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November 18, 2010

Via e-mail to: rule-comments@sec.gov

U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090
Attention: Elizabeth M. Murphy, Secretary

Re: Dodd-Frank Wall Street Reform and Consumer Protection Act Rulemaking Relevant to "Family Offices" and the Investment Advisers Act of 1940 (*Release/Reference No.: IA-3098*)

Ladies and Gentlemen:

We are responding to the invitation of the U.S. Securities and Exchange Commission (the "SEC") for comments to the Commission's proposed Rule 202(a)(11)(G)-1 under the Advisers Act that excludes "family offices" from the definition of an investment adviser. We sincerely appreciate the Commission's prompt and thoughtful proposal, but also encourage the Commission to revisit those aspects that would require exclusive ownership and control of the family office organization by the family and that define a single family by reference to a particular "founder."

As a brief background to our interest in these matters, Shearman & Sterling LLP is a global law firm with offices in twenty financial centers worldwide. The firm's clients include a number of family offices and a wide variety of US and non-US financial institutions and financial market participants. We have been counseling clients for more than a year on the legislative initiatives that ultimately were signed into law as the Dodd-Frank Act in July.

Overview

As the Commission notes in its proposing release, and as we have observed in advising our family clients, family office arrangements can ensure greater privacy, exclusivity and customized service than may be available from commercial banks, registered investment advisers and stock-brokers. It is also fair to say that family office arrangements, while all recognizably having the character of being operated for the benefit of the family members, vary widely in terms of structure, staffing and services delivered.

In enacting the Dodd-Frank Act, Congress recognized that the Advisers Act is not designed to regulate the internal workings of family investment operations and, on that basis, mandated an exclusion from the Advisers Act for family office organizations. Yet, as a result of the proposal's requirement that a family office be wholly owned and controlled by family members, many single-family organizations that we believe Congress intended to exclude from these regulations will not qualify for exclusion. We therefore offer an alternative approach that looks to:

- Whether the family office is operated principally for the benefit of the family; and
- Whether the family exercises a controlling influence over the family office.

That type of analysis, in our view, draws a readily recognizable line between family office arrangements and purely commercial investment advisory services, while at the same time limiting the import of certain artificial distinctions we highlight below. We believe this also better accords with Congress's direction that the new family office exemption "recognize the range of organizational, management, and employment structures and arrangements employed by family offices."

Separately, we are aware of family offices that identifiably serve a single family, but where the family office was not formed for the benefit of a particular "founder" family member within the snapshot-in-time manner suggested by the current proposal. We suggest a more flexible approach that defines the family group serviced by the family office only in terms of lineal descent from a reasonably identifiable ancestor or group of closely related ancestors.

Organization of the Family Office – Discussion

Under the Commission's current proposal, a "family office" to be excluded from regulation under the Advisers Act would be defined as follows:

> A family office is a company (including its directors, partners, 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 275.202(a)(11)(G)-1 for four months following the transfer of assets resulting from the involuntary event;
> >
> > (2) Is wholly owned and controlled (directly or indirectly) by family members; and
> >
> > (3) Does not hold itself out to the public as an investment adviser.

Focusing as we do throughout most of this letter on the second prong of this proposed definition, a requirement of exclusive ownership and control by family members puts pressure on a number of common family office organizational arrangements, such as family offices that are held in trust for family members or housed as divisions or offices in family-controlled companies.

- Regarding trusts, while there are cases deeming that trust beneficiaries hold a proprietary interest in the subject matter of the trust (which in this case would be the family office), there is also authority that takes the opposing view; specifically, that trust beneficiaries do not have a proprietary interest in the assets held in trust, but rather, a bundle of rights enforceable against the trustee. Therefore, under the currently proposed rule, it is possible that family members that are beneficiaries of a trust holding the family office would not be considered the owners of the family office and accordingly would not be able to rely on the proposed exclusion (or, even more oddly, whether they can or cannot may be driven by state trust law, so that similar structures will be impacted differently state-by-state). Furthermore, as described later in this letter, since trustees may be considered to control the assets held in trust, unless the trustees are <u>all</u> family members, it is possible that a family office owned by a family trust (or trusts) would not be wholly controlled by the family as would be required by the proposed exclusion.

- Regarding family-controlled companies, to the extent a family office operates as a division or office within the company, the Commission's proposal would serve to disqualify the family office whenever senior executives in the company have an ownership stake in the company, notwithstanding that such ownership otherwise would be considered normal course.

At a still more basic level, consider a family office that is wholly owned and controlled by the family and that, as is to be expected, avails itself of experienced management by hiring an investment professional as an employee. To assure access to talent, the family generously compensates the professional, likely with a performance compensation package tied to investment results and/or other benchmarks that reflect successful and efficient operations. This entity would be excluded from regulation under the proposal. If, however, the professional prefers for tax, personal liability or other reasons to organize his or her service arrangement to the family office within a corporate structure owned by the professional the exclusion would no longer be available. Nor would the exclusion be available if the family sought to incentivize the individual with any grant of equity in the operation. Even cash-settled equity options, "phantom equity" or a myriad of other incentives that an employer / employee may arrive at in negotiations between them may be suspect. This is true notwithstanding that the underlying economic and service terms of these arrangements otherwise may be substantially similar and regardless of other indicia of a relationship of service to, and control by, the family that might be presented.

