

To: Our Clients and Friends

November 1, 2010

## SEC Proposes “Family Office” Exemption From Definition of Investment Adviser

On October 12, 2010, the U.S. Securities and Exchange Commission (the “SEC”) proposed Rule 202(a)(11)(G)-1 (the “Proposed Rule”) under the Investment Advisers Act of 1940, as amended (the “Advisers Act”) to define family offices for purposes of excluding them from the definition of “investment adviser.”<sup>1</sup>

Historically, both domestic and foreign family offices have relied on the current private adviser exemption from SEC registration for investment advisers with fewer than 15 clients (the “Private Adviser Exemption”) or on exemptive orders granted by the SEC. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) repeals the Private Adviser Exemption, but creates a new exclusion from the definition of investment adviser under the Advisers Act for family offices, as defined by the SEC. The Dodd-Frank Act requires the SEC to adopt a definition of family office that is consistent with its previous exemptive orders and that recognizes the range of organizational, management and employment structures and arrangements employed by family offices.

### The Proposed Rule

Under Proposed Rule 202(a)(11)(G)-1, a “family office” will be excluded from the definition of “investment adviser” under the Advisers Act if it meets each of the following three conditions:

- **The family office provides advice to “family clients” exclusively.** A family office may have no investment advisory clients other than “family clients.” “Family clients” include:

*Family members.* “Family members” include the individual for whose benefit the family office was established and such individual’s spouse or spousal equivalent, parents, siblings and their spouses or spousal equivalents, and lineal descendants (including by adoption and stepchildren) and their spouses or spousal equivalents.

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<sup>1</sup> Family Offices, Investment Advisers Act Release No. IA-3098 (October 12, 2010) (the “Release”).

*Key employees.* The Proposed Rule permits a family office to provide investment advice to “key employees” without losing the benefit of the exemption. A “key employee” is any natural person (including a person who holds joint community property with his or her spouse) who is (i) an executive officer, director, trustee, general partner, or person serving in a similar capacity of the family office or (ii) any other employee of the family office (other than an employee performing solely clerical, secretarial, or administrative functions) who, in connection with his or her regular duties, has participated in investment activities of the family office (or similar functions or duties for or on behalf of another company) for at least twelve months.

*Family trusts, charitable organizations and other family entities.* Under the Proposed Rule, a family office may provide investment advice to any charitable foundation, charitable organization or charitable trust that is established and funded exclusively by one or more “family members” and any trust or estate existing for the sole benefit of one or more family clients. The SEC further proposes treating as a family client any pooled investment vehicle that is wholly owned and controlled, directly or indirectly, by one or more family clients and operated for the sole benefit of family clients.

*Involuntary transfers and former family members or key employees.* The Proposed Rule also includes provisions relating to certain involuntary transfers to non-family members and the provision of advice to former family members and key employees. In the event that a family office’s assets under management are transferred involuntarily (for example, through a family member’s will) from a family member to a non-family member, the Proposed Rule allows the family office to continue to advise the client for up to four months following the involuntary transfer without forfeiting its exemptive status. The Proposed Rule also proposes permitting the family office to continue to advise former family members and former key employees regarding assets that were under the family office’s management immediately prior to the family member or employee becoming a former family member or key employee.

- **The family office is wholly owned and controlled, directly or indirectly, by family members.** A family office is exempt from registration only if it is wholly owned and controlled, directly or indirectly, by the family members described above. “Control” means the power to exercise a controlling influence over the management or policies of the company, unless such power is solely the result of being an officer of the company. The SEC proposes to include this ownership and control condition to ensure that any profits generated by the family office from managing family clients’ assets accrue only to family members and to distinguish family offices from family-run offices that provide advice to persons other than family members.

As proposed, the ownership and control condition in the Proposed Rule may impact the structure of a family office’s provision of incentives to its key management. Although the Proposed Rule permits a family office to have a key employee as a family client, it does not include key employees in the definition of family member. Accordingly, the Proposed Rule lacks clarity on whether family offices can offer to key employees a profits interest or other economic interest, although the intent of the Proposed Rule and the release suggest that they may do so.

- **The office does not hold itself out as an investment adviser.** Consistent with prior SEC practice, the Proposed Rule prohibits a family office from holding itself out to the public as an investment adviser.

## Grandfathering Provisions

The Dodd-Frank Act specifically requires the SEC to “grandfather in” to its definition of “family office” any advisers who provided investment advice to certain clients on or before January 1, 2010.

Accordingly, the Proposed Rule provides that a family office is exempt from registration (even if it does not meet each of the conditions described above) if the office was not registered or required to be registered under the Advisers Act on January 1, 2010, solely because the office provides investment advice, and was engaged in providing such advice prior to January 1, 2010, to (i) natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office, have invested with the family office before January 1, 2010, and are accredited investors; (ii) any company owned and exclusively controlled by one or more family member; and (iii) any registered investment adviser that provides investment advice to the family office for assets representing not more than five percent of the value of the total assets for which the family office provides advice and that identifies investment opportunities to the family office, so long as the adviser invests in such transactions on substantially the same terms as the family office invests. Family offices that are exempt from registration pursuant to these grandfathering provisions would continue to be subject to the anti-fraud provisions of the Advisers Act.

## Exemptive Relief Still Available

The Proposed Rule notes family offices would remain free to seek an SEC exemptive order to advise an individual or entity that does not meet the proposed family client definition. Moreover, the SEC will not rescind prior exemptive orders that it has issued to family offices, as the policy underlying them does not differ substantially from that of the Proposed Rule.

## Comments and Timeline

The SEC is accepting comments on the Proposed Rule, including the definition of “family client” and the condition that the family office must be wholly owned and controlled by family members, until November 18, 2010. The final family office rule will likely become effective in the late spring of 2011.

If you would like to discuss how this matter may affect your organization, please contact any of the following members of Bryan Cave’s [Private Client Group](#):

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