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The Family Office Exclusion Under the Investment Advisers Act of 1940

Nathan Crow
nathan.crow@lockelord.com

Greg S. Crespi
Southern Methodist University, Dedman School of Law, gcrespi@smu.edu

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THE FAMILY OFFICE EXCLUSION UNDER THE INVESTMENT ADVISERS ACT OF 1940

Nathan Crow* and Gregory S. Crespi**

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* Associate, Locke Lord LLP; J.D., SMU Dedman School of Law; M.B.A., SMU Cox School of Business; B.A., New York University College of Arts and Science. I am grateful to Kevin Bryant and Michael Renetzky for their comments and suggestions.

** Professor of Law, Dedman School of Law, Southern Methodist University. J.D., Yale Law School, Ph.D., University of Iowa.
ABSTRACT

A family office is a private firm that manages the wealth of a high net worth family. This article explores Advisers Act Rule 202(a)(11)(G)-1, the “Family Office Rule,” which excludes qualifying family offices from regulation under the Investment Advisers Act of 1940. Section I discusses the business role family offices play and general trends in family office governance. Section II provides an overview of the Investment Advisers Act of 1940, in order to put the Family Office Rule in context. Section III comprehensively discusses the Family Office Rule, including its origins in the Dodd-Frank Act of 2010 as well as the specific requirements of the rule promulgated by the SEC in 2011. The rule’s definition of “family client” and its restrictions on the ownership and control of family offices are discussed in detail.

While this article fully supports the policy behind the Family Office Rule—of allowing families to conduct their personal investment activities privately and free of Advisers Act regulation—this article is critical of the SEC’s narrow interpretation of the rule’s “control” requirement. The staff of the SEC Division of Investment Management currently interprets the rule to require a majority of a family office’s board of directors to be family members, even though the rule’s text does not compel such an interpretation. This article argues that the SEC should broaden its interpretation of the control requirement to allow family offices to use the governance structure that best suits their particular needs, including a board of directors consisting of a majority of non-family members.

INTRODUCTION

“SHIRTSLEEVES to shirtsleeves in three generations.” The old saying epitomizes the propensity of family-owned enterprises to fail, and the broader difficulties families face in sustaining wealth across generations. Like many aphorisms, of course, the phrase is not universally true. There are numerous examples of successful family-owned businesses and of wealth in families that has sustained for three generations and beyond. Interestingly, however, the data on family-owned businesses indicates that there is at least a kernel of truth in the old saying. Approximately 70% of family-owned businesses either fail or are sold before the second generation gets a chance to take over. And only 10% remain active, private companies by the time the third genera-

3. Id. at 25.
Passing family wealth down through the generations is fraught with obstacles. On the one hand, there is the unavoidable risk inherent in any kind of business or investment. On the other hand, there are also more “personal” risks, such as profligacy or lack of work ethic among later generations of family members. In the case of so-called “ultra-high-net-worth” individuals, defined as persons with net worth over $30 million, successful multi-generational wealth transfer can be especially complex. Today’s marketplace presents these individuals with countless investment options and strategies, as well as countless money managers vying for their business. The solution that some ultra-high-net-worth individuals embrace is to create their own “family office,” a private investment firm that exclusively manages their family’s wealth, often with a long-term, multi-generational perspective. A 2010 study estimated that there are roughly 2,500 to 3,000 family offices in the United States, with over $1.2 trillion in assets under management. Families who elect to open a family office justify the significant time and expense required with the ability it allows them to more directly oversee their investments. In addition, a family office may better allow integration of other important priorities, such as estate planning, tax planning, and philanthropic planning. A family office may also promote a common ethos and sense of family togetherness that can be passed down to future generations, something that could prove to be a profound intangible benefit for the family.

4. Id.
5. Id. at 26.
6. Id. In Lancashire, where the English version of the phrase originated, it was said “there’s no but three generations between a clog and clog”—a reference to the wooden shoes worn by peasants. Id.: Richard M. Segal, Shirt Sleeves to Shirt Sleeves in Three Generations, CORP!, (July 1, 2008), http://www.corpmagazine.com/special-interests/family-business/shirt-sleeves-to-shirt-sleeves-in-three-generations/ [https://perma.cc/GL2J-QGDV]. In Brazil, the saying is “Pai rico, filho nobre, neto pobre” (“Rich father, noble son, poor grandson”). In China, “Fu bu guo san dai” (“Wealth never survives three generations”). Id. In Spain, “Quien no lo tiene, lo hace; y quien lo tiene, lo deshace”—“The one who doesn’t have it, does it; and the one who has it, undoes it.” Stalk & Foley, supra note 2 (author’s translation).
7. FAMILY OFFICE EXCHANGE, FOX GUIDE TO THE PROFESSIONAL FAMILY OFFICE 4 (2014).
10. ROSPLOCK, supra note 8, at 49.
11. Id. at 9.
12. Id. at 10–11.
This article focuses on the regulation of family offices under the Investment Advisers Act of 1940 (the “Advisers Act” or the “Act”), specifically the definitional exclusion now provided to family offices under Advisers Act Section 202(a)(11)(G) and Advisers Act Rule 202(a)(11)(G)-1 (the “Family Office Rule” or the “Rule”). Because a family office advises its family clients regarding investment in securities, the office will be subject to the requirements of the Advisers Act, including registration with the Securities and Exchange Commission (“SEC”), unless it can satisfy the requirements of the Family Office Rule. This article explains the Family Office Rule in detail, so that family offices and the practitioners who serve them can fully understand its requirements and thereby avoid application of the Advisers Act.

This article is divided into three main sections. Section I explores family offices in general, including the ways in which they are typically formed, the services they provide for families, and the ways in which they are typically governed. Section II provides an overview of the Advisers Act, to put the Family Office Rule in context. Section III is the core of this article and focuses on the regulation of family offices under the Advisers Act. Section III-A discusses the regulation of family offices before 2010, when Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act,” or “Dodd-Frank”). Section III-B discusses Section 409 of the Dodd-Frank Act, which created the definitional exclusion from the Advisers Act for family offices and directed the SEC to promulgate a rule defining “family office.” Section III-C explores in depth the SEC’s Family Office Rule, which lays out the detailed requirements family offices must satisfy to qualify for the exclusion.

While this article fully supports the policy behind the Family Office Rule, of allowing families to conduct their personal investment activities privately and free of Advisers Act regulation, this article is critical of the SEC’s narrow interpretation of the Family Office Rule’s “control” requirement. The staff of the SEC Division of Investment Management currently interprets the Rule to require a majority of a family office’s board of directors to be family members, even though the Rule’s text does not compel such an interpretation. This article argues that the SEC should broaden its interpretation of the control requirement to allow family offices to use the governance structure that best suits their particular needs, including a board of directors consisting of a majority of non-family members.

I. FAMILY OFFICES: IN GENERAL

Family offices are almost always the result of a family’s business success rather than its origin. They are typically founded by one or more

family members who have succeeded in some type of business, whether it be manufacturing, retail, energy, real estate, finance, technology, or conceivably any other industry sector. When a family member attains wealth that is liquid, often as the result of a partial or complete sale of the business, he (or she) faces the decision of how to invest this newfound liquidity. Modern portfolio theory holds he should invest in a broad portfolio of diverse assets. For example, a professional wealth manager might recommend he invest certain percentages of his portfolio in stocks, bonds, and alternative assets, such as real estate or hedge funds. The wealth manager would also recommend diversification within each of these asset classes, such as (in the case of bonds) certain allocations to U.S. government bonds, investment grade corporate bonds, noninvestment grade “junk” bonds, and so on. The purpose of investment diversification is to provide the investor with the lowest level of risk possible for their desired level of return.

The family member in our example, who we can think of as the family office’s “founder,” has many options for how to implement this wealth diversification strategy. Like many people in his position, the founder may delegate the task to a financial institution, such as a bank or trust company. Alternatively, assuming the founder still owns and controls an operating business, he could delegate investment responsibility to certain staff of the business, such as the chief financial officer. Finally, if the founder has attained a level of wealth that is large enough, he may elect to open his own “family office,” a new and separate company that will oversee his investments and other aspects of his financial life. If the founder and the investment team he assembles succeed in preserving and growing his wealth, then it is likely the founder will eventually choose to transfer some or all of this wealth to his children or grandchildren. These succeeding generations may then continue to have their assets managed by the family office, eventually transferring it to their own descendants, and so on. If this cycle continues, it is possible that the family office could last quite a long time indeed—perhaps even longer than the family’s original operating business in the first place.

The firm described in the preceding paragraph is the prototypical family office, founded by the same individual who started the family’s original operating business. But family offices can also be founded by later generations of family members. Like families themselves, no two family offices are completely alike. As one writer remarked, “if you’ve seen one

14. Raphael Amit et al., Wharton Global Family Alliance, Single Family Offices: Private Wealth Management in the Family Context 6 (2008) (“While some families continue to run their core operating business or other businesses, other families with SFOs have had a ‘liquidity event’ and are now focused only on managing investment assets.”). In the survey the Wharton report was based on, 58% of the families surveyed remained involved in operating businesses. Id.
16. Id.
17. Family Office Exchange, supra note 7, at 3.
family office, you’ve seen one family office.” Customizability is the hallmark of family offices. The Family Office Exchange, a membership organization of family offices, highlights this in its definition of a “family office” as “a unique family business that is created to provide tailored wealth management solutions in an integrated fashion while promoting and preserving the identity and values of the family.”

Because family offices adapt to a family’s unique characteristics, they vary widely in their assets under management, number of family clients, number of employees, and governance structure. Family offices also vary in terms of the services they provide to their client families. Many provide an array of services besides investment management, such as budgeting and accounting, tax planning, estate planning, bill paying, and philanthropic planning. Some family offices also provide services of a more personal nature, such as managing family members’ residences, travel planning, or managing certain luxury assets. Even where family offices are not able to provide a particular service directly, they often coordinate with outside firms so the family can receive the benefits of that service. Because family offices are “driven purely by the needs and preferences of the underlying family, there is no standard for how one should be structured.”

The kind of family office we have discussed, an office that manages the wealth and affairs of a single family, is often referred to in the financial industry as a “single family office,” or “SFO.” “Multi-family offices,” or “MFOs,” are also an option for ultra-high-net-worth individuals to consider. What distinguishes multi-family offices is they are typically third-party-owned wealth management firms that serve multiple different families and charge a management fee. Most often, a multi-family office is owned by a financial institution such as a bank, trust company, or investment company, but the office could also be owned by its management. Fundamentally, multi-family offices are simply “an extension of the current ubiquitous wealth management model,” but where the firm seeks to add additional value by providing some of the same services as single family offices. Multi-family offices may be an attractive option for families who either do not have enough investable assets to justify opening

18. RosPlock, supra note 8, at 8.
19. Family Office Exchange, supra note 7, at 3.
22. See RosPlock, supra note 8, at 16.
24. RosPlock, supra note 8, at 41. Because this article is concerned only with single family offices, it usually refers to them simply as “family offices.”
25. Id. at 55.
26. Id. at 56.
27. Prince, supra note 23.
their own single family office, or who simply do not wish to expend the considerable time and effort required. Multi-family offices vary greatly in terms of their size: some manage wealth on behalf of over 500 families, while others manage wealth on behalf of only two or three.\textsuperscript{28}

The considerable investment single family offices require is one of their inherent limitations. Estimates vary on the level of investable assets family offices need to be economically viable, and the topic is a subject of some debate among family wealth consultants.\textsuperscript{29} One family wealth expert put the number at $200 to $300 million, while another put it as high as $500 million to $1 billion.\textsuperscript{30} Experts agree that the level of assets required is higher than it used to be, due to the uncertainty following the 2008 recession and increases in overhead and compliance costs.\textsuperscript{31} It is important to note, however, that these estimates are merely that: there are many family offices with investable assets in the range of $50 to $200 million that identify themselves as family offices and perform the same functions as their larger peers, only on a smaller scale.\textsuperscript{32}