We emphasize that we are aware of longstanding, and from the perspective of the families involved satisfactory and productive, family office arrangements that provide for many different ownership and incentive structures as between the family and its family office advisers. These include family offices that closely match both the held-in-trust and family-controlled company scenarios just described, as well as those under which, for a variety of historical reasons (again, which may include tax, liability, agreed incentives and others), non-family members may hold meaningful ownership stakes in the organization.

With that background, we respectfully submit that the rule's presently proposed ownership and control formulation risks doing just what Congress wanted to avoid. That is, by establishing a black-white / all-or-nothing dichotomy, it unduly limits the discretion of families to privately organize their own investment arrangements.

Organization of the Family Office – Our Suggestions

1. Principally for the benefit and controlling influence

Our preferred alternative formulation to the proposed wholly owned and controlled requirement would require that the family office be operated principally for the benefit of "family clients" (defined as proposed by the Commission) and that these "family clients" exercise a controlling influence over the family office. The term "principal benefit" would reflect a facts and circumstances analysis, as would the term "controlling influence," which we expect would be understood in light of the definition of "control" under Section 202(a)(12) of the Advisers Act.

What factors would we consider in assessing whether a family office is operated for the "principal benefit" of the family? Ownership is relevant, and majority or even more substantial ownership by the family (directly or indirectly) certainly would be a strong indicia of principal benefit. Likewise, an extended history of service to the family (directly or indirectly) as opposed to third parties, and/or formation of the family office by or for the family (again, directly or indirectly), should be relevant. An investment organization that has for many years served a single family on an exclusive basis and engaged in no marketing beyond the family clients would appear (under many more variations in ownership and control than that contemplated by the Commission in its proposal) to represent a *de facto* partnership between the family and the organization under which the family is a principal beneficiary.

What factors would we consider in identifying a "controlling influence" for this purpose? Again, the degree to which ownership of the family office rests within or outside of the family (directly or indirectly) is presumably significant. But, as would be the case under Section 202(a)(12)'s definition of control, we also would take into account factors going beyond ownership, such as (a) internal management structures, e.g., operating or supervisory committees, that afford special rights to family members or trustees acting for the benefit of the family; and (b) the ability of family members or trustees acting for the benefit of the family to terminate non-family members, divest non-family member owners, remove all or substantially all family assets from the non-family member personnel involved, or otherwise alter the terms under which non-family members act on behalf of the family.

2. Additional Issues with Trusts, and Expanding "Family Members" to "Family Clients"

We have already discussed how trusts present complicated issues under a requirement of ownership by the family. They also present issues under a requirement of control, in that it is our understanding that many family assets held in trust are structured whereby control may rest with independent trustees and family members are trust beneficiaries.

It is on that basis that we emphasized that we believe trustees acting for the benefit of family members may create the requisite controlling influence that we propose as a definitional criteria. We did not intend the reference to trusts and trustees to be exclusive of other types of indirect relationships by which a family can exercise control through parties acting on its behalf, but we do believe the issues presented by trusts are among those most in need of what we expect are technical corrections to an inadvertent drafting issue in the current proposal.

In particular, it appears necessary (and, given the broader structure of the Commission's proposal, we presume it was intended by the Commission) to expand the scope of those permitted to control a family office under the exclusion from "family members" to "family clients." Given any trust existing for the sole benefit of one or more family clients is encapsulated in the currently proposed definition of "family clients," this change would operate to ensure that those trusts with a majority of non-family member trustees would satisfy the proposed exclusion.

Should the requirement that control of a family office reside solely with family members (as opposed to, for example, independent trustees of family trusts) in fact have been intended by the Commission, we offer a number of grounds why our proposed, broader formulation that substitutes "family clients" for "family members" should be viewed as an appropriate alternative:

- First, there are many situations where it is advantageous to have independent trustees rather than family members. Some families may not have the requisite background to oversee a family office, while other families may not be able to dedicate the necessary time and human resources. Moreover, given their personal stake in the matters, a family-member trustee may be inclined to put his or her own narrow interests ahead of other beneficiaries, thereby putting a protective institutional premium on independence that we do not think should be disturbed.
- Second, there is an established body of trust law that imposes a fiduciary duty on trustees to act in the best interests of the beneficiaries.
- Third, independent trustees are essential to preserve the intended tax consequences of most irrevocable trusts.
- Finally, the use of trusts as family vehicles is so well established that we are confident that it cannot be the intent of Congress to create an incentive to unwind these arrangements (and indeed an unwind typically is not an option) in favor of other kinds of arrangements.

