HUNTON& WILLIAMS

PRIVATE INVESTMENT FUND UPDATE

November 2010 SEC Implementation of the Dodd-Frank Wall Street Reform Act

SEC Proposes "Family Office" Definition

On October 12, 2010, the Securities and Exchange Commission ("SEC") proposed new Rule 202(a)(11)(G)-1 (the "Proposed Rule") to define the term "family office" under the Investment Advisers Act of 1940 (the "Advisers Act"), as required by Section 409 of the "Dodd-Frank Wall Street Reform and Consumer Protection Act" ("Dodd-Frank"). Family offices that comply with the final version of the rules, once they are adopted, will not be required to register or comply with the Advisers Act. A copy of the SEC's Proposing Release is available here.

Background

Family offices generally provide a range of services, including investment advisory services, to wealthy family members. Such services typically are the type of services that would be regulated by the Advisers Act. Currently, many family offices rely on specific SEC exemptive orders or Advisers Act exemptions, such as the "private adviser exemption" (also known as the 15 client rule), to avoid registration.

Dodd-Frank amended the Advisers Act (a) to eliminate the private adviser exemption and (b) to impose enhanced reporting and disclosure requirements on all registered investment advisers. While these reforms were perhaps directed primarily at hedge fund and other private fund managers, they also impact other types of managers, such as family offices. However, consistent with previous SEC exemptive policy, Dodd-Frank amended Section 202(a)(11) of the Advisers Act to provide that "family offices" are not "investment advisers" subject to regulation under the Advisers Act, but left to the SEC the discretion to define the scope of the exclusion. The Proposed Rule is the first step in this process and, following a comment period, the SEC will adopt final rules, which may differ from the proposals in the Proposed Rule.

For additional information on the impact of Dodd-Frank on investment advisers, please see our memorandum Dodd-Frank Act Impacts Private Fund Advisers.

Scope of the Proposed Rule

The Proposed Rule requires single family offices to satisfy three conditions in order to avoid regulation as investment advisers under the Advisers Act. The Proposed Rule provides that a family office is a company (including its directors, partners, trustees and employees acting within the scope of their position or employment) that:

1. Has no clients other than "family clients";
2. Is wholly owned and "controlled" (directly or indirectly) by family members; and
3. Does not hold itself out to the public as an investment adviser.

Under the Proposed Rule, **"Family Clients"** include the following individuals:

- Any "family member" or "former family member" (as discussed below); or
- Any "key employee" or "former key employee" (as discussed below).

Family clients also include certain entities, including:

- Any charitable foundation, charitable organization or charitable trust, in each case established and funded exclusively by one or more family members or former family members;
- Any trust or estate existing for the sole benefit of one or more family clients; or
- 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, subject to the special rules for pooled investment vehicles discussed below.

Under the Proposed Rule, **"Family Members"** include:

- the "founders," their lineal descendants (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.

While the SEC exemptive orders included adopted children, they generally have not included stepchildren, spousal equivalents and parents of the founders as family members. Thus the SEC definition reflects an expansion of the current approach under the exemptive orders. In particular, the SEC is focused on including within the definition of family members those with close ties to the family and is seeking to draw the line where the clientele of a family office starts to resemble that of a typical commercial investment adviser. For example, as drafted, the Proposed Rule excludes from regulation only single-family offices and does not exempt multifamily offices due to a concern that multifamily offices more closely resemble commercial investment advisers. The SEC recognizes that patterns of wealth accumulation and the nature of families have evolved in recent years and is soliciting comments on the appropriate breadth of the family member definition.

Under the Proposed Rule, a "**Key Employee**" must:

- be a 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);
- be 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; and
- in connection with his or her regular functions or duties, participate in the investment activities of the family office and have 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.

Key employees do not include any employee performing solely clerical, secretarial or administrative functions with regard to the family office. This approach is similar to the standard found in the SEC's "qualified client" definition in Rule 205-3(d)(iii) for the types of knowledgeable employees who can be charged performance fees.

Special Rules Applicable to Former Family Members and Former Key Employees

The Proposed Rule includes a new provision not included in the previous exemptive orders permitting former family members and former key employees to retain their investments held through the family office after they are no longer family members or key employees. However, the Proposed Rule does not permit such former family members and former key employees to freely expand their investments following that time by making new investments through the family office.