Because family offices are by their very nature private, it is difficult to obtain accurate information about the family office "sector" as a whole.\textsuperscript{33} Estimates of the number of family offices in the United States are therefore inherently imprecise.\textsuperscript{34} The Family Office Exchange estimates that over 3,000 U.S. families have an independent single family office, and at least twice that number have a family office housed within their private operating company.\textsuperscript{35} A 2010 study by the Family Wealth Alliance estimated there were between 2,500 and 3,000 single family offices, with a whopping $1.2 trillion in assets under management.\textsuperscript{36} The same study estimated there were approximately 150 multi-family offices, with over $400 billion in assets under management.\textsuperscript{37}

Given their highly customizable nature, family offices do not conform to any particular mold when it comes to leadership and governance. Some family offices are led by a family member, while others are led by a

\textsuperscript{28} ROSPLOCK, supra note 8, at 53.
\textsuperscript{29} Id. at 8–9.
\textsuperscript{30} Id.
\textsuperscript{31} Id. at 8.
\textsuperscript{32} Id.
\textsuperscript{33} AMIT ET AL., supra note 14, at 4 (acknowledging that family offices' "promise of exclusivity, privacy, and customization" "make SFOs increasingly attractive to the super rich, but they also make it particularly difficult for researchers to understand their operations, their abilities, and their achievements"); Black, supra note 9 ("Single-family offices are hard to track because they seek privacy and most are quite unique, 'born' as they are within a family business and shaped by that particular business and that particular family.").
\textsuperscript{34} ROSPLOCK, supra note 8, at 6 ("How many affluent families are utilizing the services of a family office? The short answer is that we do not know precisely, due primarily to privacy, anonymity, and exclusivity requirements of the family office and how and if a family identifies as having a family office.").
\textsuperscript{35} Id. at 7.
\textsuperscript{36} Black, supra note 9, cited in Release No. IA-3098, 75 Fed. Reg. 63,753, 63,754 (Oct. 12, 2010).
\textsuperscript{37} Id.
non-family professional. Some have a board of directors, while others do not. According to a 2008 study by the Wharton Global Family Alliance (the “Wharton Study”), certain patterns in governance emerge based on the amount of the family office’s assets and whether or not the “first generation” is still involved.\textsuperscript{38} The Wharton Study found that 43\% of U.S.-based family offices were run by a family member in the position of CEO or the equivalent.\textsuperscript{39} Of those family offices with over $1 billion in assets, however, only 27\% were headed by a family member.\textsuperscript{40} The percentage was more than double—at 55\%—for family offices with less than $1 billion under management.\textsuperscript{41} Forty-six percent (46\%) of “first generation” family offices were run by a family member, while only 37\% of later generation firms had a family member in the top position.\textsuperscript{42} This data suggests that the more assets the family office has, and the more generations of the family that have elapsed, the less likely the family office is to be run by a family member.

A similar pattern emerges with respect to a family office’s board governance. Fifty-four percent (54\%) of billionaire family offices have a board of directors, while only 25\% of millionaire family offices use a board structure.\textsuperscript{43} Later generation family offices are also more likely to have a board than first generation offices, with 54\% of such firms using a board as compared to only 29\% of first generation offices.\textsuperscript{44} The Wharton Study explains, “When the wealth creator is present, decisions are typically made by him or her, with little reliance on governance committees. However, when that founder (first generation) is no longer present the family is forced to create more inclusive governance mechanisms.”\textsuperscript{45} Family office governance structures are as idiosyncratic as families themselves. But the Wharton Study suggests that family offices that are either larger or older tend to embrace more formalized governance practices.

Given this leadership and governance data, it is perhaps no surprise that family members in first generation family offices tend to be more “hands on” with their investments than family members in later generation offices. Among the first generation firms surveyed in the Wharton Study, 37\% of these families requested reports on a monthly basis, 31\% requested them on a quarterly basis, and 11\% requested updates on a weekly basis.\textsuperscript{46} Meanwhile, none of the family members in the later-generation firms requested weekly updates, and 19\% of these families requested updates only twice per year.\textsuperscript{47} According to the Wharton Study, “[t]he larger and more diffused a family becomes, the more likely the

38. AMIT ET AL., supra note 14, at 5.
39. Id. at 17.
40. Id.
41. Id.
42. Id. at 18.
43. Id. at 22.
44. Id.
45. Id.
46. Id. at 25.
47. Id.
family will be disengaged from its family office.”

In light of the diversity among family offices, it can be difficult to draw overarching conclusions about them. With that said, what all family offices ultimately have in common is that they provide a customized wealth management solution for their family clients. Most often, family offices invest with a long-term, “patient capital point of view.” As one family office expert put it, family offices are in the “stay rich versus get rich” business, focusing on “wealth preservation rather than on wealth accumulation.”

II. THE INVESTMENT ADVISERS ACT OF 1940

One of a family office’s primary functions is to advise its family clients regarding investment in securities. Given this advisory role, a family office would ordinarily fall under the extensive regulatory regime of the Investment Advisers Act of 1940. This section discusses the Advisers Act in general terms so that the reader can better understand and appreciate the significance of being excluded from it. Because the primary and secondary literature on the Advisers Act is extensive this section merely provides a broad overview of the Act.

The Advisers Act governs individuals and businesses that are in the business of purveying advice or reports related to investment in securities. Congress enacted the Advisers Act in 1940 in response to an SEC report documenting the proliferation of abusive practices in the burgeoning investment advisory industry. Such practices included investment “tipster services” that often dealt in unsubstantiated claims, performance-based fees that encouraged advisers to take excessive risk with client funds, and investment advisers possessing the unilateral ability to assign their client contracts. In addition, the report found problems with investment advisers’ solvency and custody of client funds. Because investment advisers did not meet the definitions of either “broker” or “dealer” under the Securities Exchange Act of 1934, Congress found additional legislation necessary and passed the Advisers Act.

As originally enacted, the Advisers Act required investment advisers to register with the SEC, prohibited performance-based fees, and required the inclusion of non-assignment provisions in all investment advisory con-
tracts. In addition, the Act included a broad anti-fraud provision. In spite of these steps, commentators describe the Advisers Act's initial scope as relatively modest and as imposing relatively few new substantive requirements. In ensuing years, however, the Advisers Act was amended on numerous occasions to keep pace with the rapidly expanding investment advisory industry and perceived lapses in investor protections. Among other things, these amendments required investment advisers to maintain certain books and records, which the SEC has the right to routinely inspect. The most recent major amendment of the Advisers Act was in 2010 with the passage of the Dodd-Frank Act, which sought to bring hedge funds under the purview of the Act by requiring many previously-unregistered investment advisers to register with the SEC. As it stands today, the Advisers Act and its accompanying rules and regulations present a substantial and complex body of regulation.

A. THE DEFINITION OF "INVESTMENT ADVISER"

To understand the implications of the Advisers Act, it is first necessary to understand who or what is an "investment adviser" under the Act. Section 202(a)(11) of the Act defines "investment adviser" as:

[A]ny person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.[62]

SEC interpretive releases have construed this definition as consisting of three distinct elements: An "investment adviser" is one who (1) provides advice, or issues reports or analyses, regarding investment in securities; (2) is in the business of providing such services; and (3) provides such services for compensation. This section briefly examines each element.

57. 1 INVESTMENT ADVISER REGULATION, supra note 52, § 1:3; see Advisers Act §§ 203(a), 15 U.S.C. § 80b-3(a) (2015) (requiring any non-exempt "investment adviser" to register with the SEC), 205(a), 15 U.S.C. § 80b-5 (2015) (prohibiting any investment advisory contract entered into, extended, or renewed on or after the effective date of the Act which provides for compensation to the investment adviser based on a share of capital gains or capital appreciation, or which allows the assignment of the contract by the investment adviser without the approval of the other party to the contract).


59. 1 INVESTMENT ADVISER REGULATION, supra note 52, § 1:3.


61. 1 INVESTMENT ADVISER REGULATION, supra note 52, § 1:3; see Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403(2), 124 Stat. 1376, 1571 (2010) [hereinafter Dodd-Frank Act] (repealing the "private adviser" exemption under former Advisers Act section 205(b)(3)).


First, an investment adviser is one who provides advice, analysis, or reports with respect to investment in securities, "the value of securities" or "the advisability of investing, purchasing, or selling securities." These broad terms clearly encapsulate giving advice to buy, sell, or hold specific securities, but the SEC has also interpreted these terms to include a wider array of securities-related advice, such as advice to buy, sell, or hold certain categories of securities; market-timing advice regarding switching between securities investment alternatives; and advice regarding the merits of investing in securities as opposed to non-security alternatives. One industry treatise conceives of this first element as requiring the exercise of "judgment" by the adviser, because the adviser must in some way actively advise the client regarding securities investment decisions. Merely providing investors with administrative support or "back office" services, such as accounting or record-keeping, will not cause the definition to apply. Further, in numerous contexts where a person has merely aggregated securities data for an investor's use, without providing any investment evaluation or recommendation, the SEC has found the person not to be an "investment adviser."

Because judgment is the determinative factor, the giving of advice to investors regarding the selection of other, third-party investment advisers will also cause the advice-giver to be an investment adviser. If, on the other hand, the advice-giver merely provides an investor with a list containing a broad cross-section of pre-screened advisers and the advice-giver has no real interest in which adviser is selected, then the advice-giver will not meet the definition of an investment adviser. Similarly, a firm that matches investors and entrepreneurs in exchange for a nominal fee but which does not provide advice with regard to the advisability of particular investments or investment strategies will also be excluded from

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64. Advisers Act § 202(a)(11), 15 U.S.C. § 80b-2 (2015). Note that "security" is a defined term under Advisers Act section 202(a)(18); see 15 U.S.C. § 80b-2(a)(18). The definition is identical to that contained in section 2(a)(1) of the Securities Act of 1933. See 15 U.S.C. § 77b(a)(1). Because the ways in which the term "security" has been interpreted from time to time by the SEC and the courts is not the focus of this article, the subject is not addressed here.

65. 1 Investment Adviser Regulation, supra note 52, § 2:2.2[B]; see also Crespi, supra note 63, at 361 ("Advice need not relate to specific securities to qualify as advice regarding securities; even general advice regarding the advisability of investing in securities as opposed to other types of investments is sufficient, and advice as to the selection or retention of an investment manager may also be sufficient.").

66. 1 Investment Adviser Regulation, supra note 52, § 2:2.2[B].

67. Id.

68. Id.; Crespi, supra note 63, at 361 (citing Dayton Area Bldg. & Constr. Indus. Found., SEC No Action Letter, 1987 WL 107960 (May 7, 1987)) ("[A] person who only transmits reports or analyses concerning securities without commenting on the information transmitted need not register.").

69. 1 Investment Adviser Regulation, supra note 52, § 2:2.2[B].

