

All in the Family: Application of the SEC's Family Office Rule

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Broad family office activities may necessitate registration as an investment adviser with the Securities and Exchange Commission

The Securities and Exchange Commission adopted a rule in June 2011 that excludes family offices from the definition of "investment adviser" under the federal securities laws (the "Family Office Rule" or the "Rule"). As a result, family offices that meet the conditions of the Rule are not required to register under the Investment Advisers Act of 1940 nor to comply with its provisions. Family offices not able to rely on the Family Office Rule, however, must make the necessary changes to their operations to comply with the exclusion, register as an investment adviser, or obtain from the SEC an exemption from the application of the Advisers Act to their activities by March 30, 2012.

Background

Previously, many family offices had been exempted from registration as investment advisers by virtue of a) having fewer than 15 clients and not holding themselves out to the public as advisers, or b) having obtained an exemptive order from the SEC. The typical basis for such exemptive orders has been that, in the SEC's view, family members securing investment management of their own wealth (through, for example, pooled investing, tax planning and charitable giving) through family offices is "not the sort of arrangement that the Advisers Act was designed to regulate."

The Family Office Rule was proposed in anticipation of the repeal by the Dodd-Frank Wall Street Reform and Protection Act, effective July 21, 2011, of the 15-client private adviser exemption from registration under the Advisers Act. While the repeal was intended to permit the regulation of certain hedge funds, this action would have had a significant impact on traditional family offices that rely upon the private adviser exemption. Accordingly, Congress specifically included in the Dodd-Frank Act an exclusion from the Advisers Act for family offices, and directed the SEC to define "family office" in a manner that is consistent with the exemptive positions previously taken and taking into account "the range of organizational, management, and employment structures and arrangements employed by family offices."

The Family Office Rule

To qualify for the exclusion afforded by the new Family Office Rule, a family office must satisfy three general conditions:

1. The family office may provide advice about securities only to certain persons and entities that are “family clients,” as defined by the SEC.
2. “Family clients” must wholly own the family office and family members and/or family entities must control, directly or indirectly, the family office.
3. The family office may not hold itself out to the public as an investment adviser, or seek non-family clients.

The key terms or phrases in the Rule highlighted here serve to limit the persons to whom advice may be offered by a family office and the manner in which the office may be operated. In very general terms, “family client” is defined to include persons or entities that have a close personal tie to the family being advised, and includes the following:

- a. Current and former “family members,” defined as lineal descendants within 10 generations of a common ancestor (who may be living or deceased), as well as current and former spouses or spousal equivalents of those descendants;
- b. Certain family trusts where either family clients or charitable or non-profit entities are the only current beneficiaries, or where family clients are the sole grantors;
- c. Estates of current and former family members;
- d. Certain current and former key employees, who are or were executive officers, directors, trustees, general partners, or persons serving in a similar capacity at the family office or who, in connection with their regular functions or duties, participate in the investment activities of the family office; and
- e. Companies that are wholly owned exclusively by, and operated for the sole benefit of, family clients (with certain exceptions). Eligible companies need not be controlled by family clients, however.

The SEC commentary in connection with the Rule adoption provides further discussion concerning those persons who may or may not be family clients and circumstances that may affect a person’s status (or an heir’s status) as a family client, including adoption, divorce or death. The Family Office Rule seeks to avoid the potentially negative consequences of such events on the client, as well as the family office, by incorporating a transition period to allow for an orderly transfer of the client to another adviser, if necessary. The Rule also includes a grandfathering clause for advice by a family office to certain specified clients prior to January 2010. Although the Rule provides for some flexibility, the implications of failing to satisfy its conditions highlight the importance of evaluating each current and potential client of a family office to ensure that the client is within the scope of the Rule.

The detail in the final Family Office Rule and the SEC commentary provide valuable insights into the SEC’s intentions with respect to the Rule. The SEC does not seek to disrupt the management of familial affairs or to inject itself into matters that, if disputed, would best be handled by the family

courts. Rather, the Rule is intended to curb activities that are more consistent with a commercial investment advisory operation and may involve persons in need of the protection of the securities laws. For this reason, under the new Rule, a family office may only serve members of a single family. In the view of the SEC, offices that serve multiple families more closely resemble a commercial investment advisory business and should be registered. There are ongoing discussions with the SEC about certain aspects of the Family Office Rule that could be more flexible while still carrying out the SEC's goals, such as situations where family members of spouses are being advised by the family office or are beneficiaries of trusts that own an interest in the family office.

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