March 2, 2012

Updated SEC Guidance on the Family Office Exclusion

Family offices are entities established by wealthy families to manage their wealth, plan for their families' financial future, engage in investment opportunities and provide other services to family members. A new rule created by the Securities and Exchange Commission (the "Family Office Rule") provides that qualifying family offices shall not be considered to be an "investment adviser" for purposes of the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Persons that are considered investment advisers under the Advisers Act are subject to extensive registration, reporting, record-keeping and other compliance requirements. Because the Family Office Rule provides an exclusion from the Advisers Act, qualifying family offices do not have to comply with these Advisers Act requirements.

Previously, the most commonly utilized exemption for many family offices had been the "private adviser exemption" from registration as investment advisers by virtue of (i) having fewer than 15 clients during the preceding 12 months, (ii) not holding themselves out publicly in the U.S. markets as investment advisers and (iii) not advising any registered investment company or business development company. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), effective July 21, 2011, repealed this "private adviser exemption" from registration. Dodd-Frank, however, created another exclusion for family offices and left it to the SEC to define this term. Accordingly, the Family Office Rule is an important and powerful exclusion for family offices.

The staff of the SEC's Division of Investment Management recently published answers to certain categories of Family Office Rule questions regarding, among other things, (i) ownership and control of family offices, (ii) key employees, (iii) family members and (iv) the provision of nonadvisory services. These answers provide clarity to some of the more difficult scenarios presented to entities seeking to rely on the Family Office Rule. For the full text of the staff's commentary, please see the following link: www.sec.gov/divisions/investment/guidance/familyofficefaq.htm.

Family Office Definition

Under the Family Office Rule, a "family office" is an entity providing investment advisory services that (i) has only clients that are "family clients," (ii) is wholly owned by family clients and controlled by "family members" and (iii) does not hold itself out to the public as an investment adviser. The Division of Investment Management staff's responses clarify many of the elements of the Family Office Rule.

Family Clients

Pursuant to the Family Office Rule, "family clients" include current and former family members, certain key employees and former key employees of the family office, charities funded exclusively by family clients, estates of current and former family members or key employees, certain family trusts with either family clients or charitable entities as the only current beneficiaries or with family clients as the sole grantors and certain key employees' trusts. Additionally, the Family Office Rule treats as a family client any company that is wholly owned, directly or indirectly, by one or more family clients and operated for the sole benefit of family clients.

Family Members

For purposes of the Family Office Rule, a "family member" includes all of the descendants of a common ancestor (who may be living or deceased), as well as current and former spouses or spousal equivalents of those descendants, provided the common ancestor is no more than 10 generations removed from the youngest generation of family members. Notably, all children by adoption and current and former stepchildren are considered family members.

The Division of Investment Management staff noted the Family Office Rule does not include in-laws as family members or as family clients. Additionally, the staff stated that the definition of family member does not include descendants of a stepchild whose parent later divorced the family member stepparent.[1] Finally, the staff clarified that under the Family Office Rule, a "cohabitant occupying a relationship generally equivalent to that of a spouse" may qualify as a spousal equivalent.

Key Employees

The Family Office Rule permits family offices to provide investment advice to any natural person who is (i) an executive officer, director, trustee, general partner or person serving in a similar capacity at the family office or its affiliated family office, or (ii) any other employee of the family office or its affiliated family office, other than an employee performing solely clerical, secretarial or administrative functions. These "key employees" must, in connection with their regular duties, participate in the investment activities of the family office or affiliated family office, provided such key employees have, for the past 12 months, been performing such duties for or on behalf of the family office or an affiliated family office or have been performing substantially similar duties for or on behalf of another company.