70. Id.
the definition.\textsuperscript{71}

Second, an "investment adviser" is one who is engaged "in the business" of providing securities investment advice or issuing analyses or reports concerning securities. To satisfy this requirement, the provision of securities investment advice or reports does not have to be a person's principal business activity, or even constitute a significant portion of their business activities. Rather, the SEC has said whether someone is engaged in the "business" of providing investment advice depends on all the relevant facts and circumstances, such as whether the person "[h]olds himself out as an investment adviser or as one who provides investment advice," whether they receive any "separate or additional compensation that represents a clearly definable charge for providing advice about securities," and whether they provide investment advice "on anything other than rare, isolated, and non-periodic instances."\textsuperscript{72} If the person provides securities-related advice or reports on any kind of a regular basis, regardless of how frequently such advice or reports are given, then the "business" element will be satisfied.\textsuperscript{73}

Third, the advice, analysis, or report must be offered in exchange for "compensation." Such compensation can take the form of "any economic benefit," whether an advisory fee, a commission, a combination of fees and commissions, or any other arrangement.\textsuperscript{74} Payments made in exchange for advisory services do not necessarily have to be separately itemized or broken out from the charges for other services in order to create an investment advisory relationship.\textsuperscript{75} Nor does payment necessarily have to be made by the actual recipient of the advice, as payments made by a third party will still cause the definition to apply.\textsuperscript{76} With that said, if someone provides investment advice without receiving any form of compensation, then that person will not be an "investment adviser" under the Act.\textsuperscript{77}

The Act's definition of "investment adviser" is sweeping, but the definition's application is narrowed by several enumerated exclusions.\textsuperscript{78}

These exclusions include publishers of bona fide news publications; advisers whose advice, analyses, and reports relate only to U.S. government securities; banks, except for divisions providing investment advice to registered investment companies; and certain financial rating organiza-

\textsuperscript{71} Crespi, supra note 63, at 361 (citing Evanston Bus. Inv. Corp., SEC No Action Letter, 1987 WL 108022 (Apr. 27, 1987)).


\textsuperscript{73} Id.

\textsuperscript{74} Id.; see also Crespi, supra note 63, at 362–63.

\textsuperscript{75} Release No. IA-1092, 52 Fed. Reg. at 38,403.


\textsuperscript{77} HAZEN, supra note 56, § 21.2[1][A] (citing Dominion Res., Inc., SEC No Action Letter, 1985 WL 54428 (July 23, 1985)).

Professionals such as lawyers, accountants, engineers, teachers, brokers, and dealers are also excluded from the definition, so long as the “performance of such [investment advisory] services is solely incidental to the practice of [their] profession.” Subsection (G) of the definition excludes “any family office, as defined by rule, regulation, or order of the Commission, in accordance with the purposes of this title[.]” In addition, the statute gives the SEC the broad authority to exclude persons it finds to be “not within the intent” of the definition, by rule, regulation, or order. Importantly, all these various categories of excluded persons under Section 202(a)(11) fall outside the scope of the Advisers Act altogether, as opposed to merely being exempt from registration with the SEC. A definitional exclusion is therefore more advantageous than exemption from registration, as it frees the person or company from having to comply with the Act entirely.

B. THE REGISTRATION REQUIREMENT

At the core of the Advisers Act is the registration requirement. Unless the investment adviser qualifies for an exemption from registration or is instead required to register with a state securities commission, it must register with the SEC. Advisers register by filing Form ADV and paying a nominal registration fee. Form ADV requires disclosure of basic information about the adviser, including “the adviser’s various trade names, principal places of business, basis for registration, the identity of person who controls the adviser, how the adviser’s operations are financed, the number and size of the adviser’s... clients, the disciplinary background of the adviser, the types of advisory services provided,” and the various fees charged by the adviser, among other items. If the adviser is a company, then the company itself must register, not the adviser’s officers or employees.
After the adviser has filed Form ADV, the SEC has forty-five days in which to either grant the application or institute proceedings to determine if there are grounds to deny it.\textsuperscript{89} Registration is not a merit review. Rather, it is a review to determine whether the adviser's application for registration was complete; whether the adviser is eligible for federal registration or must instead pursue state registration; and whether the adviser or one of its employees has performed one of the acts prohibited under Section 203(e), such as making a false statement to the SEC, willfully violating federal or state securities laws, committing a securities-related crime, or committing a non-securities related crime punishable by imprisonment for one year or longer.\textsuperscript{90} The SEC must generally make the adviser's registration statement publicly available, and the adviser is required to give all clients Part 2 of the Form ADV, often referred to as the adviser's "brochure."\textsuperscript{91}

There are numerous exemptions from registration available under the Advisers Act, although these exemptions have become more limited after the passage of Dodd-Frank. Some of these exemptions include "adviser[s] whose only clients are insurance companies," "foreign private adviser[s]" who have fewer than fifteen clients in the United States and meet other requirements, and certain charitable organizations.\textsuperscript{92} Dodd-Frank's largest impact on the investment adviser registration regime was its elimination of the so-called "private adviser" exemption under former Section 203(b)(3).\textsuperscript{93} Under this exemption, an investment adviser was exempt from registration so long as it had fewer than fifteen clients (i.e. fourteen clients or less) during the preceding year, did not hold itself out to the public as an investment adviser, and did not act as an investment adviser to a registered investment company or business development company.\textsuperscript{94} Advisers to large private funds, such as hedge funds and private equity funds, were often able to rely on this exemption, since under then-Rule 203(b)(3)-1, each fund under advisement counted as only one client, regardless of its number of beneficial owners.\textsuperscript{95} Many family offices were also able to take advantage of this exemption if they managed funds on behalf of fewer than fifteen family members or entities.\textsuperscript{96}

As a result of Dodd-Frank's elimination of the private adviser exemption, most large private advisers became required to register as investment advisers with the SEC. Dodd-Frank did, however, carve out a new

\textsuperscript{90} Id. § 80b-3(c)(2), (e).
\textsuperscript{91} Id. § 80b-10; Advisers Act Rule 204-3 17 C.F.R. § 275.204-3 (2006); see also 1 INVESTMENT ADVISER REGULATION, supra note 52, § 1:3.1.
\textsuperscript{92} See 15 U.S.C. § 80b-3(b); id. § 80b-2(a)(30) (defining "foreign private adviser").
\textsuperscript{93} Dodd-Frank Act, supra note 61, § 403(2).
\textsuperscript{95} Advisers Act Rule 203(b)(3)-1, 17 C.F.R. § 275.203(b)(3)-1 (2015), repealed by Dodd-Frank Act, supra note 61, § 403(2); see also Crespi, supra note 63, at 373; HAZEN, supra note 56, § 21.2[1][D].
\textsuperscript{96} HAZEN, supra note 56, § 21.2[3].
exemption in Section 203(m) for advisers who have less than $150 million in assets under management and who advise only "private funds," as that term is defined in Section 202(a)(30). The Act’s definition of “private fund” encompasses many private wealth funds such as hedge funds and private equity funds, since in most cases these would be “investment companies” under the Investment Company Act of 1940 but for certain exclusions provided in that law. Dodd-Frank also provided an exemption to advisers solely to “venture capital funds,” as that term is defined under Rule 203(l)-1. Although advisers who qualify for the private fund exemption under Section 203(m) or the venture capital fund exemption under Section 203(l) are indeed exempt from registration, these advisers are still subject to certain SEC reporting requirements. For this reason, these advisers are sometimes referred to as “exempt reporting advisers.”

While SEC registration is central to the Advisers Act’s regulatory scheme, Dodd-Frank amended the Act to provide for state registration instead of federal registration in many cases. In fact, some advisers are specifically prohibited from registering with the SEC and instead must register with the state or states where they conduct business. So-called “small advisers” with less than $25 million in assets under management may only register with the states and are prohibited from registering with the SEC. “Mid-sized advisers” with between $25 and $100 million under management must register with the states, unless doing so would require them to register with fifteen or more state securities commissions, in which case they may register with the SEC. Advisers with more than $100 million under management must register with the SEC and are not

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97. Advisers Act § 203(m), 15 U.S.C. § 80b-3(m) (2013) (providing an exemption from registration to “any investment adviser of private funds, if each of [sic] such investment adviser acts solely as an adviser to private funds and has assets under management in the United States of less than $150,000,000”); id. § 80b-2(a)(29) (defining “private fund” as “an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 . . . but for section 3(c)(1) or 3(c)(7) of that Act”); see also 17 C.F.R. § 275.203(m)-1 (“Private Fund Adviser Exemption”).

98. See Investment Company Act of 1940 § 3(c)(1), 15 U.S.C. § 80a-3(c)(1) (2011) (Generally excluding from the definition of “investment company” “issuer[s] whose outstanding securities . . . are beneficially owned by not more than one hundred persons and which are not making and do not . . . propose to make a public offering of its securities.”); id. § 80a-3(c)(7) (Generally excluding from the definition of “investment company” issuers whose outstanding securities are purchased exclusively by “qualified purchasers,” as that term is defined in Company Act section 2(a)(51), 15 U.S.C. § 80a-2(a)(51) (2011), and which is not making or proposing to make a public offering of its securities.).


100. 15 U.S.C. § 80b-3(l), (m)(2).

101. HAZEN, supra note 56, § 21.2[1][D].


103. Id.

104. Investment Company Act of 1940 § 3(c)(1), 15 U.S.C. § 80b-3a(a)(2) (2010). Interestingly, mid-sized advisers with their principal place of business in New York or Wyoming are not permitted to register with their state securities commission, and instead must register with the SEC. The SEC has explained that this is because advisers based in these states are not “subject to examination” by their state securities commission, as required under Advisers Act section 203A(a)(2)(B), 15 U.S.C. § 80b-3a(a)(2)(B). Securities and Exchange
required to register with the states.\textsuperscript{105}

While exemption from registration is advantageous for advisers from a compliance and cost standpoint, it is important to remember that it does not cause an adviser to be exempt from the other provisions of the Advisers Act. This again highlights the important distinction between the definitional exclusions under Section 202(a)(11), including the exclusion for "family offices," and the exemptions from registration under Section 203. Advisers excluded from the very definition of "investment adviser" are not subject to any of the Advisers Act's provisions, nor can they be subject to state registration, licensing or qualification requirements.\textsuperscript{106}

C. OTHER REQUIREMENTS AND RESTRICTIONS

The Advisers Act imposes voluminous ongoing filing and record-keeping requirements on investment advisers. Advisers who are not exempt from registration are required to file an annual updating amendment to Form ADV.\textsuperscript{107} All advisers, both exempt and non-exempt from registration, are required to maintain detailed ongoing records, including all their financial statements, all communications sent and received relating to investment advice or securities orders, and copies of all notices, letters, reports, and advertisements distributed to more than ten clients.\textsuperscript{108} These records are subject to examination at any time by the SEC.\textsuperscript{109} If an adviser has custody of client funds or securities, it must also retain an independent public accountant who will conduct a "surprise" examination of the adviser at an undisclosed time during the fiscal year to review whether the adviser is maintaining proper internal controls.\textsuperscript{110}

The Act also restricts how advisers may be compensated. The Act generally prohibits compensation that is directly based on a client's capital gains or capital appreciation.\textsuperscript{111} The Act does, however, allow compensation based on the client's average total assets under management during a defined period. In effect, therefore, advisers may indirectly receive compensation on their clients' capital appreciation.\textsuperscript{112} In addition, the SEC has promulgated other exceptions from the compensation restriction, such as where advice is given to "qualified clients," who are generally persons or companies having at least $1 million under management by the adviser, having total net worth in excess of $2 million, or who are

\begin{itemize}
\item \textsuperscript{105} 15 U.S.C. § 80b-3(a); § 203A(b)(1), 15 U.S.C. § 80b-3a(b)(1). The SEC has the statutory authority to raise the $100 million threshold for federal registration by rulemaking. 15 U.S.C. § 80b-3a(a)(2)(B)(i)(II).
\item \textsuperscript{107} Advisers Act Rule 204-1, 17 C.F.R. § 275.204-1 (2011).
\item \textsuperscript{108} Id. § 275.204-2.
\item \textsuperscript{109} 15 U.S.C. § 80b-4.
\item \textsuperscript{110} 17 C.F.R. § 275.206(4)-2.
\item \textsuperscript{112} Id. § 80b-5(b).
\end{itemize}
insiders of the adviser.\textsuperscript{113}

Section 206 is the Act's anti-fraud provision, the language of which is based in part on Section 17(a)(1) of the Securities Act of 1933.\textsuperscript{114} Section 206 prohibits any investment adviser "to employ any device, scheme, or artifice to defraud any client or prospective client," "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," or "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative" as defined by SEC rule.\textsuperscript{115} Section 206 also forbids investment advisers from buying securities from their clients or selling securities to their clients from their own account, unless they provide prior written notice to the client and obtain the client's consent.\textsuperscript{116} The Supreme Court has held that investment advisers owe a fiduciary duty to their clients.\textsuperscript{117} However, the Court has refused to recognize any private cause of action under Section 206, holding that injured clients may only void their contract with their adviser under Section 215.\textsuperscript{118} The SEC has broad authority to enforce the Advisers Act through various means, such as by suspending an adviser's registration, barring or suspending an individual from associating with an investment adviser, and assessing monetary penalties.\textsuperscript{119}

There are numerous other restrictions and requirements under the Advisers Act that are beyond the scope of this article. We now turn to the family office exclusion under the Advisers Act and the Family Office Rule.

