



Family Office Exclusion from Investment Adviser Registration – SEC Final Rule

Executive Summary

In an open meeting held on June 22, 2011, the Securities and Exchange Commission (“SEC” or “Commission”) adopted a final rule to define “family offices” which will be excluded from the definition of an investment adviser under the *Investment Advisers Act of 1940* (“Advisers Act”) and will therefore not be subject to regulation under the Advisers Act.

In general, the rule defines a “family office” to mean a company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their position or employment) that:

- Provides investment advice only to family clients, as defined by the rule;
- Is wholly owned by family clients and is exclusively controlled by family members and/or family entities, as defined by the rule; and
- Does not hold itself out to the public as an investment adviser.

Definitions are also provided for “family clients,” “family members” and “family entities,” among others. Family offices that do not meet the new definition for exclusion will be required to register with the SEC as an investment adviser by March 30, 2012. Family offices that previously obtained exemptive orders may continue to operate as a family office under the applicable exemptive order.

Background

Historically, many family offices avoided registration under the Advisers Act by relying on the “private adviser exemption,” which exempts from registration any adviser that during the course of the preceding 12 months had fewer than 15 clients and neither held itself out to the public as an investment adviser nor advised any registered investment company or business development company. Many other family offices that did not meet the private adviser exemption sought and received orders from the SEC declaring the offices were not investment advisers within the intent of Section 202 of the Advisers Act. With the enactment of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, the private adviser exemption has been eliminated effective July 21, 2011 and a new exclusion from the definition of an investment adviser has been created for family offices that meet the definition established by the SEC. By being excluded from the definition of an investment adviser, a family office, as defined, is not subject to any of the provisions of the Advisers Act.

Description

General Exclusion

Family Office

To qualify for the family office exclusion, a family office must:

- Provide investment advice only to “family clients,” as defined by the rule.
- Be wholly owned by family clients and exclusively controlled by “family members” and/or “family entities,” as defined by the rule.
- Not hold itself out to the public as an investment adviser.

The final rule also provides a grandfather provision that precludes exclusion from the definition of a family office for persons that were not registered or required to be registered on January 1, 2010 solely because the person gave investment advice to:

- Officers, directors or employees of the family office who are accredited investors and made their investment prior to January 1, 2010;
- Any company owned exclusively by and controlled by family members; or
- Any registered investment adviser that provides investment advice to the family office, identifies investment opportunities and invests in such transactions on substantially the same terms as the family office, but does not invest in other funds advised by the family office, and whose assets as to which the family office provides investment advice represents, in the aggregate, not more than 5 percent of the value of the total assets to which the family office provides investment advice; provided that the family office would be deemed an investment adviser for purposes of paragraphs (1), (2) and (4) of Section 206 of the Advisers Act.

Separately, the SEC states that previously issued exemptive orders will not be rescinded and family offices currently operating under an exemptive order may continue to rely on that order.

Definitions

Family Clients

“Family Clients” include:

- Family members and former family members;
- Key employees (and certain former key employees);
- Nonprofit organizations, charitable foundations and charitable trusts funded by family members;
- Any estate of a family member or former family member, key employee or certain former employees;
- Any irrevocable trusts in which one or more family clients are the current beneficiaries;
- Any irrevocable trusts funded by family clients in which other family clients are the current beneficiaries;
- Any revocable trust in which family clients are the sole grantor;
- Any trust of which: (A) each trustee or other person authorized to make decisions with respect to the trust is a key employee; and (B) 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; and
- Any company wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more other family clients.

A transition period is provided under the final rule for family offices that would qualify as family offices but for having as a client nonprofit organizations, charitable foundations or charitable trusts that have been funded by non-family clients. The transition requires the family office to come into compliance with the new requirement no later than December 31, 2013 and prohibits it from accepting any additional non-family client funding after August 31, 2011, except for fulfillment of pledges made prior to August 31, 2011.

Family Members

"Family members" include all lineal descendants (including by adoption, stepchildren, foster children, and individuals that were a minor when another family member became a legal guardian of that individual) of a common ancestor (who may be living or deceased), and such lineal descendants' spouses or spousal equivalents; provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members. The family office may choose the common ancestor and may change that designation over time as the family office clientele changes.

When family office assets are involuntarily transferred to someone other than a family client, the family office will have up to one year to provide advice for the assets while the assets are transferred to another investment adviser. Failure to transfer the assets would result in the family office no longer meeting the definition for exclusion and cause the family office to seek an exemptive order or register with the SEC.

Family Entities

"Family entities" include any of the trusts, estates, companies or other entities included as family clients, except for key employees and their trusts.

Key Employees

A family office is permitted to provide advice to any 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 key employee) who is:

- An executive officer, director, trustee, general partner, or person serving in a similar capacity at the family office or its affiliated family office or
- Any other employee of the family office or its affiliated family office (other than an employee performing solely clerical, secretarial, or administrative functions) who, in connection with his or her regular functions or duties participates in the investment activities of the family office or affiliated family office,
 - Provided that such employee has been performing such functions or duties for the family office or its affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least twelve months

Commentary

Adoption of the final rules addressing family offices comes following the release of proposed rules by the SEC in October 2010. In response to those proposed rules, the SEC received extensive industry commentary. In issuing the final rule, the SEC made many changes which appear to have been prompted by that commentary, which had broadly focused on the possibility that the rules as proposed would not exclude from the definition of investment adviser a swath of advisory firms that meet conventional notions of what constitutes a family office. While changing many of the specifics, the SEC did keep the broad framework of the proposed rule, which largely required a limited number and type of clients, ownership and/or control by those limited clients, and a requirement that the firm not hold itself out to the public as an investment adviser.

Following issuance of these final rules, advisers that may be able to meet the new family office definition are advised to carefully consider whether the new rules apply to their respective businesses. Firms that find that they will not fulfill the new requirements may, as an alternative, look to some of the other exemptions from registration that the SEC has finalized.

Family offices should also be aware of potential state registration requirements and possible regulation by the Commodity Futures Trading Commission, which will be discussing the applicability of the *Commodity Exchange Act* to family offices soon.

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