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Re: **File No. S7-25-10**
Family Offices

November 18, 2010

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Dear Ms. Murphy:

We are writing in response to the Commission's request for comments on proposed rule 202(a)(11)(G)-1 (the "**Proposed Rule**")[1] under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"). We appreciate the opportunity to comment on the Proposed Rule.[2]

We recognize the Commission's important role in implementing the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") and the difficulty faced by the Commission in adopting a definition of "family office" that is "consistent with the [Commission's] previous exemptive policy" and that also recognizes "the range of organizational, management, and employment structures and arrangements employed by family offices."[3] The Proposed Rule would define "family office" for purposes of Section 202(a)(11)(G) of the Advisers Act, which contains an exclusion from the definition of an "investment adviser" for family offices. Section 409 of the Dodd-Frank Act includes this new exclusion in order to address the fact that, absent exemptive relief, many family offices will be required to register with the Commission as investment advisers as a consequence of the Dodd-Frank Act's repeal, effective July 21, 2011, of the exemption from registration contained in Section 203(b)(3) of the Advisers Act. We believe that, in several respects, the Proposed Rule will further the Commission's goals. However, we respectfully submit that certain portions of the Proposed Rule are drafted too narrowly and, as a result, would not capture many family offices that currently rely on the exemption in Section 203(b)(3) and that Congress intended to be excluded from regulation under the Advisers Act.

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[1] Family Offices, Investment Advisers Act Release No. 3098, 75 Fed. Reg. 63,753 (proposed October 12, 2010). Page references to the Proposed Rule herein are to the Proposed Rule as released in Commission Proposing Release IA-3098.

[2] The opinions expressed herein represent those of the undersigned and not necessarily those of our clients.

[3] Section 409(b) of the Dodd-Frank Act.

We ask that the Commission consider the following recommendations prior to adopting the Proposed Rule.

I. Definition of "Founder" and "Family Member"

The Proposed Rule defines "family office" as a company that, among other things, has only "family clients"[4] and, in turn, defines "family clients" to include any "family member."[5] The term "family member" in the Proposed Rule is defined by reference to the so-called "founders"—namely, "the natural person and his or her spouse or spousal equivalent for whose benefit the family office was established and any subsequent spouse of such individuals."[6]

We appreciate the Commission's effort to define a single person as a point of reference from which the rest of the family can be defined and as a way to limit the number of "family members" who would be permissible clients of a family office. However, for the reasons set forth below, we recommend that the Commission clarify the meaning of the term "founder," with corresponding changes to the meaning of the term "family member."

In common parlance, "founder" means a person who founds (*i.e.*, sets up) an institution. In the Proposed Rule, "founder" is defined as the person (and his or her spouse) "<u>for whose benefit</u> the family office was established," which could have several different meanings. It could be read to mean the person (or persons) who sets up the office (such person would after all presumably do so for his or her own "benefit," and potentially for the benefit of his or her spouse as well). However, the people who set up a family office could also do so "for the benefit of" someone other than themselves—for instance, they could do so to assist their parents or their children in managing their wealth. Multiple people (*e.g.*, siblings or cousins) often establish a family office to provide services to (and therefore arguably "for the benefit of") an even more extended group of relatives. In its discussion, the Commission suggests that it is, in fact, the person who built the wealth managed by the family office that should be considered the "founder"—*i.e.*, the founder of the wealth.[7] The Commission acknowledges that this person may differ from the person who actually sets up the office[8] but the Proposed Rule does not make clear whether such founder would have to be alive at the time the family office is set up. Indeed, it is difficult to see how such a person would qualify as someone "for whose benefit the family office was established" if he or she is no longer alive at the time the office is set up. In addition, identifying one "founder" of a family's wealth may be difficult in many cases and, in many cases, the family office is established or evolves generations after the "founding" of the wealth.

We suggest permitting each of the natural persons who set up the office (and the spouse or spousal equivalent of each such person) collectively to be considered the "founders" (*i.e.,* of the family office) but requiring that these "founders" (each of whom must be alive at the time the office is set up) have a common parent, grandparent or great-grandparent (*i.e.,* the founders may be related as siblings, cousins or second-cousins). Correspondingly, we believe that the lineal

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[4] Proposed Rule 202(a)(11)(G)-1(b)(1).