\section*{III. THE FAMILY OFFICE EXCLUSION}

The term "family office" did not appear in the Advisers Act until the passage of the Dodd-Frank Act in 2010. Dodd-Frank paved the way for the SEC to promulgate the Family Office Rule, which for the first time provided a set of requirements for family offices to meet in order to exclude themselves from the Advisers Act. Section III-A, below, discusses how family offices could avoid regulation under the Advisers Act before Dodd-Frank. Section III-B examines Section 409 of the Dodd-Frank Act, which created the definitional exclusion from the Advisers Act for family

\begin{flushleft}
\textsuperscript{113} Id.; Advisers Act Rule 205-3(d)(1), 17 C.F.R. § 275.205-3(d)(1) (2012).
\textsuperscript{114} HAZEN, supra note 56, § 21.4[1][A].
\textsuperscript{115} 15 U.S.C. § 80b-6(1), (2), (4).
\textsuperscript{116} Id. § 80b-6(3).
\textsuperscript{118} Lewis, 444 U.S. at 24; Advisers Act § 215, 15 U.S.C. § 80b-15(b) (2012) ("Every contract made in violation of any provision of this [Act] and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of any provision of this [Act], or any rule, regulation, or order thereunder, shall be void.").
\textsuperscript{119} Advisers Act § 203(e), (f), (i), 15 U.S.C. § 80b-3(e), (f), (i); § 209, 15 U.S.C. § 80b-9 (2013).
\end{flushleft}
offices and set out certain guidelines for the SEC to follow in defining the term “family office.”\textsuperscript{120} Section III-C comprehensively explores Advisers Act Rule 202(a)(11)(G)-1, the Family Office Rule ultimately promulgated by the SEC in June 2011.

**A. BACKGROUND: REGULATION OF FAMILY OFFICES BEFORE DODD-FRANK**

Before the passage of Dodd-Frank in 2010, family offices avoided Advisers Act regulation in one of two ways. The first way, previously discussed in Section II-B, was through the “private adviser” exemption of former Section 203(b)(3).\textsuperscript{121} This generally allowed a family office to be exempt from registration so long as it had fewer than fifteen clients during the preceding year and did not hold itself out to the public as an investment adviser.\textsuperscript{122} While the latter requirement was typically easy for family offices to satisfy, satisfying the “fewer than fifteen clients” requirement depended on the office’s facts and circumstances.\textsuperscript{123} If the office served fewer than fifteen family members or entities, it could qualify for the exemption. Former Advisers Act Rule 203(b)(3)-1 was helpful in this regard, since it provided flexible standards for counting the number of clients. Under the old rule, family offices could count as only one client a natural person, that person’s minor children, and that person’s relatives living at their principal residence.\textsuperscript{124} Accounts and trusts for the benefit of any of those persons could also be included.\textsuperscript{125} The rule also stated that any business entity counted as one client, regardless of its number of beneficial owners, and that entities with identical owners could be counted as one client.\textsuperscript{126} Finally, clients whom the family office provided with investment advice without receiving any compensation did not count as clients at all.\textsuperscript{127} This last provision was particularly helpful for family offices, as many do not charge their family clients for advisory services.\textsuperscript{128}

\textsuperscript{120} 15 U.S.C. § 80b-2(a)(11)(G) (excluding from the “investment adviser” definition “any family office, as defined by rule, regulation, or order of the Commission, in accordance with the purposes of this [title]”); see also Family Offices, Investment Advisers Act Release No. IA-3220, 76 Fed. Reg. 37,983 (June 9, 2011) [hereinafter Release No. IA-3220].


\textsuperscript{122} Id.

\textsuperscript{123} 3 INVESTMENT ADVISER REGULATION § 59.2 (Clifford E. Kirsch ed., 3d ed. 2011).


\textsuperscript{125} Id.

\textsuperscript{126} Id. § 275.203(b)(3)-1(a)(2).

\textsuperscript{127} Id. § 275.203(b)(3)-1(b)(4).

\textsuperscript{128} 3 INVESTMENT ADVISER REGULATION, supra note 123, § 59.2 (“Because many family offices receive their income in a manner that does not affect, directly or indirectly, many of their clients, those family offices could rely on former Rule 203(b)(3)-1 to comply with the requirements of former section 203(b)(3) because they had fewer than fifteen clients from which they received any compensation. Other family offices simply had fewer than fifteen ‘clients.’”).
If the family office was unable to take advantage of the Section 203(b)(3) safe harbor, it could still apply to the SEC for a special exemptive order. The Act granted and continues to grant the SEC discretion to exclude from the Act "by rules and regulations or order" any adviser it finds to be "not within the intent" of the Act's definition of "investment adviser." The SEC typically granted these exemptive orders to family offices liberally, under the rationale that family members who received investment advice through their family office were not in need of the Advisers Act's protections. Interestingly, offices that received exemptive orders became exempt from all of the Advisers Act's provisions, and not just the registration requirement. Family offices that received exemptive orders were therefore arguably better off than offices that chose to rely on the "private adviser" exemption from registration, although the secondary literature does not suggest that this distinction was particularly important to family offices in practice.

In spite of these two methods available for family offices to avoid the Advisers Act, it seems that many of them still failed to utilize either of them. In its final family office rulemaking, the SEC acknowledged what had apparently been a widespread practice among family offices: "We are troubled by comment letters we receive by counsel to some family offices that appear to acknowledge that their clients were operating as unregistered investment advisers, although they were not eligible for the private adviser exemption and had not obtained an exemptive order from us."

The SEC's liberal granting of exemptive orders and its lack of enforcement actions seems to have created an atmosphere in which family offices perceived that the Act did not apply to them, even though "an adviser may not 'rely' on exemptive orders issued to other persons."

We next turn to Section 409 of the Dodd-Frank Act, which for the first time provided a definitional exclusion from the Advisers Act specifically for family offices.

**B. Dodd-Frank Section 409**

Because Dodd-Frank eliminated the "private adviser" exemption, absent further statutory change family offices would have had no means of exempting themselves from the Advisers Act other than by obtaining a special exemptive order. To prevent such an outcome, Section 409 specifically excluded "family offices" from the definition of "investment ad-

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130. 3 INVESTMENT ADVISER REGULATION, supra note 123, § 59.2.
131. Id.
133. Id.
134. Dodd-Frank Act, supra note 61, § 403(2).
viser.” Section 409 laid out basic criteria for the SEC to follow in its rulemaking and required the SEC to promulgate a definition of “family office” that “is consistent with the previous exemptive policy of the Commission, as reflected in exemptive orders for family offices in effect on the date of enactment of this Act” and which would “recognize[e] the range of organizational, management, and employment structures and arrangements employed by family offices.”

Section 409 also included a grandfather provision that mandated that no family office could be stripped of exemption solely because it had provided investment advice to any of the following before January 1, 2010: (1) an officer, director, or employee who is an “accredited investor” under Regulation D of the Securities Act, (2) a company owned exclusively and controlled by family members, or (3) a registered investment adviser who advised the family office and co-invested with the family office, so long as the co-invested funds are not more than 5 percent of the family office’s assets under management.

While Section 409 erroneously read in terms of providing an “exemption” from the Advisers Act, it in fact specifically provided a complete definitional exclusion from the Act.

In its report issued on April 30, 2010, the Senate Committee on Banking, Housing, and Urban Affairs explained its rationale for the family office exclusion. As the only documented legislative history regarding Section 409, the report provides the only insight into Congress’s intent in creating the exclusion:

Family offices provide investment advice in the course of managing the investments and financial affairs of one or more generations of a single family. Since the enactment of the Investment Advisers Act of 1940, the SEC has issued orders to family offices declaring that those family offices are not investment advisers within the intent of the Act (and thus not subject to the registration and other requirements of the Act). The Committee believes that family offices are not investment advisers intended to be subject to registration under the Advisers Act. The Advisers Act is not designed to regulate the interactions of family members, and registration would unnecessarily intrude on the privacy of the family involved. Accordingly, Section 409 directs the SEC to define “family office” and excludes family offices from the definition of investment adviser [under] [sic] Section 202(a)(11) of the Act.

135. Id. § 409 (“Family Offices”) (enacting Advisers Act section 202(a)(11)(G), 15 U.S.C. § 80b-2(a)(11)(G) (2013), excluding from the definition of “investment adviser” “any family office, as defined by rule, regulation, or order of the Commission, in accordance with the purposes of this title”). See infra Appendix 1 for the full text of section 409.

136. Dodd-Frank Act, supra note 61, § 409(b)(1)-(2).

137. Id. § 409(b)(3). Notably, family offices exempted solely on the basis of this grandfather provision were not exempted from the antifraud provisions under paragraphs (1), (2), and (4) of Advisers Act section 206. Id. § 409(c).


139. The House of Representatives’ version of Dodd-Frank did not include any exclusion for family offices, and the Conference Committee that reconciled the House and Senate versions did not publish a report. The legislative history of Section 409 from the Senate bill is therefore the only published expression of Congress’s intent in creating the exclusion. 3 INVESTMENT ADVISER REGULATION, supra note 123, § 59.2.
As the committee report indicates, Congress believed investment advisers engaged primarily in the management of a single family's wealth were not intended to be regulated under the Advisers Act. The Committee stated its rationale in terms of respect for family privacy, but likely it also had to do with a belief that members of what are typically financially sophisticated families are not in need of the protections and safeguards provided by the Act. The committee report went on to acknowledge the frequent practice among family offices of allowing co-investment by non-family insiders:

Section 409 directs the SEC to adopt rules of general applicability defining “family offices” for purposes of the exemption. The rules shall provide for an exemption that is consistent with the SEC's previous exemptive policy and that takes into account the range of organizational and employment structures employed by family offices. The Committee recognizes that many family offices have become professional in nature and may have officers, directors, and employees who are not family members, and who may be employed by the family itself or by an affiliated entity. Such persons (and other persons who may provide services to the family office) may co-invest with family members, enabling them to share in the profits of investments they oversee, and better aligning the interests of such persons with those of the family members served by the family office. The Committee expects that such arrangements would not automatically exclude a family office from the definition.141

Although the Committee’s “expectations” regarding the SEC's rulemaking were not technically binding on the agency, it appears they were highly persuasive.142 Of course, Section 409's requirement that the final rule “recogniz[e] the range of organizational, management, and employment structures and arrangements employed by family offices” was binding, as was the grandfather provision for family offices that allowed co-investment by insiders in prior years.143 It is therefore unsurprising that the SEC's final rule did give family offices wide latitude to allow for co-investment by certain officers, directors, and employees.144 We now examine the SEC's final rule under Section 202(a)(11)(G), defining the term “family office.”

