SEC ADOPTS RULE DEFINING "FAMILY OFFICE" UNDER THE INVESTMENT ADVISERS ACT

July 15, 2011

To Our Clients and Friends:

On June 22, the Securities and Exchange Commission (the "SEC") adopted a final rule defining "family offices" that are exempt from regulation under the Investment Advisers Act of 1940 (the "Advisers Act"). The rule will become effective on August 29, 2011.

BACKGROUND

Private family offices sometimes are established by wealthy families to provide financial, legal, management and other services to family members, trusts for the benefit of family members and entities owned and controlled by family members. To the extent a family office provides investment advisory services for compensation (for example, by giving advice regarding the buying and selling of securities), the family office may be considered an "investment adviser" required to register and subject to regulation under the Advisers Act.

In order to avoid registration under the Advisers Act, many family offices have depended on the Advisers Act's private adviser exemption, which excluded an entity from the requirement to register if it had fewer than 15 clients and did not hold itself out to the public as an investment adviser. On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") repealed the private adviser exemption, effective July 21, 2011, but provided that "family offices" are not considered investment advisers under the Advisers Act and thus are not subject to any of the Act's provisions. The Dodd-Frank Act left it to the SEC to define the term "family office."

On June 22, 2011, the SEC adopted rule 202(a)(11)(G)-1 under the Advisers Act, which defines the term "family office." The new rule also extends the period for family offices to come into compliance with its provisions or to register under the Advisers Act, if required.

FAMILY OFFICE DEFINED

The rule defines "family office" as a company that has three key characteristics: (i) it has no clients other than family clients (that is, current and former members of a single family and certain other categories of clients discussed below); (ii) it is wholly owned by the family clients and is exclusively controlled (directly or indirectly) by family members and/or family entities; and (iii) it does not hold itself out to the public as an investment adviser. The exclusion does not apply to multi-family offices.

Family Clients

The rule provides that the following persons and entities are family clients:

- Family members. "Family members" include all of the lineal descendants of a common ancestor (including adopted children, stepchildren, foster children and individuals who were minors when a family member became their legal guardian), so long as all of the individuals are within 10 generations of that common ancestor. Spouses and spousal equivalents (*i.e.*, unmarried cohabitants) of descendants are also considered to be family members. Importantly, the common ancestor need not be the family member who originally generated the family's wealth. For example, a person establishing a family office today may select a common ancestor that will assure that most relations (including fourth or fifth cousins) can be treated as family members. The common ancestor may also be changed over time to assure that the family office can advise new generations of family members.
- Former family members. This category includes spouses, spousal equivalents and stepchildren who were at some point, but are no longer, family members (*e.g.*, due to divorce from a family descendant). The rule permits former family members to continue to make new investments through the family office.
- Key employees. The category of key employees includes: (i) executive officers, directors, trustees and general partners of the family office or an affiliated family office;[1] and (ii) any other employee of the family office or an affiliated family office, who, as part of his or her regular duties, participates in the investment activities of the family office or an affiliated family office and has been working in such capacity for at least 12 months (or has been performing substantially similar functions for another company for at least 12 months). Former key employees are also classified as family clients, but the family office may only

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[1] *An affiliated family office is defined as "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."*

advise such former employees with respect to assets that the family office was advising prior to the retirement or termination of such person.

- Certain charitable entities. A non-profit organization, charitable foundation, charitable trust (if its sole current beneficiaries are charitable or non-profit organizations or other family clients) or other charitable organization is considered to be a family client *only if* all of the funds held by the entity came from other family clients. This provision may create problems for family offices advising private foundations or other non-profit entities that have received funds from unrelated parties. In recognition of the impact that this new provision may have on some family offices, the new rule contains transition provisions (discussed below) allowing family offices to continue to provide advice to such foundations until December 31, 2013.

- Certain estates. The estates of family members, former family members, key employees and former key employees (but only with respect to certain assets, as described above) are considered family clients. The rule focuses on the identity of the decedent, rather than the identities of the estate's beneficiaries, to determine whether an estate is a family client.

- Certain trusts. The rule treats four kinds of trusts as family clients:

    - Revocable trusts that have one or more family clients as their sole grantor. The identities of the beneficiaries of a revocable trust are not relevant until the trust becomes irrevocable, at which point the current beneficiaries must be limited to family clients.

    - Irrevocable trusts that have one or more family clients as their sole current beneficiaries.

