SEC Proposes Definition of "Family Office"

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On October 12, 2010, the Securities and Exchange Commission ("SEC") released for comment a new proposed Rule 202(a)(11)(G)-1 (the "Proposed Rule"). The Proposed Rule defines what will constitute a "family office" within the meaning of Section 202(a)(11)(G) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), implemented by Section 409 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Any firm falling within the definition of a family office set forth in the Proposed Rule will be exempt from the definition of "investment adviser" within the meaning of the Advisers Act.

At present, many family offices that would otherwise be required to register under the Advisers Act rely on the so-called "private adviser exemption" from registration as an investment adviser provided by Section 203(b)(3) of the Advisers Act . Title IV of the Dodd-Frank Act eliminates the private adviser exemption, effective July 21, 2011. As a result, such family offices will need to qualify under another exemption or will be required to register as an investment adviser with the SEC or applicable state regulators.

In order to qualify for the exemption afforded by Section 202(a)(11)(G), the Proposed Rule will generally require a family office to satisfy the following three prong test:

- Advisory Clients of the Family Office Must Be Limited to "Family Clients."
- The Family Office Must Be Wholly Owned and Controlled, Either Directly or Indirectly, by Family Members.
- The Family Office Must Not Hold Itself Out to the Public as an Investment Adviser.

For purpose of the first prong of this test, a "family client" will include "family members" (see below) and "key employees" (see below) of the family office, as well as former family members (such as a former spouse or spousal equivalent of a family member, or former stepchildren of a family member) and former key employees (in each case, solely with respect to investments made with the family office while such person was a family member or key employee, as the case may be).

In addition, a "family client" will include any charitable foundation, charitable organization, or charitable trust established and funded exclusively by one or more family members and any trust or estate existing for the sole benefit of one or more family clients (including, family members and key employees), as well as any company (including a pooled investment vehicle) that is wholly owned and controlled, directly or indirectly, by family clients and operated solely for the benefit of family clients. Finally, the Proposed Rule provides that any unaffiliated third party that acquires assets of a family client under the family office's management as a result of an involuntary transfer by a family client will be considered a family client for a limited period of up to four months following such involuntary transfer.

The SEC has expressed the view that the above stated definition is simply a codification of its prior exemptive orders. However, to the extent that any firm was the recipient of such a prior exemptive order, the SEC has stated that it expects that such orders will continue in effect and family offices may continue to operate in reliance thereon.

In addition to the foregoing, the Proposed Rule includes a grandfathering provision as required by Section 409(a)(3) of the Dodd-Frank Act, which provides that a person that was not registered or required to be registered under the Advisers Act on January 1, 2010, will not be excluded from the definition of a family office (and, therefore, to the extent otherwise meeting the definition of a family office set forth above still able to rely on the Section 202(a)(11)(G) exemption) solely because such person provides investment advice to (and was engaged prior to January 1, 2010 to provide investment advice to):

- natural persons who are accredited investors and who at the time of their investment were officers, directors or employees of the family office,

- a company owned and controlled by family members, or
- any SEC registered investment adviser who identifies investment opportunities to the family office and invests in such opportunities on the same terms as the family office, but does not invest in other funds advised by the family office and represents less than five percent of the total assets under the management of the family office.

Notwithstanding the foregoing, any person operating as a family office in reliance on this grandfathering provision, as opposed to an entity qualifying based on the three prong test set forth above or as a result of a prior exemptive order still in effect, will be considered to be an investment adviser for purposes of the anti-fraud provisions set forth in paragraphs (1), (2) and (4) of Section 206 of the Advisers Act.

The SEC has requested that any comments on the Proposed Rule be submitted on or before **November 18, 2010**.

Key Terms

- A "family member" will include the founder(s) of such family office, his or her spouse or spousal equivalent, their parents, their lineal descendants (including by adoption and stepchildren) and any spouses or spousal equivalents of any such lineal descendants.
- A "key employee" means a natural person that is (i) an executive officer, director, trustee, general partner, or person serving a similar capacity of the family office, or (ii) any other employee of the family office (other than an employee performing solely clerical, secretarial, or administrative functions) who, in connection with his or her regular duties, has 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.

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