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140. S. REP. NO. 111-176, at 75 (emphasis added).
141. Id. at 75-76 (emphasis added).
143. Dodd-Frank Act, supra note 61, § 409(b)(2).
Advisers Act Rule 202(a)(11)(G)-1, more commonly known as the "Family Office Rule," was promulgated by the SEC on June 22, 2011 in SEC Release IA-3220 (the "Adopting Release"). At over 1,500 words and with nine defined terms, the Rule is surprisingly intricate and complex. Subsection (b) of the Rule frames the definition of "family office" in terms of three fundamental requirements: (1) a "family client" requirement, (2) an ownership and control requirement, and (3) a private adviser requirement. The full text of subsection (b) is as follows:

(b) Family office. A family office is a company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their position or employment) that:

(1) Has no clients other than family clients; provided that if a person that is not a family client becomes a client of the family office as a result of the death of a family member or key employee or other involuntary transfer from a family member or key employee, that person shall be deemed to be a family client for purposes of this section for one year following the completion of the transfer of legal title to the assets resulting from the involuntary event;

(2) Is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and

(3) Does not hold itself out to the public as an investment adviser.

The term "company" used in the opening clause is defined broadly in the Advisers Act to include entities such as corporations, partnerships, trusts, and "any organized group of persons, whether incorporated or not." For purposes of the exclusion, it therefore does not matter what type of legal entity a family office utilizes. In fact, given the Act's flexible definition of "company," a family office could conceivably just be a division within a family's operating business, so long as the business satisfies the Rule's other requirements. One commentator points out that the phrase "has no clients other than," taken in context, can only mean "has


146. See infra Appendix 2 for the complete text of the Family Office Rule.


148. Advisers Act § 202(a)(5), 15 U.S.C. § 80b-2(a)(5) (2013) ("'Company' means a corporation, a partnership, an association, a joint-stock corporation, a trust, or any organized group of persons, whether incorporated or not; or any receiver, trustee, in a case under Title 11 of the United States Code, or similar official, or any liquidating agent for any of the foregoing, in his capacity as such.").

149. 3 INVESTMENT ADVISER REGULATION, supra note 123, § 59.4.2.A.
no [investment advisory] clients other than,” since the giving of investment advice is the only activity the SEC can regulate under the Advisers Act. A family office may therefore provide other services (e.g. tax, accounting, etc.) to persons who are not “family clients” and still be eligible for the exclusion.

We now analyze in detail each of the three requirements contained in subsection (b) of the Rule.

1. The “Family Client” Requirement

The first requirement under subsection (b)(1) of the Family Office Rule is that the family office “has no clients other than family clients.”

Subsection (b)(1) also contains a one-year grace period in the case of involuntary transfers to persons who are not “family clients.”

The implications of the client requirement under subsection (b)(1) hinge on the Rule’s definition of “family client,” a lengthy and complex definition that itself contains several other defined terms. Distilled to its fundamentals, a “family client” must be a “family member,” “former family member,” “key employee,” “former key employee,” the estate of one of these persons, a company owned and controlled by one or more of these persons, or an affiliated trust or non-profit organization meeting certain requirements. This article does not explore all of the nuances related to eligible trusts and non-profit organizations, but it analyzes the other enumerated categories in detail.

a. Family Members

The first and most expansive enumerated category of persons included in the definition of “family client” is “[a]ny family member.” The Rule defines a “family member” as:

[A]ll 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.

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150. Id.
151. Id. The SEC Staff has acknowledged this possibility, as well. See Staff Response to Questions About the Family Office Rule, U.S. Securities and Exchange Commission, at Question IV.1 (April 27, 2012) [hereinafter SEC Staff Q&A], http://www.sec.gov/divisions/investment/guidance/familyofficefaq.htm [https://perma.cc/M9UM-3RTD]. See infra Appendix 3 for selections from the Staff Q&A.
153. Id.
155. Id.
156. Id. § 275.202(a)(11)(G)-1(d)(6).
In essence, a “family member” includes all the lineal descendants of a common ancestor up to ten generations removed from that common ancestor, plus those lineal descendants’ spouses or spousal equivalents. The definition is very flexible in that it includes a lineal descendant’s adopted children, stepchildren, and foster children, as well as persons who were minors when a lineal descendant became their legal guardian. As the definition is worded, adopted children, stepchildren, and persons under guardianship as minors retain their “family member” status even after they reach the age of majority.\footnote{157}

The Rule continues its flexible approach with regard to spouses, as it includes not only spouses who are legally married to lineal descendants but also “spousal equivalents,” defined elsewhere in the Rule as “a cohabitant occupying a relationship generally equivalent to that of a spouse.”\footnote{158} The SEC staff has explained that a “spousal equivalent” includes “same-sex domestic partners as well as opposite sex partners that have determined not to marry even though they live together in a relationship generally equivalent to married couples.”\footnote{159} Because the definition of “family member” is based on descent from a common ancestor, a lineal descendant’s in-laws are not included in the definition and therefore may not invest through the family office.\footnote{160}

The Rule imposes a limit of ten generations between the common ancestor and the last generation of descendants. It is important to recognize, however, that because the common ancestor himself is actually not included in the definition of “family member,” there are in effect only nine generations between the oldest and youngest generations of “family members.” In the Adopting Release, the SEC explained it believed some kind of generational limit was necessary in order to prevent abuse.\footnote{161} Without such a limiting principle, smaller commercial investment advisory offices seeking to avoid registration could conceivably research their clients’ genealogy as far back as necessary in order to locate a remote common ancestor and take advantage of the exclusion.\footnote{162} Without a generational limit, multiple families could also join together to create a multi-family office and qualify for the exclusion as long as they could locate a remote common ancestor. The SEC has explained that the family office exclusion is intended for single family offices only, so a genera-

\footnote{157. This would not seem to be the case for foster children, who lose their foster status when they reach majority age.}


\footnote{159. SEC Staff Q&A, supra note 151, at Question III.3.}

\footnote{160. See id. at Question III.1; 3 INVESTMENT ADVISER REGULATION, supra note 123, § 59.4.2.B.1.}


\footnote{162. Id. (“In order to prevent families from choosing an extremely remote ancestor, which could allow commercial advisory businesses to rely on the rule, we are imposing a 10 generation limit between the oldest and youngest generation of family members. Such a limit, suggested by several commenters, would constrain the scope of persons considered family members while accommodating the typical number of generations served by most family offices.”).}
tional limit was believed necessary in order to prevent such a practice.\textsuperscript{163} Some commentators have criticized the ten generation limit as unduly restrictive.\textsuperscript{164} But the seeming harshness and arbitrariness of this limitation is mitigated by two important factors. The first is the simple truth that ten generations encompasses quite a long period of time. If a generation is measured as thirty years,\textsuperscript{165} then ten generations would allow for 300 years between the birth of the common ancestor and the birth of the tenth generation. If that measure is shortened to twenty-five years, that span of time is still 250 years. The second mitigating factor is that a family office can re-designate its common ancestor at any time it desires.\textsuperscript{166} There is no formal process or filing necessary to make this re-designation.\textsuperscript{167} Nor is there any requirement for the designated common ancestor to have been the founder of the family office.\textsuperscript{168} The SEC specifically chose a “common ancestor” approach over the “office founder” approach it originally proposed in Release IA-3098 (the “Proposing Release”) after it received comment letters pointing out that the founder approach would apply different limits to family offices depending on when they were founded.\textsuperscript{169}

A family office faces trade-offs depending on how far “up” or “down” the chain of generations it selects a common ancestor. Selecting a common ancestor farther “up” the chain will allow the family office to serve a greater number of “collateral” kindred, such as distant cousins.\textsuperscript{170} On the other hand, choosing a common ancestor farther “down” the chain will allow the family office to serve a greater number of current family mem-

\textsuperscript{163} Release No. IA-3098, 75 Fed. Reg. 63,753, 63,756 (Oct. 12, 2010) (“The rule would not extend to family offices serving multiple families. We have never granted an exemptive order to a multifamily office declaring them not to be an investment adviser and thus including them would seem to be inconsistent with our prior exemptive policy. Many multifamily offices more resemble a typical commercial investment adviser appropriately subject to the Advisers Act.”).

\textsuperscript{164} See \textit{3 Investment Adviser Regulation}, supra note 123, § 59.4.2.B.1 (“The limitation to ten generations is also unfortunate and will, over time, adversely affect every family office whose family wealth was created by a common ancestor during the nineteenth or early twentieth century.”).

\textsuperscript{165} See \textit{generation, n.}, \textit{Oxford English Dictionary}, Feb. 2, 2016, at 3(b), http://www.oed.com/view/Entry/77521?redirectedfrom=generation#eid [https://perma.cc/FP54-BP4K] (defining “generation” as “[t]he average time it takes for children to grow up, become adults, and have children of their own, generally considered to be about thirty years, and used as a rough measure of historical time”).

\textsuperscript{166} Release No. IA-3220, 76 Fed. Reg. at 37,985 (“Under this approach, the family office will be able to choose the common ancestor and may change that designation over time such that the family office clientele is able to shift over time along with the family members served by the family office.”).

\textsuperscript{167} Id. at 37,985 n.27.


\textsuperscript{169} Id. (“Some commenters also criticized our approach because it would treat who could be a family member differently depending on when the family office was established. For example, one commenter stated that our proposal would have allowed a family office that was formed a long time ago to provide services to persons that [sic] are currently third or fourth cousins to each other, but that a family office established today may need to wait at least 40 or 50 years before being able to provide services to equivalent types of family members.”).

\textsuperscript{170} Id. at 37,985.
bers’ future lineal descendants.171

b. Former Family Members

The next category of family client is “former family members.”172 This definition is relatively straightforward: “a spouse, spousal equivalent, or stepchild that was a family member but is no longer a family member due to a divorce or other similar event.”173 In the case of divorce, a family office may continue to serve former spouses and former stepchildren, with no limit on the duration of time and no prohibition on the making of new investments.174 It is unclear precisely what constitutes an “other similar event” under the definition, but assumedly it encompasses marital separation or, in the case of spousal equivalents, an ending of the relationship.

Both the Rule and the Adopting Release are notably silent with regard to the surviving spouses or surviving spousal equivalents of deceased lineal descendants. Do these persons remain “family members” after the lineal descendant’s death, or do they become “former family members”? The distinction is of no consequence, as in either case they preserve their “family client” status.175 Because divorced spouses retain their ability to invest through the family office, it seems all but certain that surviving spouses and spousal equivalents retain that ability, as well.176

c. Key Employees

The Family Office Rule allows “key employees” to receive investment advice from the family office.177 As previously discussed, this was a congressional priority reflected in the Senate Banking Committee’s report,178 and before the passage of Dodd-Frank the SEC had issued exemptive orders to family offices allowing such arrangements.179 The SEC’s rationale for including key employees as “family clients” was twofold: First, given these employees’ financial sophistication and insider status, they should be able to protect themselves without the protections of the Ad-
visers Act. Second, family offices need the ability to allow co-investment by certain personnel in order to attract top talent and to align the interests of the family with those of its employees.

"Key employee" is defined as:

[Any natural person (including any key employee’s spouse or spouse 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 of the family office or its affiliated family office or any employee of the family office or its affiliated family office (other than an employee performing solely clerical, secretarial, or administrative functions with regard to the family office) 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 and duties for or on behalf of the family office or affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months.]

The sheer length of the definition obscures the fact that it actually contains two distinctly different categories of persons. The first category includes persons in a position of managerial authority, including executive officers, directors, trustees, general partners, or similarly situated persons. Some of these persons, such as directors and trustees, might not actually be employed by the family office at all. The second category encompasses employees "who, in connection with [their] regular functions or duties, participate in the investment activities" of the office or affiliated office. These employees need not necessarily hold positions of managerial authority, but they must not be administrative or clerical in nature. Furthermore, they must have served in an investments-related role for at least twelve months. According to the Adopting Release, this twelve-month requirement is a safeguard intended to limit participa-

180. Release No. IA-3220, 76 Fed. Reg. at 37,990 ("Key employee receipt of family office advice is permitted because their position and experience should enable them to protect themselves and to allow family offices to attract talented investment professionals as employees.").