[5] Proposed Rule 202(a)(11)(G)-1(d)(2)(i).

[6] Proposed Rule 202(a)(11)(G)-1(d)(3) and 202(a)(11)(G)-1(d)(5).

[7] *See* Proposed Rule, 12 ("While the family offices that have obtained an exemptive order from the Commission typically were managing wealth built by an older generation—and thus the 'parents' are typically the 'founders,' we understand that this may not always by the case. For example, some entrepreneurs (such as in the technology and private fund management sectors) have built sizeable fortunes at an early age and may form a family office." (footnotes omitted)).

[8] *See id.*

descendants (whether by birth or adoption, and including step-relationships) of such common great-grandparent, and such descendants' spouses (or spousal equivalents) should be included in the definition of "family member." Because family offices may be restructured from time to time, we believe the definition of "family member" should be based on the founder or founders of the original family office without regard to subsequent restructuring or reorganization.

II. Death and Other Involuntary Transfers

Under the Proposed Rule, if a person not meeting the definition of "family client" becomes a client of the family office as a result of the death of, or other involuntary transfer from, a family member or key employee, such person will be deemed to be a "family client" for four months following the transfer.[9] We recommend that the non-family client be permitted to continue to be treated as a "family client" indefinitely with respect to those transferred assets. In the case of interests in an entity that is otherwise family-controlled (*e.g.*, shares of a family-controlled company or interests in a family-controlled investment vehicle), the transferred assets will often be illiquid. In such cases, the family would seek to extricate the transferee from ownership of such assets. However, in the case of unmarketable securities, selling those interests to another family client may be possible only at a depressed price, or might not be possible at all because family members or third parties refuse to give the requisite consent or the relevant parties fail to come to terms on the price. Requiring a sale of this kind would not be in the interests of either the family or the transferee.

Because our recommendation is limited to involuntary transfers, we do not believe there is any significant risk that a family office would be able to manipulate the proposed rule to operate as a more typical investment adviser. Indeed, we see no reason why involuntary transferees should not be treated as family clients with respect to transferred assets in much the same way as a key employee would be treated once he or she becomes a "former" key employee. In addition, as the Commission points out,[10] we note that permitting involuntary transferees to continue in the shoes of the transferring family client would be consistent with the treatment of involuntary transfers of interests in a private investment fund exempted from the definition of "investment company" by virtue of Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), under Section 3(c)(7)(A) of the Investment Company Act,[11] which permits transfers without regard to whether the transferee has the qualifications needed to make the investment directly.

If the Commission disagrees with continuing to treat all involuntary transferees as family clients, we respectfully submit that at least estates (and revocable trusts that become irrevocable at death for the period during which they function as estate equivalents) should be treated as family clients, even if they have non-family client beneficiaries. In addition, we suggest that a period of three years following distribution of the assets from an estate (or revocable trust counterpart) would be reasonable to permit the non-family client beneficiaries of such estates (or revocable trusts) to secure a new advisor and, if necessary, achieve any restructuring of assets that may be necessary.

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[9] Proposed Rule 202(a)(11)(G)-1(b)(1).

[10] Proposed Rule, 15 n.31.

[11] *See also* Rule 3c-6 under the Investment Company Act (beneficial ownership by the transferee of securities of both a private fund relying on Section 3(c)(1) and a private fund relying on Section 3(c)(7) shall be deemed to be beneficial ownership by the transferor).

With respect to involuntary transfers other than by reason of death, we also respectfully urge that the Commission extend the period during which the family office would be permitted to treat the involuntary transferee as a "family client." Four months is insufficient to ensure that an appropriate investment adviser is found to replace the family office and to achieve any necessary restructuring. We would recommend a period of at least three years following the completion of the transfer to ensure as smooth a transition as possible.

