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Subject: **SEC Proposes Rule to Exempt Many "Family Offices" from Requirement to Register as Investment Advisers under 1940 Act, as Amended by Dodd-Frank Act**

Major References: ***SEC Proposed Rule 202(a)(11)(G)-1 [17 CFR 275.202(a)(11)(G)-1] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] (October 18, 2010)***

Prior AALU Washington Reports: *10-89; 10-79*

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On June 30, the House passed the "Wall Street Reform and Consumer Protection Act" (Dodd-Frank) (see our Bulletin No. 10-79), which generally imposes new regulatory reforms on a wide spectrum of financial activities, many of which were not previously subject to such regulation. One change made by Dodd-Frank in its desire to regulate hedge funds was to repeal, effective July 11, 2011, section 203(b)(3) of the Investment Advisers Act of 1940 ("Advisers Act"). That section had exempted from registration as an "investment adviser" any adviser who had fewer than 15 clients and who neither held itself out generally to the public as an investment adviser, nor acted as an investment adviser to any investment company or business development company. A potential consequence of this repeal is that many "family offices" that have relied on the 15-client exemption would be required to register under the Advisers Act or seek an exemptive order from the SEC before the July 11, 2011 effective date.

To prevent that consequence, section 409 of the Dodd-Frank Act creates a new exclusion from the Advisers Act in section 202(a)(11)(G), under which family offices, as defined by the SEC, are not investment advisers subject to the Advisers Act. Section 409 instructs that any definition adopted by the SEC should be "consistent with the previous exemptive policy" of the Commission and recognize "the range of organizational, management, and employment structures and arrangements employed by family offices."

The SEC has now proposed, and is accepting comments on, a new definition of "family office."

The term "family offices" generally refers to entities established by wealthy families, many of which have more than $100 million of investable assets, to manage their wealth, plan for their families' financial future, and provide other services to family members. According to the SEC, industry observers have estimated that there are 2,500 to 3,000 single family offices managing more than $1.2 trillion in assets. Family office services typically can include managing securities portfolios, providing personalized financial, tax, and estate planning advice, providing accounting services and return preparation, and directing charitable giving.

Family offices often work closely with life insurance professionals and other advisors to structure estate planning and other transactions.

The SEC proposal would exempt family offices from the definition of investment adviser under the following three general conditions:

1. It would limit the availability of the rule to family offices that provide advice about securities only to certain "family clients,"

2. It would require that family members wholly own and control the family office, and

3. It would preclude a family office from holding itself out to the public as an investment adviser.

<u>Family Clients</u>. For purposes of the first condition, above, "family clients" would include family members, certain key employees of the family office, charities established and funded exclusively by family members or former family members, trusts or estates existing for the sole benefit of family clients, and entities wholly owned and controlled exclusively by, and operated for the sole benefit of, family clients (with certain exceptions), and, under certain circumstances, former family members and former employees.

"Family members" would include the individual and his or her spouse or "spousal equivalent" (generally equivalent to a cohabitant relationship) for whose benefit the family office was established, and any of their subsequent spouses or spousal equivalents, their parents, their lineal descendants (including adopted children and stepchildren), and such lineal descendants' spouses and spousal equivalents. The proposed definition of "family member" also would include siblings of the founders of the family office, their spouses or spousal equivalents, their lineal descendants (including adopted children and stepchildren), and such lineal descendants' spouses or spousal equivalents.

"Key" employees would be limited to those employees who are (i) executive officers, directors, trustees, general partners, or persons serving a similar capacity of the family office, or (ii) any other employees of the family office (other than an employee performing solely clerical, secretarial, or administrative functions) who, in connection with their regular duties, have participated in the investment activities of the family office, or similar functions or duties for or on behalf of another company, for at least twelve months. The purpose of limiting the access to the family office only to "key" employees appears in part to be to keep the investment opportunity available only to "knowledgeable" investors.

The proposal explicitly rejects extending the exemption to family offices that serve multiple families in order to save costs. The SEC explains that issuing such an exemption would be inconsistent with its prior exemptive policy.

If assets under management were transferred to a non-family member in an involuntary transfer (such as a transfer of assets to an unrelated charity by will), the transferee could only be advised by the family office for a period of four months after the transfer. Former family members could continue to be advised by the family office, but would not be able to make new investments through the family office.

Ownership and Control. The requirement that the family office be "wholly" owned and controlled by a single family does not admit of the possibility of any minority ownership. The SEC requests comments on whether, and to what extent, minority ownership should be permitted.

***Holding Out*.** According to the SEC, the preclusion on holding itself out the public as an investment adviser is put forth because it would be inconsistent with prior exemptive relief, as well as with the policy goals of the family office definition.

Grandfathering. As required in the Dodd-Frank Act, the SEC rule would grandfather "persons not registered or required to be registered on January 1, 2010 that would meet all of the required conditions under rule 202(a)(11)(G)-1 but for their provision of investment advice to certain clients . . ." These grandfathered clients include natural persons who, at the time of their investment, are officers, directors, or employees of the family office, and had invested with the family office before January 1, 2010. They must be accredited investors under Regulation D of the Securities Act of 1933. The other grandfathered clients are investment advisers registered under the Advisers Act that, in turn, provide investment advice and identify investment opportunities to the family office and invest in such transactions on substantially the same terms as the family office invests, but do 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.

The proposed rule also does not rescind previously issued exemptive orders.

AALU solicits its members input concerning how they may be impacted by the foregoing proposals. Comments on the proposed rule must be received by the SEC by November 18, 2010. On August 30, 2010, AALU submitted comments to the SEC on its study of the broker-dealer and investment adviser standard of care regulatory obligations. (*See* our Bulletin No. 10-89.)

Any AALU member who wishes to obtain a copy of SEC Proposed Rule 202(a)(11)(G)-1 may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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