SEC Adopts Final Rule Defining Family Offices Exempt From SEC Registration

On June 22, 2011, the Securities and Exchange Commission (the "SEC") adopted Rule 202(a)(11)(G)-1 under the *Investment Advisers Act of 1940* ("Advisers Act") to create an exemption from registration for qualified "family offices." The new rule comes in the wake of the repeal of the so-called "private adviser exemption" under the Advisers Act by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("Dodd-Frank"). Ropes & Gray's alert regarding the repeal of the private adviser exemption and related SEC rule changes can be found here.

Many family offices that have relied on the private adviser exemption to operate without investment adviser registration with the SEC will have to instead rely on the new "Family Office Rule" if eligible to do so, or otherwise register as investment advisers. A family office may rely on the new rule only if: (1) the family office provides advice about securities only to "family clients;" (2) family clients wholly own the family office and "family members" and/or "family entities" control the family office; and (3) the family office does not hold itself out to the public as an investment adviser. Family offices that primarily provide investment advice to members of a single family and are exempt from registration as of July 20, 2011 in reliance on the private adviser exemption have until March 30, 2012 to either comply with the Family Office Rule or else register as investment advisers.

A summary of the Family Office Rule appears below. The SEC's release adopting the Family Office Rule may be found here.

Who Are "Family Clients"?

Under the Family Office Rule "family clients" include family members, certain current (and in some cases former) family office employees, foundations and other charities funded exclusively by family clients, estates of family members or key employees, certain trusts, and companies/vehicles wholly and exclusively owned by and operated for family clients.

Family Members. The definition of family member in the rule proposal referred to the "founder" of the family office and, as such, did not necessarily encompass the family member(s) who created the family wealth or prevailing family legal instruments or their lineal descendants. The final rule addresses related concerns raised during the comment process by expanding the definition of family members to include all lineal descendents of a common ancestor (living or deceased) no more than 10 generations removed from the youngest generation. The Family Office Rule also provides flexibility for family offices to redesignate the common ancestor over time, in an effort to place family offices that are newly established and those that are generations old on a level playing field. The SEC adopting release notes that no formal documentation or procedure is required when designating or redesignating the common ancestor. "Family members" also include adopted children, current and former stepchildren, foster children, children in legal guardianship relationships, and current and former spouses (or spousal equivalents). This unqualified inclusion of former spouses in the definition of family members is more permissive than the proposed rule, which contained a proviso that former spouses could not receive advice from the family office with respect to investments made post-divorce.

The final rule also allows a person who becomes a client of the family office as a result of a bequest or other involuntary transfer to be deemed a family client for one year (beginning upon completion of the transfer of legal title), as opposed to the four month period originally proposed. Thereafter, however, if the client does not otherwise satisfy the definition of family client, the responsibility for advising with respect to such assets needs to be moved to another adviser or the family office must register or otherwise restructure its activities to comply with the Advisers Act. The release notes that a family office may continue to rely on the Family Office Rule if it does not provide investment advice about securities for compensation to the recipient of the involuntary transfer. While making such a determination may involve a facts and circumstances test, this may provide a family office with some flexibility in determining how to address situations in which it obtains a non-family client through a bequest or other involuntary transfer of assets.

Employees. Certain key employees (including spouses or spousal equivalents when there is a joint property interest), their estates, and certain entities through which the employees may invest are also treated as family clients. A family office is permitted to provide investment advice to, and make investment opportunities available to: (1) executive officers, directors, trustees, general partners, or persons serving in a similar capacity at the family office or an "affiliated family office," and (2) certain other employees of the family office or an affiliated family office that participate, as part of their regular functions or duties, in the investment activities of the family office or affiliated family office, provided they have been doing so for at least twelve months. Family clients also include trusts of which the eligible employee (or a current or former spouse or spousal equivalent, in certain circumstances) is the sole contributor to the trust and the key employee is the sole person authorized to make decisions with respect to the trust. After a key employee leaves the family office, he or she remains a family client if the only investment advice he or she receives relates to assets advised by the family office immediately prior to the key employee's departure and additional investments that the former key employee was contractually obligated to make, and that related to a family-office advised investment existing, in each case, prior to the key employee's departure.