181. Release No. IA-3098, 75 Fed. Reg. at 63,758 ("Permitting participation by key employees allows such family offices to incentivize key employees to take a job with the family office and to create positive investment results at the family office under terms that could be available to them as employees of other types of money management firms. It is our understanding that in some cases family offices may need to provide such incentives to attract highly skilled investment professionals who may not otherwise be attracted to work at a family office.").


183. "Executive officer" is defined broadly in the Rule to mean "the president, any vice president in charge of a principal business unit, division or function (such as administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the family office. Id. § 275.202(a)(11)(G)-1(d)(3).

184. Id. § 275.202(a)(11)(G)-1(d)(8).

185. Id.
tion to "those employees that are likely to be in a position or have a level of knowledge and experience in financial matters sufficient to be able to evaluate the risks and take steps to protect themselves." 186 Interestingly, these employees need not serve in an investments-related role for twelve months at the family office itself. Rather, if they fulfilled "substantially similar functions or duties for or on behalf of another company" for a twelve month period, the Rule is satisfied. 187

The definition of "key employee" encompasses not only the key employees of the family office, but also the key employees of an "affiliated family office." As the term suggests, an "affiliated family office" is a separate family office that is owned by family clients of the original family office, is controlled by members of the same family, and satisfies the Rule's requirements. 188 (The ownership and control requirements for family offices are discussed in Section III-C.2, below.) The Rule allows for such an arrangement because some families may have more than one family office due to a variety of business, tax, or other structuring reasons. 189 Allowing key employees of an affiliated family office to receive investment advice from the family office therefore allows greater flexibility. 190 The SEC declined to define "key employees" to include employees of "family entities" (a term that captures companies wholly owned by family clients, also discussed in Section III-C.2), as many family-owned companies are operating businesses that do not specialize in investments. 191 As such, the SEC believed "[t]here is no reason to expect that [key employees of family entities] have a level of knowledge and experience in financial matters sufficient to protect themselves without the protections afforded by the Advisers Act." 192 For the same reason, the agency refused to include the spouses of key employees, except insofar as they have a joint property interest in the invested property. 193

d. Former Key Employees

"Former key employees" are included as "family clients," "provided that upon the end of [their] employment by the family office, [they] shall

188. Advisers Act Rule § 203(b)(3)-1, 17 C.F.R. § 275.202(a)(11)(G)-1(d)(1) (2011) (defining "Affiliated Family Office" 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").
189. Release No. IA-3220, 76 Fed. Reg. at 37,989 n.88 ("Some commenters pointed out that a family may establish more than one family office for tax or other structuring reasons and recommended that the definition of key employee include employees of multiple family offices that serve the same family.").
190. See id. at 37, 989.
191. Id.
192. Id.
193. Id. at 37, 990 ("There is no reason to believe that the key employee's spouse or immediate family members independently have the financial sophistication and experience to protect themselves when receiving investment advice from the family office.").
not receive investment advice from the family office. . . other than with respect to assets advised (directly or indirectly) by the family office immediately prior to the end of [their] employment[.]

The SEC decided that after key employees terminate their employment with the family office, they may continue to keep their preexisting investments under the family office’s management. This decision was motivated at least in part by a desire to prevent adverse tax or investment consequences to the former key employee. Former key employees may not enter into any new investments through the family office, except with regard to previous contractual obligations related to preexisting investments. The SEC based this restriction on the belief that once the key employee departs from the family office, the previous rationale that they do not require the Advisers Act’s protections no longer applies.

e. Estates and Trusts

The inclusion of estates and certain trusts as “family clients” recognizes the reality that families’ estate plans are by necessity often intertwined with the family office. Any estate of a family member, former family member, key employee, or former key employee is included as a family client. Any revocable trust that has one or more family clients as its sole grantor or grantors is also permitted to be a family client. The Rule focuses on the grantor of a revocable trust, as opposed to its beneficiaries, because these beneficiaries “have no reasonable expectation of obtaining any benefit from the trust until the trust becomes irrevocable (generally upon the death of the grantor).” Therefore, if persons other than family clients are included as beneficiaries of a revocable trust, it does not flout the policy behind the Family Office Rule.

With regard to irrevocable trusts, the Rule does take the trust’s current beneficiaries in to consideration. An irrevocable trust will be a “family

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196. Id.
198. Release No. IA-3220, 76 Fd. Reg. at 37,990 (“We are including key employees as family clients because their particular role in the family office causes us to believe that the employee should be in a position to protect him or herself without the need for the protections of the Advisers Act. Once the employee is no longer in that role, this policy rationale no longer holds true to the same degree.”).
202. Id.
client” so long as all its current beneficiaries are family clients. The Adopting Release explains that the contingent beneficiaries of an irrevocable trust need not be family clients for similar reasons as with revocable trusts, and also because the contingent beneficiaries of an irrevocable trust are often named specifically in case all of the trust’s current beneficiaries (the family members) are deceased. The irrevocable trust’s current beneficiaries may also include “non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations,” but only if the irrevocable trust is “funded exclusively by one or more other family clients.” Here, the SEC’s broader decision pertaining to the inclusion of non-profit and charitable organizations as “family clients” is relevant.

f. Non-Profit Organizations, Charitable Foundations, and Charitable Trusts

The Rule allows non-profit organizations, charitable foundations, charitable trusts, and other charitable organizations to qualify as family clients, so long as “all the funding such foundation, trust or organization holds came exclusively from one or more other family clients.” In other words, charitable entities that receive any funding from persons other than family clients do not qualify. In the Adopting Release, the SEC explained its rationale in terms of a non-family-funded non-profit “lack[ing] the characteristics necessary to be viewed as a member of a family unit”: “Permitting such [non-family-funded] organizations to be advised by a family office would be inconsistent with the exclusion’s underlying rationale that recognizes that the Advisers Act is not designed to regulate families managing their own wealth.” The SEC did, however, soften its initial proposal, which had required the charitable organization or trust to also have been founded by family members. Now, “as long as all the funding currently held by the charitable organization came solely from [family] clients,” the SEC explained, “the individuals or entities that originally established it are not of import for our policy rationale.”

g. Companies Wholly Owned by Family Clients

The final category of family client is “[a]ny company wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of,
one or more other family clients[]."\(^211\) Here, the "wholly owned" and "operated for the sole benefit" requirements present a high hurdle: any investment in the company by a non-family client will prevent it from being a "family client" eligible to receive investment advice from the family office. This category can be useful if the family's operating business wishes to receive investment advice through the family office, or if family clients create an entity in order to pursue a specific investment opportunity.\(^212\)

This concludes this article's examination of the various categories of "family client" a family office may serve: family members, former family members, key employees, former key employees (with regard only to previously-committed and preexisting investments), certain estates and trusts, non-profit organizations exclusively funded by other family clients, and companies wholly owned by other family clients.

h. One-Year Grace Period for Involuntary Transfers

We now turn to the remainder of subsection (b)(1) of the Rule, which provides a one-year grace period for investments by non-family clients who "become a client of the family office as a result of the death of a family member or key employee or other involuntary transfer from a family member or key employee."\(^213\) This grace period is intended to prevent a family office from losing its excluded status simply because of an involuntary transfer, such as a family client's bequest to a non-family member of assets in a family office-advised private fund.\(^214\) The Adopting Release explains that the purpose of the one-year grace period is to "permit the family office to orderly transition that client's assets to another investment adviser or otherwise restructure its activities to comply with the Advisers Act."\(^215\) This one-year period is longer than the four-month period originally proposed by the SEC.\(^216\) In spite of comment letters arguing for an even longer or more flexible standard, the SEC insisted that "relief for involuntary transfers must be temporary" because "after several such bequests the office could cease to operate in any way as a family office."\(^217\)

Now that we have discussed subsection (b)(1)'s restrictions on the type of clients a family office is allowed to serve, we may turn to subsection

\(^{211}\) Advisers Act Rule § 202(a)(11)(G)-1, 17 C.F.R. § 275.202(a)(11)(G)-1(d)(4)(xi) (2011). The full definition also provides "that if any such entity is a pooled investment vehicle, it [must be] excepted from the definition of 'investment company' under the Investment Company Act of 1940." Id.

\(^{212}\) See 3 INVESTMENT ADVISER REGULATION, supra note 123, § 59.4.2.B.6. In this commentator's view, "the 'owned exclusively' and 'for the sole benefit of' conditions are simply too stringent and not necessary in situations where a legitimate family office is not attempting to give 'investment advice' to non-family members or non-family clients that also own interests in the intermediate holding company." Id.


\(^{215}\) Id.

\(^{216}\) Id.

\(^{217}\) Id.
2. The Ownership and Control Requirement

For a family office to be excluded from the Advisers Act, subsection (b)(2) of the Rule requires the family office to be "wholly owned by family clients" and "exclusively controlled (directly or indirectly) by one or more family members and/or family entities[.]") Subsection (b)(2)'s brevity belies its complexity and nuance. The requirements for the ownership group and the control group are distinct, and the precise meaning of "exclusively controlled (directly or indirectly)" is difficult to discern.

Subsection (b)(2) states that the family office must be wholly owned by "family clients," the broad group of persons previously discussed above. The family office must be "exclusively controlled," however, by only "family members and/or family entities." As previously discussed, includes lineal descendants up to ten generations removed from a common ancestor, plus their spouses and spousal equivalents. The Rule defines "family entities" as the various estates, trusts, non-profit organizations, and wholly-owned companies that are included in the definition of "family clients," but "excluding key employees and their trusts from the definition of family client solely for purposes of this definition." The control group is therefore more restrictive than the ownership group, as it specifically excludes key employees and their affiliated entities and trusts.

a. Analysis

Given the critical distinction between the ownership group and the control group, a family office must analyze each group carefully to ensure it is in compliance with the Rule. The placement of two such distinct requirements next to one another in the same sentence is arguably confusing. This placement is likely the result of the rule that the SEC originally proposed, which required family offices to be both wholly owned and controlled solely by "family members." The SEC explained that public comment letters persuaded it to broaden the ownership group to "family clients" for two reasons. First, family offices are sometimes owned by family trusts, which technically do not satisfy the definition of "family member." Second, family offices sometimes allow their employees to own an equity interest in the office as an incentive for good perform-
In light of these practices, the SEC agreed to expand the ownership group to "family clients." But the SEC specifically declined to expand the control group to "family clients," instead restricting it to "family members and/or family entities." The SEC did not elaborate on its decision, saying only that it believed "exclusive control" by family members and family entities was necessary "for our core policy rationale to be fulfilled—that a family office is essentially a family managing its own wealth.") In short, the SEC apparently believed a family office would lose its fundamental character if it were under the control of non-family members or entities, despite the fact the office might actually be owned in part by such non-family persons.

The requirement that the family office be "wholly owned" by family clients is straightforward. While the Adopting Release does not discuss the various possible ownership configurations, assumedly if the family office is a corporation then all of its shares must be owned by family clients. Similarly, if it is an LLC or partnership, then all of its membership or partnership interests must be owned by family clients. The SEC staff has explained that in its view, any non-voting shares in the family office must also be owned by family clients.

While the ownership requirement is quite clear, the control requirement defies simple explanation. The Rule states that the family office must be "exclusively controlled (directly or indirectly) by one or more family members and/or family entities." The Rule defines "control" as "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company." The SEC explained that it added the word "exclusively" before "control" in the final rule "to clarify that 'control' cannot be shared with individuals or companies that are not family members or family entities." However, the SEC did not elaborate on the purpose of the phrase "(directly or indirectly)" after "exclusively controlled."

The Rule plainly states that family members cannot establish "control" over the family office merely by holding officer positions. Therefore, one logical possibility might be that family members must establish control over the family office by controlling its governing body—its board of directors, if a corporation, or its board of managers, if a manager-managed LLC. Another logical possibility might be that majority ownership in the family office, with the associated right to control the family office's "management or policies," would also be sufficient to establish control. Control via ownership would particularly seem to satisfy the Rule given the fact it states control may be established "(directly or indirectly)."

