request for Comment

The SEC has requested comment on, among other things, the definition of family member. Comments are due by November 18, 2010.

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