III. Charitable Entities, Trusts and Estates

In addition to family members, the Proposed Rule includes in its definition of "family clients" (1) "[a]ny trust or estate existing for the sole benefit of one or more family clients"[12] and (2) "[a]ny charitable foundation, charitable organization, or charitable trust, in each case established and funded exclusively by one or more family members or former family members,"[13] among others. While we agree with the Commission's inclusion of these types of entities in the definition of "family client," we believe that the definition is too narrow to capture many typical tax and estate-planning structures.

A. "For the Sole Benefit Of"

In our experience, it is common for trusts and estates to name certain non-family client beneficiaries, in addition to family client beneficiaries. For instance, a typical trust might name one or more family members as the primary beneficiaries of the trust but name non-family clients, such as third-party charities, as contingent beneficiaries in the event that the family members die without issue.[14] In addition, a trust might name a third-party charity as the remainderman, such that the charity would receive what is remaining in the trust once all of the other, family interests have terminated or, conversely, as the lead beneficiary, with family members receiving the remainder upon the termination of the charitable interest. Moreover, it is common for wills and revocable trust agreements to include certain limited bequests payable to non-family clients following death, whether to god-children, friends, alma maters or other third-party charities or beneficiaries. Limiting the definition of family clients to those trusts and estates that exist "for the sole benefit of" family clients would exclude many trusts and estates with which we are familiar.

Estates

As discussed in "*II. Death and Other Involuntary Transfers*" above, we believe that the Commission should permit a family office to treat all involuntary transferees, including estates (and revocable trusts that become irrevocable at death) and the non-family client beneficiaries of estates (and such revocable trusts), as family clients. If the Commission disagrees with this approach, we respectfully submit that estates (and revocable trusts that become irrevocable at death) with non-family client beneficiaries should nevertheless be permitted to be treated as

[12] Proposed Rule 202(a)(11)(G)-1(d)(2)(iv) (emphasis added).

[13] Proposed Rule 202(a)(11)(G)-1(d)(2)(iii) (emphasis added).

[14] We note that "charitable trusts" are included in subsection (d)(2)(iii) of the definition of "family client," which provides that such trusts would qualify as family clients as long as they are "established and funded exclusively by one or more family members or former family members." However, because the term "charitable trust" is not itself defined, we assume for purposes of this discussion that it is meant to refer to a wholly charitable trust (*i.e.*, one with charitable organizations as current and future beneficiaries). Therefore, for purposes of this discussion, we assume that "split interest trusts" (*i.e.*, those with both charitable and non-charitable beneficiaries, such as charitable lead and remainder trusts) would fall into subsection (d)(2)(iv) of the definition of "family client."

family clients and that, for a period of at least three years after the receipt of the relevant assets, the non-family client beneficiaries of any such estate (or revocable trust) should themselves be permitted to be treated as family clients.

Trusts

Because trusts are often not set up for the "sole benefit" of family clients, we respectfully urge the Commission to eliminate this condition. We recommend that trusts established by (*i.e.*, funded exclusively by) family members (and, in certain cases discussed in "I*V. Key Employees*" below, by key employees) be captured in the definition of "family client" regardless of who the beneficiaries are. Indeed, it is the grantor of a trust, not the beneficiaries, who establishes the terms of the trust, and the trustees carry out the grantor's wishes in this regard. From this perspective, the focus in the Proposed Rule on beneficiaries is misplaced. Indeed, in the case of a wholly charitable trust, the Proposed Rule itself takes the position that funding by family members creates a sufficient connection for such a trust to be treated as a family client.[15]

If the Commission disagrees with this proposal, we believe that, at a minimum, trusts established primarily for the benefit of family clients should qualify as "family clients," without regard to the identity of the contingent beneficiaries and remaindermen.[16] This approach would capture many typical trusts, including those that name non-family clients as contingent beneficiaries and remaindermen (*e.g.*, charitable remainder trusts) and those that make certain limited provision for non-family clients as current beneficiaries. Because this approach would not generally capture charitable lead trusts—another common trust structure, in which charitable organizations receive payments from the trust for a specified period, with the remainder going to specified beneficiaries—unless the charitable organization was itself a family client, if the Commission adopts this "primary current beneficiaries" approach, we recommend that the final rule also specify that charitable lead trusts qualify as family clients if the ultimate beneficiaries are family clients (even if the current charitable beneficiaries are non-family clients).