That said, if the Commission believes that expanding the entities that may control the family office from "family members" to "family clients" does not provide adequate safeguards, we would ask that the Commission at least confirm that reliance on the exclusion still would allow ownership by trusts controlled by independent trustees but under which the trustees are subject to removal or the trust can be dissolved at the behest of family members. Even if never exercised, this threat of removal provides powerful leverage. That type of leverage should, in our view, be deemed to represent control of assets underlying the trust for these purposes.

We also note that simply taking an internal interpretive view of whether control is present may provide comfort for some family office organizations. That is so even without the suggested change to "family clients" and an endorsement of the position that the power to remove trustees or dissolve trusts translates into control of underlying assets for these purposes (although those are improvements that we reiterate we find appropriate and that add certainty as to the scope of the exclusion). To stay with the example of a family office that is held in a family trust with non-family member trustees, while there is not *de jure* control by the family members, there likely would be (even with no ownership flowing through to the family members) a *de facto* controlling influence by family members over the family office arising from the scope of the relationship among the family office, the trust, the trustees and the family member beneficiaries.

Organization of the Family Office – Other Alternative Approaches

If the Commission is absolutely committed to its original wholly owned and controlled by standard – and even if the technical modification of ownership and control by "family clients" instead of "family members" discussed above is implemented – we still would encourage the Commission to consider alternatives short of full investment adviser regulation. Otherwise, many types of family offices will become subject to the Advisers Act (or be forced through the burdensome and intrusive process of seeking tailored exemptive relief) that simply do not represent the same types of risks as commercial advisers.

A possible alternative intended to balance the Commission's investor protection mandate with Congress's expressed interest in preserving the discretion and privacy of families to manage their own internal investment affairs would be an exclusion that is contingent on an additional substantive requirement, perhaps as follows:

- The federal securities laws frequently incorporate an asset based test to determine whether a particular individual or entity needs the protections afforded by such laws. The same approach could be adopted in this situation by creating a "qualified family" standard. The family office of a qualified family could be excluded from the definition of investment adviser, regardless of how ownership and control is organized, provided the remaining criteria of the Commission's proposed rule are satisfied (i.e., the single family office has no clients other than family clients and does not hold itself out to the public as an investment adviser).

- Likewise, an alternative to full regulation could be made for those families willing to implement specified internal protections. For example, the Commission's investment adviser custody rules could be extended to these families (again, provided the remaining criteria of the Commission's proposed rule are satisfied).

Definition of the Family and its "Founder" – Discussion and Our Suggestions

As noted above, we are aware of family offices that identifiably serve a single family, but where the family office was not formed for the benefit of a particular "founder" family member in the manner suggested by the current proposal. In particular, the currently proposed definition appears to conflate within the concept of a "founder" both the generation of the family's wealth and the organization of the family office.

We are aware of no policy reason to suggest that a family office is any less private or less closely tied to the family – and therefore less clearly eligible for exclusion from the Advisers Act – because the family office was formed by or for a descendant of a "founder" as opposed to the founder or, to choose another example, by a multi-generational family trust as opposed to the founder. We therefore suggest a more flexible approach that defines the family group serviced by the family office simply in terms of lineal descent from a reasonably identifiable ancestor or group of closely related ancestors.

Conclusion

Congress requested that the Commission draft an exclusion for family offices from the definition of investment adviser that recognizes the range of organizational structures operating in the marketplace. The currently proposed formulation is an important first step, but could be improved to further take into account the range of family office structures that appropriately should be excluded from regulation.

In its proposing release, the SEC asked whether there are reasons that a single family office need not be wholly owned and controlled by family members. We believe that the answer is yes, and that ownership and control can be more flexibly applied without sacrificing the Commission's interest in regulating truly commercial arrangements and appropriately protecting the investing public. We also are concerned that the definition of a family by reference to a "founder" in the manner currently proposed is unduly limiting. We therefore respectfully encourage the Commission to revisit those aspects of the proposed rule highlighted in this letter.

* * *

We appreciate the opportunity to comment on these matters and are available to discuss these comments and recommendations should the Commission or the staff so desire. From Shearman & Sterling's investment adviser practice, Nathan Greene is at 212-848-4668 or ngreene@shearman.com. From our private client practice, C. Jones Perry is at 212-848-8854 or jperry@shearman.com. Either would be pleased to be of further assistance.

Two final notes: First, our comments and recommendations represent the views of the attorneys of the firm named above and should not be ascribed to any current or former client of the firm. Second, while we certainly are broadly supportive of the Commission's proposal, we do not intend to suggest that we are in full agreement with every proposed provision on which we have not commented. Rather, we limited our comments to those that we believe go the furthest towards satisfying the objectives of Congress in directing this rulemaking.

Respectfully submitted,

Shearman & Sterling LLP (NJG)

Shearman & Sterling LLP

Please assure copies to the following:

Mary L. Schapiro, Chairman
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