Special Rule for Pooled Investment Vehicles

The Proposed Rule considers a pooled investment vehicle to be a family client only if it is wholly owned and controlled (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more family clients, and is excepted from the definition of "investment company" under the Investment Company Act of 1940. Section 3(c)(1) and Section 3(c)(7) funds are common examples of types of pooled investment vehicles excepted from the definition of investment company.

Special Rules for Involuntary Transfers

If a person who 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 shall be deemed to be a family client for purposes of the Proposed Rule — but only for four months following the transfer of assets resulting from the involuntary event. The SEC believes this four-month transition period should allow for an orderly transition of those assets to another investment adviser, or for the family office to seek exemptive relief or otherwise restructure. The Proposed Rule does not permit voluntary transfers to nonfamily members.

Control

To distinguish family offices from family-run offices providing advice to other clients, and consistent with the exemptive orders, the Proposed Rule includes a condition that the family office be controlled by family members. "Control" means 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. Contrary to some of the previous exemptive orders, the SEC did not include a condition relating to the profit or fee structure of the family office.

Grandfathering

As required by Section 409 of Dodd-Frank, a "family office" may not exclude any office that was not registered or required to be registered on January 1, 2010, solely because such office provides investment advice to, and was engaged before January 1, 2010 in providing investment advice to:

- Natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office who have invested with the family office before January 1, 2010 and are accredited investors, as defined in Regulation D under the Securities Act of 1933;
- Any company owned exclusively and controlled by one or more family members; or
- 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.

A family office that relies on the grandfathering provision will be deemed to be an investment adviser for purposes of the antifraud provisions in Section 206(1), (2) and (4) of the Advisers Act, but would not be required to register.

Effect on Previously Issued Exemptive Orders

The SEC proposes to leave the previously issued specific exemptive orders in effect such that family offices operating under these orders can continue to rely on the orders or, alternately, rely on the final rules once adopted. However, the SEC is soliciting comment on whether to rescind some of the earlier exemptive orders that imposed fewer conditions.

Failure to Satisfy Conditions of Proposed Rule

If a family office fails to satisfy the conditions of the Proposed Rule once it is adopted and if no other exemptions are available, the family office could seek an exemptive order from the SEC. If it does not receive such an exemptive order, the family office would be required to register under the Advisers Act on or before July 21, 2011, or to restructure to comply with the final rules.

Timetable

The SEC currently plans to finalize and adopt final rules in the second quarter of 2011 in advance of the effective date of Title IV of Dodd-Frank on July 21, 2011. The SEC's deadline for submitting comments on the Proposed Rule is November 18, 2010.

Conclusion

The SEC's view is that the Advisers Act was not intended to govern the operation of single family offices and that disputes among the clients of single family offices are best handled within the family unit as family matters or in state courts under state law. Those family offices that qualify for the full exclusion (rather than only the grandfather provision) need not comply with any provisions of the Advisers Act, including the antifraud provisions of Section 206 of the Advisers Act.

The SEC is soliciting comments on a number of aspects of the Proposed Rule and it is possible that the final rule may differ in some material respects from the Proposed Rule. Family offices should review their ownership structures, clients and other arrangements for compliance with the Proposed Rule and determine whether additional actions or restructuring may be necessary to comply with the rules. We can assist in evaluating these issues, preparing to address the new rules and drafting proposed comments to the SEC regarding the Proposed Rule.

Additional Information

The Hunton & Williams Private Investment Fund practice group regularly represents funds, sponsors and a variety of investors in all types of private investment fund matters, including structuring, formation, offerings and compliance. We will continue to monitor the progress of the SEC's rulemaking to implement Dodd-Frank's requirements relating to investment advisers as well as relevant trends in investment adviser and private investment fund regulation.

For additional information on financial industry recovery proposals, see our related memoranda, available on www.huntonfinancialindustryresourcecenter.com. For additional information on recent proposals relating to regulation of private investment funds and their advisers, see our prior memoranda available on our website at www.hunton.com.

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