Moreover, even if the Commission deems it appropriate to continue to impose the "sole benefit" condition on trusts, we nevertheless believe that revocable trusts should be addressed separately from irrevocable trusts. In the case of a revocable trust, the grantor(s) can revoke or amend the trust at any time, and therefore effectively own and control assets of the trust until such time as the trust becomes irrevocable (*e.g.*, at death). Accordingly, revocable trusts established by family members (and, we believe, family clients more generally) should be treated as family clients, regardless of who the beneficiaries are, at least until such time as the trust becomes irrevocable.[17] As indicated above, we also believe that a revocable trust that becomes

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[15] *See* Proposed Rule 202(a)(11)(G)-1(d)(2)(iii) (including in the definition of "family client" "[a]ny charitable foundation, charitable organization, or charitable trust, in each case established and funded exclusively by one or more family members or former family members" added).

[16] If the term "existing" in subsection (d)(2)(iv) of the definition of "family client" in the Proposed Rule is intended to be used in this way—in other words, the interests of beneficiaries entitled to receive current distributions would be taken into consideration but future interests (contingent, vested or otherwise) would be disregarded, *see* David F. Freeman, Jr., Arnold & Porter, Comment Letter to Release IA-3098 (Nov. 11, 2010)—we believe the final rule should be clarified in this regard.

[17] The Commission has applied similar reasoning in the context of Rule 501(a)(8) of Regulation D under the Securities Act of 1933, as amended, which provides that an entity is accredited if all of its "equity owners" are accredited investors. In considering a revocable trust that could be amended or revoked by the grantors at any time, the Commission has said that "where the grantors of a revocable trust are accredited investors under Rule 501(a)(6) (i.e. net worth exceeds $1,000,000) [sic] . . ., the trust is accredited because the grantors will be deemed the equity owners of the trust's assets." Securities Act Release No. 6455, at Question 30 (Mar. 3, 1983); *see also* Lawrence B. Rabkin, Esq., SEC. No-Action Letter (Aug. 16, 1982) (expressing the view that "if each grantor of the revocable grantor trust is an accredited investor . . ., then such trust may be

irrevocable at death should be treated in a manner similar to an estate.

B. "Funded Exclusively By"

We believe that the Commission's requirement that charitable foundations, charitable organizations and charitable trusts[18] be "funded exclusively by" family members (or former family members) is also too narrow. Many charitable entities, such as foundations, are set up and funded primarily by family members, but non-family members are also permitted to contribute funds. We would suggest that charitable entities controlled by family members should qualify as "family clients" regardless of whether non-family members also make contributions to such entities. We can see no policy reason for excluding charities of this kind, since the third-party contributor would effectively give up control of its assets upon making the contribution.

IV. Key Employees

The Proposed Rule includes "key employees" in the definition of "family client"[19] and, in turn, defines "key employee" as any natural person who is an "executive officer, director, trustee, general partner, or person serving in a similar capacity of the family office," in addition to any employee (other than those performing solely clerical, secretarial, or administrative functions) who participates in the investment activities of the family office as long as such employee has been doing so for at least twelve months.[20]

We note that, as an operational matter, many family offices are structured as separate advisory entities to address various tax-related and other concerns. Accordingly, an employee of one family office entity may not be formally employed by a related family office entity. We believe that the definition of key employee should be clarified to permit key employees of one family office entity to qualify as key employees of a related family office entity as long as the clients of both entities would collectively qualify as family clients of a single family office if the separate family office entities were structured as a single entity. We believe this approach is necessary to reflect the structure of many family offices and to avoid respecting form over substance. This approach would also afford families flexibility to structure their family offices appropriately going forward.

In addition, we recommend that the Commission expand the concept of "key employee" so that the term "family client" encompasses personal tax and estate-planning entities set up for the benefit of key employees' spouses (or spousal equivalents) and lineal descendants and such descendants' spouses (or spousal equivalents). As discussed above, the proposed definition of "family client" includes "[a]ny trust or estate existing for the sole benefit of one or more family clients"[21] and, as such, would include trusts and estates existing for the sole benefit of key employees and other family clients. However, the Proposed Rule does not appear to

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considered an accredited investor under Rule 501(a)(8)). Just as the Commission looked at the accreditation of the grantors of the revocable trust, rather than that of the beneficiaries, so we think it is appropriate for the Commission to treat a revocable trust as a family client if the grantor is a family client, without regard to the beneficiaries.

