July 2011

SEC Adopts "Family Office" Definition

SEC Implementation of the Dodd-Frank Wall Street Reform Act

On June 22, 2011, the Securities and Exchange Commission ("SEC") adopted new Rule 202(a)(11)(G)-1 (the "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 will not be required to register or comply with the Advisers Act. A copy of the SEC's Final Rule 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 SEC proposed rules on October 12, 2010, reviewed comments received and modified the proposals in some respects.

Scope of the Rule

The Rule requires single-family offices to satisfy three conditions to avoid regulation as investment advisers under the Advisers Act. The 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 by family clients and "controlled" (directly or indirectly) by family members and/or family entities; and

3. Does not hold itself out to the public as an investment adviser.

Under the 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 nonprofit organization, charitable foundation, charitable organization or charitable trust (including charitable lead trusts and charitable remainder trusts whose only current beneficiaries are other family clients and charitable or nonprofit organizations), or other charitable organization, in each case for which all the funding came exclusively from one or more other family clients;

- Any estate of a family member, former family member, key employee or, subject to the special rule discussed below, former key employees;

- Any irrevocable trust in which one or more family clients are the only current beneficiaries;

- Any irrevocable trust funded exclusively by one or more other family clients in which other family clients and nonprofit organizations, charitable foundations, charitable trusts or other charitable organizations are the only current beneficiaries;

- Any revocable trust of which one or more other family clients are the sole grantor(s);

- 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; or

- Any "company" (as defined in Section 202(a)(5) and including any limited liability company, partnership, corporation or other entity) wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more other family clients, subject to the special rules for pooled investment vehicles discussed below.

Under the Rule, "family members" include all lineal descendants (including by adoption, stepchildren, foster children and minors for whom another family member becomes a guardian) of a common ancestor and such lineal descendants' spouses or spousal equivalents; provided that the common ancestor is no more than 10 generations removed.

"Family entities" include any of the trusts, estates, companies or other entities included in the definition of family client, but exclude key employees and their trusts.

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. The SEC further expanded their definition from the proposed rule by including foster children and children under guardian arrangements.

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, the 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.

Under the Rule, a "key employee" must:

- be a natural person (including any key employee's spouse or spousal equivalent who holds a joint, community property or other similar shared ownership interest with that person);

- be 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; and

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

An "affiliated family office" includes a family office wholly owned by family clients of another family office and that is controlled (directly or indirectly) by one or more family members of such other family office and/or family entities affiliated with such other family office and has no clients other than family clients of such other family office.

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 Key Employees

The Rule includes a new provision not included in the previous exemptive orders permitting former key employees to retain their investments held through the family office after they are no longer key employees. However, the Rule does not permit such former key employees to freely expand their investments following that time by making new investments through the family office. Although the proposed rule contained a similar limitation applicable to former family members, the SEC was persuaded to remove that limitation from the final Rule.

Special Rule for Pooled Investment Vehicles

The Rule considers a pooled investment vehicle to be a family client only if it is wholly owned (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 Rule — but only for one year following the transfer of legal title to the assets resulting from the involuntary event. The SEC extended this transition period from four months as originally proposed to one year to 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 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 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 is leaving 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 Rule.

Transition

The Rule includes a transition period for certain types of offices that do not qualify under the new Rule. Any company engaged in the business of providing investment advice, directly or indirectly, primarily to members of a single family on July 21, 2011, and that is not registered in reliance on Section 203(b)(3) (the private adviser exemption) on July 20, 2011, is exempt until March 30, 2012, as long as (i) during the course of the preceding 12 months the company has had fewer than 15 clients; and (ii) the company neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any registered investment company or business development company.

In addition, any company existing on July 21, 2011, that would qualify as a family office but for it having as a client one or more nonprofit organizations, charitable foundations, charitable trusts or other charitable organizations that have received funding from one or more individuals or companies that are not family clients shall be deemed a family office until December 31, 2013, as long as such nonprofit or charitable organization does not accept any additional funding from any nonfamily client after August 31, 2011, (other than funding received prior to December 31, 2013, in fulfillment of pledges made prior to August 31, 2011).

If a family office fails to satisfy the conditions of the Rule 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, or to restructure to comply with the final Rule.

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.

Family offices should review their ownership structures, clients and other arrangements, including any co-investment arrangements, for compliance with the Rule and determine whether additional actions or restructuring may be necessary to comply with the Rule. We can assist in evaluating these issues and preparing to address the new Rule.

Further Information

The Hunton & Williams Private Investment Funds 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 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 legislation and regulations relating to regulation of private investment funds and their advisers, see our prior memoranda available on our website at www.hunton.com.

Contacts

Cyane B. Crump
ccrump@hunton.com

James S. Seevers, Jr.
jseevers@hunton.com