The Division of Investment Management staff answered three important questions regarding key employees. First, only key employees of the family office or an affiliated family office that serves the same family are included in the definition of key employee. Second, the Family Office Rule provides that the definition of a family client includes a trust that is founded and managed by a key employee or, with respect to joint property, his or her spouse or spousal equivalent. Third, the staff provided instructions for family offices seeking to determine the amount of a former key employee's assets for which the family office may provide advice as of the August 29, 2011, effective date of the Family Office Rule. The staff stated that the family office should look only to the amount of assets the former key employee invested through the family office as of August 29, 2011, plus any additional investments the former key employee was contractually obligated to make, and which related to a family office investment, prior to August 29, 2011.

Ownership and Control

For purposes of the Family Office Rule, the family office must be wholly owned by family clients and exclusively controlled, directly or indirectly, by one or more family members or entities owned by family members. Although the Family Office Rule requires that family clients wholly own the family office, family members and their related entities must control the family office. The result is that key employees, among others, may own a noncontrolling stake in the family office. This permits family offices to utilize equity awards as a part of a key employee's incentive compensation package.

Issues regarding ownership and control require careful examination by family offices, due to the imprecise definitions contained within the Family Office Rule. In an attempt to clarify the application of these definitions to the structures and practices of family offices, the Division of Investment Management staff addressed a number of questions in the context of three hypothetical ownership and control scenarios.

First, the staff stated that a family office board would be considered exclusively controlled by family members or family entities if (i) the board had seven members, four of which are family members and three of which are non-family members, (ii) all board members had equal voting power and (iii) the non-family member minority of the board did not have veto power.

The staff did note, however, that the presence of a special shareholders agreement or arrangement that gave a person that is not a family member control over the management or policies of the family office would result in a lack of exclusive control by family members or family entities.

Second, the staff clarified that a family office would not be considered to be exclusively controlled by family members in a situation where all members of the board of directors of such family office are neither family members nor family entities, even though all board members are appointed by family members who have the right to appoint, terminate or replace board members. According to the staff, the right to appoint, terminate or replace board members does not, in itself, satisfy the requirement that the family office be exclusively controlled by family members.

Third, the staff took a strict interpretation of the exclusivity-of-ownership requirement and stated that ownership of nonvoting shares by a person that does not qualify as a family client renders the family office ineligible for reliance on the Family Office Rule exclusion.

No Holding Out

The Family Office Rule prohibits a family office from holding itself out to the public as an investment adviser. Such holding out suggests the family office seeks to enter into typical advisory relationships with non-family clients, which thus disqualifies the entity from the relief provided by the Family Office Rule. Notably, the Division of Investment Management staff stated that family offices that provided catering, tax-filing, accounting and housekeeping services to non-family members would not lose their eligibility for the Family Office Rule due to the provision of such services. However, the staff was quick to caution family offices that the provision of such seemingly nonadvisory services may overlap with advisory services and cause the family office to lose its eligibility to rely on the Family Office Rule. The staff urged family offices to examine closely the facts and circumstances surrounding the services they provide.

Conclusion

The Family Office Rule provides a powerful and useful exclusion from the Advisers Act for qualifying family offices. If a family office had been relying on the now-expired "private adviser exemption" and does not qualify for the new Family Office Rule exclusion, it was required to register as an investment adviser by March 30, 2012, unless it qualifies under another exemption, relies on some other relief or reorganized itself in a manner that qualifies it as a family office. Although the Family Office Rule intends to provide flexibility to permit a variety of family offices to rely on the exclusion, its nuanced definitions require careful consideration and examination. The Division of Investment Management staff's guidance helps to clarify some of the more difficult determinations for family offices, but careful consideration must be given to the facts and circumstances of each family office's situation. Please contact any of the Day Pitney attorneys listed here to discuss the Family Office Rule in more detail.

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[1] In *Peter Adamson III,* SEC Staff Letter (April 3, 2012), the Division of Investment Management reiterated that the exclusion for family offices does not extend to family offices serving multiple families, and if several unrelated families established separate family offices staffed with the same or substantially the same employees, such employees would be managing a *de facto* multifamily office, such that the family offices could not rely on the exclusion.

[2] The staff did note, however, that the family office may continue to provide advisory services to the stepchild because the stepchild is still a family client.