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224. Id.
225. Id.
226. Id. at 37,991.
227. SEC Staff Q&A, supra note 151, at Question 1.3.
Although the SEC itself has not officially addressed how “control” can be established, the staff of the SEC’s Division of Investment Management has addressed the question in a document available on the SEC website titled “Staff Responses to Questions About the Family Office Rule” (the “Staff Q&A”). While the Staff Q&A represents the views of the SEC staff only, and is “not a rule, regulation, or statement of the Securities and Exchange Commission,” family offices would seem to ignore this document at their peril since the Division of Investment Management is responsible for enforcement of the Advisers Act.

The relevant passages of the Staff Q&A are directed at family offices organized as corporations. Surprisingly, given the Rule’s inclusion of the phrase “(directly or indirectly),” the SEC staff does not consider mere majority ownership of a family office by family members and family entities to be a sufficient means of fulfilling the control requirement. This is apparently the staff’s view regardless of whether family members’ and family entities’ ownership gives them the ability to appoint the family office’s board of directors. According to the SEC staff, “The right to appoint, terminate, or replace board members, by itself, does not satisfy the ‘exclusively controlled’ standard.” The determinative factor, from the SEC staff’s standpoint, is actual board participation. And in the SEC staff’s view, only majority board participation by family members is sufficient to meet the control standard. (Bear in mind family entities cannot participate on a board of directors, as only natural persons can do this under the laws of most states.) In the example given by the SEC staff, if a family office’s board of directors has seven members, four of whom are family members and three of whom are non-family members, the exclusive control requirement is fulfilled “assuming there are no special shareholders agreements or other arrangements that would give someone that is neither a family member nor a family entity control over the management or policies of the family office.”

The fact that majority, as opposed to unanimous, family member board participation is sufficient is arguably in tension with the Rule’s use of the phrase “exclusively controlled,” which the Adopting Release explained is supposed to clarify that control “cannot be shared” with persons other than family members or family entities. By allowing majority board participation to suffice, the SEC staff is certainly taking a more realistic and

230. SEC Staff Q&A, supra note 151, at Questions 1.1 and 1.2.
231. SEC Staff Q&A, supra note 151.
232. Id. at Question 1.2.
233. Id.
234. Id. at Question 1.1.
235. Id.
236. See, e.g., Del. Code Ann. tit. 8, § 141(b) (West 2015) (“The board of directors of a corporation shall consist of 1 or more members, each of whom shall be a natural person.”); N.Y. Bus. Corp. Law § 701 (McKinney 2015) (“The business of a corporation shall be managed under the direction of its board of directors, each of whom shall be at least eighteen years of age.”); Fla. Stat. Ann. § 607.0802 (West 2015) (“Directors must be natural persons who are 18 years of age or older.”).
237. SEC Staff Q&A, supra note 151, at Question 1.1.
pragmatic approach than it otherwise might have. An outright ban on outside directors would massively disrupt the governance structure of many family offices and arguably be detrimental to those offices' owners and family clients.238

The Staff Q&A did not address LLC's or partnerships, so we can only speculate how family offices organized as one of these types of entities would satisfy the control requirement. In the case of a manager-managed LLC, it seems almost certain that the SEC would view such a family office in the same way as a corporation and require majority family member participation on the board of managers. In the case of member-managed LLC's, however, the answer is less clear. Could key employees and their affiliated entities or trusts be allowed to vote on any policies of the firm? Or would complete, 100% voting control by family members and family entities be required in the LLC's operating agreement? The answer to this question is unclear.

With regard to family offices organized as limited partnerships, the determinative factor would presumably be the exercise of control over the general partner. If the general partner is a corporation or manager-managed LLC, then majority board participation by family members would seem to suffice. But if the general partner is a member-managed LLC, the family office would face the same dilemma of how much influence non-family members such as key employees would be able to exercise.

b. Critique

The control requirement of subsection (b)(2) is problematic for a number of reasons. As discussed, the meaning of “exclusively controlled (directly or indirectly)” is unclear from the text of the Rule itself. Furthermore, the SEC staff's interpretation seems to gloss over the text, giving full effect neither to the phrase “exclusively controlled” nor to the “(directly or indirectly)” parenthetical that follows it.

Given the SEC staff's statement that “[t]he right to appoint, terminate, or replace board members, by itself, does not satisfy the ‘exclusively controlled’ standard,” it seems as though the SEC may have read “(directly or indirectly)” out of the Rule altogether. Perhaps “(directly or indirectly)” was simply carried over from the originally-proposed rule, ending up in the final Rule without receiving close scrutiny. In the originally-proposed rule, “(directly or indirectly)” modified both the ownership and the control requirements, as follows: “Is wholly owned and controlled (directly or indirectly) by family members[.].”239 The Adopting Release explains that “(directly or indirectly)” was originally included to allow family members to own the family office indirectly, through family enti-

238. One study found that family office boards are composed of an average of five members—four family members and one non-family member. See Rosplock, supra note 8, at 260.
ties.\textsuperscript{240} In the final Rule, however, "(directly or indirectly)" appears to modify only the "exclusively controlled" requirement. This view is supported by the fact "(directly or indirectly)" is no longer necessary to modify the ownership requirement, since "family clients" already includes the many various family entities that allow for indirect ownership. In light of the SEC staff's interpretation that essentially reads the words "(directly or indirectly)" out of the final Rule, their purpose is unclear.

The SEC staff's narrow interpretation of what suffices as "control," in addition to being in tension with the Rule's text, denies family offices the ability to select the governance structure that best meets their needs. While the Staff Q&A does allow family offices to include outside, non-family directors on their board, these directors may only serve in a minority role, as family members must still constitute the majority. Given the value of having "outside directors," who are neither owners nor employees of the company, the SEC's restrictive interpretation seems misplaced.\textsuperscript{241} While one study found only 20% of family office directors are outsiders,\textsuperscript{242} some family offices may actually prefer a majority non-family board. There could be several reasons for such a preference. For example, there may be an insufficient number of family members of adult age or who have the necessary business sophistication to make board service worthwhile. Or, the family office may have reached a stage similar to that discussed in Section I, where over time family members have become less involved with the family office's investment activities and desire outside expertise and guidance.\textsuperscript{243} Alternatively, the family may strive to operate its family office with the discipline and objectivity characteristic of a non-family wealth management firm, and it could find outside directors helpful in this regard. Given the statistics surrounding the failure of family businesses after they have been passed down from the founding generation,\textsuperscript{244} the decision to utilize non-family members in a majority of board positions could be prudent under certain circumstances.

As owners of the family office, the family would likely still have the power to appoint and replace outside directors, so the family would hardly be ceding complete control. Allowing majority board participation by non-family members would therefore not undermine the policy goals

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\item \textsuperscript{240} Release No. IA-3220, 76 Fed. Reg. 37,983, 37,990 (June 9, 2011) ("Some [commenters] stated that many family offices are owned by family trusts, and that allowing family members to indirectly own and control the family office did not provide sufficient clarity that such a trust could own and control the family office." (emphasis added)). Nothing in the Adopting Release suggests the phrase still modifies the "wholly owned" requirement. Regardless of whether it does or not, because the ownership group ("family clients") already consists of a broad array of entities owned and controlled by family clients, this seems to be a purely academic question.
\item \textsuperscript{241} Rosplock, supra note 8, at 259 (noting "it is clearly a best practice in corporate governance to have independent directors" as well as a study by one leading family business researcher recommending a minimum of three independent directors for family businesses).
\item \textsuperscript{242} Id. at 260.
\item \textsuperscript{243} See supra text accompanying notes 46–48.
\item \textsuperscript{244} See supra text accompanying notes 3–4.
\end{itemize}
\end{footnotes}
of the family office exclusion or of the Advisers Act. As the Senate Banking Committee explained, “family offices are not investment advisers intended to be subject to registration under the Advisers Act. The Advisers Act is not designed to regulate the interactions of family members, and registration would unnecessarily intrude on the privacy of the family involved.” The SEC itself reiterated these sentiments in both the Proposing Release and the Adopting Release. Few things would seem to be more “private” or important to a family office than the choice of who is to serve on its board of directors. Such a decision goes to the very heart of a family office’s identity, as well as its ability to thrive over the long term.

It is unclear what the SEC staff’s rationale was when it construed the control requirement so narrowly. Perhaps it feared a reduced control requirement could be used as a loophole by persons trying to take advantage of the family office exclusion. Let us suppose, for the sake of argument, that various investors join together to form an investment firm, satisfy the Rule’s definition of “key employee,” and select an outside investor with significant financial means to serve as the nominal “family member.” We can suppose, also, that these “key employees” establish the governance of the organization in such a way that prevents the “family member” from exercising any meaningful control. This structure would undeniably be contrary to the spirit and purpose behind the Family Office Rule. The captive “family member,” meanwhile, would be at the mercy of the “key employees.” Perhaps this is the type of arrangement the SEC staff sought to prevent. Such a scenario could only come to pass, however, if the SEC were to abrogate the family control requirement of subsection (b)(2) completely. So long as family members and family entities must still exercise at least indirect “control” over the family office, as the Rule already states, the arrangement described in this paragraph would be prohibited.

To remedy the current situation, the SEC does not need to amend the text of the Rule at all. Rather, all that the SEC must do is simply give effect to the phrase “(directly or indirectly)” by recognizing that the ability to appoint and remove a majority of a family office’s board of directors is sufficient to establish “control.” The SEC should issue a Release, or the SEC staff should amend the Staff Q&A, clarifying that family

246. Release No. IA-3098, 75 Fed. Reg. 63,753, 63,754 (Oct. 12, 2010) (Before the passage of Dodd-Frank, “[the SEC] viewed the typical single family office as not the sort of arrangement that Congress designed the Advisers Act to regulate. We also were concerned that application of the Advisers Act would intrude on the privacy of family members. Thus, each of our orders exempted the particular family office from all of the provisions of the Advisers Act (and not merely the registration provisions.”); id. at 63,755 (“The core policy judgment that formed the basis of our exemptive orders (and which prompted Congressional action) is the lack of need for application of the Advisers Act to the typical single family office.”); Release No. IA-3220, 76 Fed. Reg. 37,983, 37,984 (June 9, 2011) (“As we discussed in the Proposing Release, our orders have provided an exclusion for family offices because we viewed them as not the sort of arrangement that the Advisers Act was designed to regulate.”).
members and family entities exercise “control” under the Rule so long as they either control the family office directly, through majority board participation, or indirectly, through the ability to appoint, terminate, or replace a majority of the board.