[18] As noted in footnote 14 above, we assume for purposes of the above discussion regarding "split interest trusts," such as charitable lead trusts and charitable remainder trusts, that the term "charitable trust" refers to wholly charitable trusts. However, we would recommend that the Commission clarify the intended meaning of "charitable trust" in the final rule.

[19] Proposed Rule 202(a)(11)(G)-1(d)(2)(ii).

[20] Proposed Rule 202(a)(11)(G)-1(d)(6).

[21] Proposed Rule 202(a)(11)(G)-1(d)(2)(iv).

contemplate trusts and estates set up for the benefit of the key employee's spouse (or spousal equivalent) and lineal descendants. Key employees should be permitted to make co-investments through personal tax and estate-planning vehicles that benefit their immediate family members; the use of these types of vehicles is common and the ability to use them should not be limited to family members. In addition, as discussed above in section "*III.A—Charitable Entities, Trusts and Estates—"For the Sole Benefit Of,"*" we do not think that the "for the sole benefit of" is a workable limitation on these types of entities; this is equally true in the context of trusts formed by, and estates of, key employees.

V. Ownership and Control

The second prong of the definition of a "family office" under the Proposed Rule requires that the office be a company that is "wholly owned and controlled (directly or indirectly) by family members."[22] This requirement is unnecessarily limiting and would exclude a significant number of family offices because many are owned, at least in part, by employees and/or may be owned by family trusts with non-family member trustees (*e.g.*, for governance purposes). We recommend instead a requirement that a family office be owned and controlled by key employees[23] and entities that meet the definition of "family client," in addition to family members. Expanding the ownership and control requirement in this way would give families flexibility to take into account various considerations in structuring their family offices and to align the incentives of their employees by granting them ownership interests in the family office as a retention or recruitment tool. We do not believe that permitting these additional types of family clients to own and control a family office should raise concerns that the family office is operating as a more typical investment adviser. This is especially true in light of the protections afforded by the third prong of the definition of "family office" requiring that the office "not hold itself out to the public as an investment adviser"[24] and by the prohibition in Section 208(d) of the Advisers Act against doing indirectly what would be unlawful to do directly.

In addition, in the event that the Commission agrees with our recommendation and permits family clients to own and control a family office, we nevertheless respectfully urge the Commission not to impose as part of the definition of a family office any conditions relating to whether the family office generates a profit.[25] The structure of a family office and tax considerations will dictate whether the office breaks even or generates a net profit. The calculus for each family office differs in this regard and a requirement relating to the profit structure of a family office would be an unnecessary intrusion into the management of the wealth of such families. Because "profits" may be shared through either equity ownership or other forms of incentive compensation (*e.g.*, a bonus), we respectfully disagree with the Commission that 100% family member ownership of a family office should alleviate its concerns regarding whether the family office makes a profit. Granting an equity interest or other profit share to key employees serves to align the interests of such employees with those of the family and does not necessitate the protections of the Advisers Act for such employees.

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[22] Proposed Rule 202(a)(11)(G)-1(b)(2).

[23] We note that the term "key employee" is defined in the Proposed Release to include the directors of a family office, which suggests that the Commission was contemplating that non-family members could serve on the board of a family office.

[24] Proposed Rule 202(a)(11)(G)-1(b)(3).

[25] Proposed Rule, 23-24 ("Requiring that the family office be wholly owned by family members alleviates any concern that we may otherwise have about the profit structure of the family office, because any profits generated by the family office from managing family clients' assets only accrue to family members. Accordingly, we are not proposing a specific condition regarding whether the family office generates a profit.").

We appreciate the opportunity to respond to the Commission's request for comments and we hope that these comments and observations contribute to the important work of the Commission. If you have any questions with respect to the matters raised in this letter, please contact any of the undersigned.

Very truly yours,

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