Foundations and Other Charities. Certain foundations and other charitable and non-profit organizations are also family clients. The rule, as adopted, provides that such an organization will qualify as a family client only if all of the funding it currently holds came exclusively from one or more other family clients. The SEC provided a special transition rule that allows a family office advising such an organization that does not satisfy these criteria until December 31, 2013 to register as an adviser or otherwise address the issues raised by the office's services to the organization (e.g., discontinue providing services to the organization, restructure the organization, or arrange to have the organization dispose of the non-family funding) and remain unregistered, provided that the organization does not accept contributions from non-family clients after August 31, 2011, except for contributions received prior to December 31, 2013 pursuant to a pledge made prior to August 31, 2011.

Trusts and Estates. Certain family trusts also fall under the "family client" definition. The Family Office Rule treats as family clients all irrevocable trusts in which one or more family clients are the only *current* beneficiaries; the final rule disregards contingent beneficiaries for purposes of identifying *current* beneficiaries. The final rule also designates as "family clients" irrevocable trusts funded exclusively by one or more family clients in which the only current beneficiaries are other family clients and non-profit organizations and charitable foundations, trusts, or organizations. Revocable trusts, however, count as family clients if the sole grantor(s) are family clients — regardless of whether the current beneficiaries are or are not family clients — because of the extent of control the grantor exercises over such a trust. Estates are family clients if they are the estates of a family member, former family member, key employee, or, if conditions are satisfied, former key employee.

Other Family Entities. Any companies, including pooled investment vehicles (provided they are excepted from the definition of investment company under the *Investment Company Act of 1940*), wholly owned, directly or indirectly, by one or more family clients and operated for the sole benefit of family clients are also treated as family clients under the Family Office Rule. The final rule eliminates a requirement in the proposed rule that the entity also be controlled by family clients.

Additional Requirements for Reliance on the Family Office Rule

To qualify for exclusion from registration under the Advisers Act, the Family Office Rule further requires that the family office itself be (a) wholly owned by family clients and (b) exclusively controlled, directly or indirectly, by one or more family members and related entities. This represents a relaxation of the proposed rule, under which only "family members" were permitted to own the family office. The broader ownership definition will permit arrangements under which key employees own a non-controlling stake in the family office (e.g., through incentive compensation plans). The final rule, however, retains the proposed requirements that control of family offices be restricted exclusively to family members or family entities.

Finally, to qualify for exclusion under the Family Office Rule, a family office may not hold itself out to the public as an investment adviser. A family office that is currently registered as an investment adviser and chooses to deregister in reliance on the Family Office Rule is not precluded from relying on the rule because it held itself out to the public as an investment adviser while it was registered.

The SEC declined to extend the Family Office Rule to family offices serving multiple families and noted that if several unrelated families establish separate family offices that are staffed with the same or substantially the same employees, these families have established *de facto* multifamily offices that are not eligible to rely on the rule.

Grandfathering Provision; Exemptive Orders

As required by Dodd-Frank, the Family Office Rule provides a grandfathering exemption with respect to certain clients of a family office prior to January 1, 2010 that would not otherwise qualify as "family clients" under the rule. Specifically, the exemption from registration provided by the Family Office Rule explicitly does not exclude from the definition of a family office eligible to rely on the rule a person 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 following clients: (1) natural persons, who at the time of their investment were officers, directors, or employees of the family office, who invested with the family office before January 1, 2010, and who are accredited investors; (2) any company owned exclusively and controlled by family members; and (3) a registered investment adviser that advises the family office, identifies investment opportunities to the family office, invests in such opportunities 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 represent, in the aggregate, not more than 5% of the value of the total assets as to which the family office provides investment advice. However, such a family office is deemed to be an investment adviser for purposes of the anti-fraud provisions of the Advisers Act.

Exemptive orders previously issued to family offices under section 202(a)(11)(G) of the Advisers Act will not be rescinded even if the particular family office would not be exempt from Advisers Act registration under the Family Office Rule.

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If you would like to learn more about the issues raised in this alert, please contact your usual Ropes & Gray adviser.