3. The Private Adviser Requirement

The Rule’s third and final requirement in subsection (b)(3) prohibits the family office from “hold[ing] itself out” to the public as an investment adviser.\footnote{247 Advisers Act Rule § 202(a)(11)(G)-1, 17 C.F.R. § 275.202(a)(11)(G)-1(b)(3) (2011).} The SEC has interpreted this standard broadly in the investment adviser context.\footnote{248 1 INVESTMENT ADVISER REGULATION, supra note 52, § 2.2.1[A]. Holding oneself out to the public, it should be recalled, is one of the factors the SEC considers in determining whether one is “in the business” of providing investment advice and, therefore, whether one is an investment adviser under the Act. See Release No. IA-1092, 52 Fed. Reg. 38,400, 38,402 (Oct. 16, 1987); see also supra text accompanying note 72.} For example, the SEC has found an adviser to hold itself out to the public where it used public advertising to obtain clients, referred to itself as an investment adviser on business cards, or sought word-of-mouth referrals from its existing clients.\footnote{249 1 INVESTMENT ADVISER REGULATION, supra note 52, § 2.2.1[A] (citing Brighton Pac. Realty Asset Mgmt. Co., SEC No-Action Letter, 1992 WL 75593 (Feb. 10, 1992); Weiss, Barton Asset Mgmt., SEC No-Action Letter, 1981 WL 26285 (Mar. 12, 1981); DJZ Assocs., SEC No-Action Letter, 1976 WL 12192 (Nov. 19, 1976); Frank T. Hines, SEC No-Action Letter, 1972 WL 8250 (Aug. 21, 1972)).} Subsection (b)(3) does not pose any difficulty to the family offices contemplated by the Rule, which are private enterprises designed to offer investment advice exclusively to a single family. The Rule is not directed to multi-family offices or wealth management firms that simply happen to be family-owned.\footnote{250 Release No. IA-3220, 76 Fed. Reg. at 37,991.} In addition, because the Rule already prohibits a family office from advising anyone other than “family clients,” it would have no incentive to hold itself out to the public as an investment adviser in the first place. As the Adopting Release states, “Holding itself out to the public as an investment adviser suggests that the family office is seeking to enter into typical advisory relationships with non-family clients, and thus is inconsistent with the basis on which we have provided exemptive orders and are adopting this rule.”\footnote{251 Id.}

The Rule’s third and final requirement is therefore easy for family offices to satisfy.

CONCLUSION

Certainly there is much about the family office exclusion and the Family Office Rule that is commendable. Dodd-Frank’s enactment of the exclusion was a positive step, as Congress correctly recognized family offices are not within the sphere of investment advisers intended to be covered by the Advisers Act. Subjecting family offices to regulation would be needless as well as harmful. No doubt there are many aspects of
the Advisers Act that are necessary to protect the public from predatory or dubious investment advice. Family offices, however, are not among the advisers in need of such regulation because they advise only family clients.

Features of the Family Office Rule demonstrate a brilliant solution by the SEC, one that balances family offices’ need for flexibility with the simultaneous need to protect the public from attempted abuse of the Rule. For example, the ten-generation limit on “family members” ingeniously provides a family office with great latitude to determine the scope of family members it wishes to serve. At the same time, the ten-generation limit prevents misuse of the Rule by advisers trying to subvert the Advisers Act. Another example of the Rule’s success is its inclusion of “key employees” as “family clients,” a feature that respects the business realities faced by family offices and the people who serve them. Here, the Rule’s definition of “key employee” was well-considered and skillfully drafted not to turn exclusively on the employee’s formal position, but rather on their role at the family office and their degree of financial sophistication.

Given the many well-conceived aspects of the Family Office Rule, it is perplexing why a component so fundamental as subsection (b)(2)’s control requirement seems to have been drafted so haphazardly. While the precise meaning of the phrase “exclusively controlled (directly or indirectly)” is vague, the SEC staff’s interpretation requiring majority family member board participation is grounded neither in the Rule’s text nor in plain logic. “Control,” defined as “the power to exercise a controlling influence over the management or policies” of a family office, should not be interpreted so narrowly as to require direct majority board participation by family members in every instance. Rather, indirect control, exercised through the ability to select the board’s membership, should also be sufficient to satisfy the Rule. The SEC should therefore either issue a release or amend the Staff Q&A to state that family members and family entities may satisfy the Rule’s control requirement through the ability to appoint, terminate, or replace a majority of a family office’s board of directors.
SMU LAW REVIEW

APPENDIX 1

Dodd-Frank Wall Street Reform and Consumer Protection Act

Section 409 - “FAMILY OFFICES”

(a) IN GENERAL.—Section 202(a)(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)(11)) is amended by striking “or (G)” and inserting the following: “; (G) any family office, as defined by rule, regulation, or order of the Commission, in accordance with the purposes of this title; or (H)”.

(b) RULEMAKING.—The rules, regulations, or orders issued by the Commission pursuant to section 202(a)(11)(G) of the Investment Advisers Act of 1940, as added by this section, regarding the definition of the term “family office” shall provide for an exemption that—

(1) is consistent with the previous exemptive policy of the Commission, as reflected in exemptive orders for family offices in effect on the date of enactment of this Act, and the grandfathering provisions in paragraph (3);

(2) recognizes the range of organizational, management, and employment structures and arrangements employed by family offices; and

(3) does not exclude any person who was not registered or required to be registered under the Investment Advisers Act of 1940 on January 1, 2010 from the definition of the term “family office”, solely because such person provides investment advice to, and was engaged before January 1, 2010 in providing investment advice to—

(A) natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office who—

(i) have invested with the family office before January 1, 2010; and

(ii) are accredited investors, as defined in Regulation D of the Commission (or any successor thereto) under the Securities Act of 1933, or, as the Commission may prescribe by rule, the successors-in-interest thereto;

(B) any company owned exclusively and controlled by members of the family of the family office, or as the Commission may prescribe by rule;

(C) any investment adviser registered under the Investment Adviser Act of 1940 that provides investment advice to the family office and who identifies investment opportunities to the family office, and invests in such transactions on substantially the same terms as the family office invests, but does 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 percent of the value of the total assets as to which the family office provides investment advice.

(c) ANTIFRAUD AUTHORITY.—A family office that would not be a family office, but for subsection (b)(3), shall be deemed to be an investment adviser for the purposes of paragraphs (1), (2) and (4) of section 206 of the Investment Advisers Act of 1940.
Advisers Act Rule 202(a)(11)(G)-I - “Family offices”

(a) Exclusion. A family office, as defined in this section, shall not be considered to be an investment adviser for purpose of the Act.

(b) Family office. A family office is a company (including its directors, partners, members, managers, trustees, and employees acting within the scope of their position or employment) that:

(1) Has no clients other than family clients; provided that if a person that is not a family client becomes a client of the family office as a result of the death of a family member or key employee or other involuntary transfer from a family member or key employee, that person shall be deemed to be a family client for purposes of this section for one year following the completion of the transfer of legal title to the assets resulting from the involuntary event;

(2) Is wholly owned by family clients and is exclusively controlled (directly or indirectly) by one or more family members and/or family entities; and

(3) Does not hold itself out to the public as an investment adviser.

(c) Grandfathering. A family office as defined in paragraph (a) of this section shall not exclude any person, who was not registered or required to be registered under the Act on January 1, 2010, solely because such person provides investment advice to, and was engaged before January 1, 2010 in providing investment advice to:

(1) Natural persons who, at the time of their applicable investment, are officers, directors, or employees of the family office who have invested with the family office before January 1, 2010 and are accredited investors, as defined in Regulation D under the Securities Act of 1933;

(2) Any company owned exclusively and controlled by one or more family members; or

(3) Any investment adviser registered under the Act that provides investment advice to the family office and who identifies investment opportunities to the family office, and invests in such transactions on substantially the same terms as the family office invests, but does 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 represents, in the aggregate, not more than 5 percent of the value of the total assets as to which the family office provides investment advice; provided that a family office that would not be a family office but for this paragraph (c) shall be deemed to be an investment adviser for purposes of paragraphs (1), (2) and (4) of section 206 of the Act.

(d) Definitions. For purposes of this section:
(1) Affiliated family office means 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.

(2) Control means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of being an officer of such company.

(3) Executive officer means the president, any vice president in charge of a principal business unit, division or function (such as administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions, for the family office.

(4) Family client means:

(i) Any family member;

(ii) Any former family member;

(iii) Any key employee;

(iv) Any former key employee, provided that upon the end of such individual’s employment by the family office, the former key employee shall not receive investment advice from the family office (or invest additional assets with a family office-advised trust, foundation or entity) other than with respect to assets advised (directly or indirectly) by the family office immediately prior to the end of such individual’s employment, except that a former key employee shall be permitted to receive investment advice from the family office with respect to additional investments that the former key employee was contractually obligated to make, and that relate to a family-office advised investment existing, in each case prior to the time the person became a former key employee.

(v) Any non-profit organization, charitable foundation, charitable trust (including charitable lead trusts and charitable remainder trusts whose only current beneficiaries are other family clients and charitable or non-profit organizations), or other charitable organization, in each case for which all the funding such foundation, trust or organization holds came exclusively from one or more other family clients;

(vi) Any estate of a family member, former family member, key employee, or, subject to the condition contained in paragraph (d)(4)(iv) of this section, former key employee;

(vii) Any irrevocable trust in which one or more other family clients are the only current beneficiaries;
(viii) Any irrevocable trust funded exclusively by one or more other family clients in which other family clients and non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations are the only current beneficiaries;

(ix) Any revocable trust of which one or more other family clients are the sole grantor;

(x) Any trust of which: Each trustee or other person authorized to make decisions with respect to the trust is a key employee; and 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 who, at the time of contribution, holds a joint, community property, or other similar shared ownership interest with the key employee; or

(xi) Any company wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more other family clients; provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of “investment company” under the Investment Company Act of 1940.

(5) Family entity means any of the trusts, estates, companies or other entities set forth in paragraphs (d)(4)(v), (vi), (vii), (viii), (ix), or (xi) of this section, but excluding key employees and their trusts from the definition of family client solely for purposes of this definition.

(6) Family member means 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.

(7) Former family member means a spouse, spousal equivalent, or stepchild that was a family member but is no longer a family member due to a divorce or other similar event.

(8) Key employee means 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 of the family office or its affiliated family office or any employee of the family office or its affiliated family office (other than an employee performing solely clerical, secretarial, or administrative functions with regard to the family office) 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 and duties for or on behalf
of the family office or affiliated family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months.

(9) Spousal equivalent means a cohabitant occupying a relationship generally equivalent to that of a spouse.

(e) Transition.

(1) Any company existing on July 21, 2011 that would qualify as a family office under this section but for it having as a client one or more non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations that have received funding from one or more individuals or companies that are not family clients shall be deemed to be a family office under this section until December 31, 2013, provided that such non-profit or charitable organization(s) do not accept any additional funding from any non-family client after August 31, 2011 (other than funding received prior to December 31, 2013 and provided in fulfillment of any pledge made prior to August 31, 2011).

(2) Any company engaged in the business of providing investment advice, directly or indirectly, primarily to members of a single family on July 21, 2011, and that is not registered under the Act in reliance on section 203(b)(3) of this title on July 20, 2011, is exempt from registration as an investment adviser under this title until March 30, 2012, provided that the company:

(i) During the course of the preceding twelve months, has had fewer than fifteen clients; and

(ii) Neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a), or a company which has elected to be a business development company pursuant to section 54 of that Act (15 U.S.C. 80a-54) and has not withdrawn its election.
APPENDIX 3

Selections from Staff Responses to Questions About the Family Office Rule

I. Ownership and Control of Family Office

Question I.1

Q: A family office has a board of directors with seven directors, of which four are family members and three are non-family members. Under the governing documents of the family office, each director has an equal voting power and no minority veto power. Does this satisfy the standard set forth in rule 202(a)(11)(G)-1(b)(2) that a family office must be "exclusively controlled" by family members and/or family entities?

A: Yes, assuming there are no special shareholders agreements or other arrangements that would give someone that is neither a family member nor a family entity control over the management or policies of the family office. (Posted January 19, 2012)

Question I.2

Q: All members of the board of directors of the family office are neither family members nor family entities, but they are all appointed by family members that have the right to appoint, terminate, or replace the directors. Does this arrangement satisfy the "exclusively controlled" standard?

A: No, unless the governing documents of the family office provide that matters relating to the management or policies of the family office must be decided by shareholders that are family members or family entities. The right to appoint, terminate, or replace board members, by itself, does not satisfy the "exclusively controlled" standard. (Posted January 19, 2012)

Question I.3

Q: A family office plans to issue non-voting shares to a person that does not qualify as a family client. Would this affect the determination of whether the office is a family office under the new rule?

A: Yes, a family office must be wholly owned by family clients as defined under the rule. A non-family client owning non-voting shares would cause the office to lose its qualification as a family office under the rule. (Posted January 19, 2012)