    - Irrevocable trusts that have only family clients, non-profit organizations, charitable foundations, charitable trusts or other charitable organizations as their current beneficiaries *only if* the trusts are funded exclusively by one or more family clients.

    - Trusts of which each trustee and each settlor (or any other person contributing assets) are key employees.

In the case of irrevocable trusts, the final rule clarifies that one should look only to the current beneficiaries of a trust when determining if the trust is a family client and not to the trust remaindermen or remote contingent beneficiaries. The rule also allows certain trusts associated with key employees to be advised by the family office.

- Family companies. Certain companies are considered to be family clients if they are wholly owned (directly or indirectly) by, and operated for the sole benefit of, other family clients. Subject to certain exceptions, this would include pooled investment vehicles.

Although the rule generally requires that the family office have only family clients, it provides for a one-year window during which a family office will retain its exemption if it has a non-family client as the result of an involuntary transfer, such as a family member's death. For example, a family member may establish a revocable trust and provide for payments to be made to other family members and friends out of the trust after his or her death. Once the family member dies and the trust has become irrevocable, the family office may continue to advise the trust for a period of one year even though the trust no longer qualifies as a family client. If all required distributions to named friends are made during that one-year period, leaving only family members as current beneficiaries, the family office may continue to advise the trust beyond that window period and retain its excepted status under the rule.

Family Office Ownership and Control

In order to qualify for the exemption, a family office must be wholly owned by family clients and exclusively controlled (directly or indirectly) by family members or "family entities" (which consist essentially of the charitable organizations, estates, trusts and companies described above, but excluding those associated with key employees). This means that key employees may own an interest in the family office (as part of a compensation arrangement, for example), but they may not, directly or indirectly, share in its control. The rule defines "control" as "the power to exercise a controlling influence over the [family office's] management or policies…unless such power is solely the result of being an officer" of the family office.

Holding Out

A family office may not hold itself out to the public as an investment adviser. The SEC believes that doing so would suggest the office was in the business of advising non-family members and would be inconsistent with the SEC's prior exemptive orders.

GRANDFATHERING PROVISIONS

The Dodd-Frank Act directed the SEC not to exclude from the definition of family office persons that were not registered or required to be registered under the Advisers Act on January 1, 2010, solely because these persons provided investment advice to certain enumerated individuals and other entities before that date and continue to do so. The final rule incorporates these provisions. The individuals and entities that may continue to be advised under the grandfathering provisions are: (i) natural persons who are accredited investors and who, at the time of their applicable investment, are officers, directors or employees of the family office who invested with the family office before January 1, 2010; (ii) companies owned exclusively and controlled by one or more family members; and (iii) investment advisers registered under the Advisers Act who provide a family office with investment advice and opportunities, and invest in those opportunities on substantially the same terms as the family office, provided that an investment adviser's assets advised by the family office do not represent more than 5% of all assets advised by the family office.

Any family office that falls within the definition solely because of the grandfathering provisions will, however, be subject to the anti-fraud provisions of the Advisers Act.

TRANSITION PROVISIONS

The final rule contains two transition provisions which grant family offices additional time to determine their eligibility for the exemption, restructure if necessary to bring themselves into compliance with the new rule or register under the Advisers Act, if required.

- Extension until December 31, 2013 for family offices with certain charitable entities as clients. A family office that has as a client a non-profit or charitable entity that has received funding from a person that is not a family client will still qualify for the family office exemption until December 31, 2013, so long as the family office meets all of the other requirements of the family office exemption and the non-profit or charitable entity does not accept additional funding from any non-family client after August 31, 2011 (other than pursuant to a pledge made before August 31, 2011). This extension is designed to give the charitable entity time to spend or dispose of the funds received from any non-family client so that the family office may continue to advise the entity without jeopardizing its exemption.

- General deferral of registration until March 30, 2012. Family offices that will not meet the terms of the new rule and are not registered under the Advisers Act on July 20, 2011 in reliance on the private adviser exemption have until March 30, 2012 to register under the Act. Until that time, however, these family offices must continue to comply with the requirements of the private adviser exemption.

EXEMPTIVE ORDERS

Historically, family offices that failed to qualify under an exemption to the Advisers Act have been permitted to apply to the SEC for an exemptive order declaring that they are not investment advisers subject to the Advisers Act. The SEC has decided not to rescind previously issued exemptive orders and has indicated that family offices that do not meet the requirements of the new rule may continue to apply for exemptive orders.

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Please feel free to contact us with any questions you may have about the SEC's rule or to discuss its relevance to your particular situation.

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