# KOZUSKO HARRIS VETTER WAREH LLP

November 18, 2010

*Via electronic mail*
*(rule-comments@sec.gov)*

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

Re: Family Offices
Proposed Rule 202(a)(11)(g)-1 under the Investment Advisers Act of 1940
File Number S7-25-10

Dear Ms. Murphy:

We are writing in response to Investment Advisors Act Release No. IA-3098 requesting comments on proposed rule 202(a)(11)(G)-1 (the "Proposal" or "Proposed Rule") under the Investment Advisers Act of 1940 (the "Advisers Act" or the "Act"). You have indicated that you are seeking input from practitioners whose experiences may be different from yours and who might provide a different perspective on, or other solutions to, certain issues.

We represent a number of families who asked us to comment on the Proposal, but our comments are not limited to their specific circumstances. We have drawn on our collective experience in working with over 20 families who maintain family offices and with many other families whose business and investment structures could possibly constitute a "family office" subject to the Proposed Rule, even though the family has not historically viewed its structure or business as a family office. The senior partners in our firm have been working with family offices for over 30 years. Accordingly, we appreciate the opportunity to comment on the Proposed Rule.

Attached to this letter are the following exhibits:

- List of our recommendations
- Explanation of our recommendations
- Redline of the Proposed Rule incorporating our recommendations

We would like to acknowledge the work of the Private Investor Coalition and note our general support for its recommendations. We also want to be clear that we do not view our comments as inconsistent with the Coalition's views. Rather, we have attempted to supplement the Coalition's recommendations with information and suggestions related to more specific concerns and existing family office circumstances.

Finally, we want to thank you for the effort that went into drafting the Proposed Rule, which we believe is an excellent first step toward reaching an outcome that meets the requirements contained in Section 409 of the Dodd-Frank Act while at the same time

recognizing the unique circumstances that exist in family offices. We would appreciate the opportunity to work with the Commission and its staff in crafting a final rule that best satisfies the goals of all interested parties and would be happy to respond to any questions you may have with regard to our comments and recommendations. Again, thank you.

Sincerely,

Donald D. Kozusko
Rashad Wareh
Miles Padgett
George N. Harris, Jr.

1666 K Street NW, Suite 400, Washington DC 20006 202.457.7200 202.457.7201 fax KOZlaw.com
575 Madison Avenue, Suite 7B, New York, NY 10022 212.980.0010 212.751.0084 fax

Exhibit 1

**List of Recommendations**
**(Submitted by Kozusko Harris Vetter Wareh LLP)**

**1. In defining the limits of what constitutes a "family member" for purposes of determining whether a family office is a single family office ("SFO"), and in applying the grandfathering exception, the test should turn on the family relationships among current clients of the office and include all clients who are descended from a common ancestor, instead of asking who were the "founders" of the office.**

**A. The "founders" concept unnecessarily raises a number of issues and unduly restricts the scope of who is in the "family."**

**B. "Family" is better defined as those persons who can prove a link to a common ancestor, and limiting the "family" to a maximum number of generations is unnecessary.**

**C. If the term "family" is to be limited to a maximum number of generations, the number should be at least ten generations and minors should not be counted as a generation apart from their parents.**

**2. Resource sharing and the use of overlapping directors and other personnel with another SFO should not cause an SFO to be at risk of losing its exempt status because of a claim that each office is also serving the clients of the other, and thus has clients who are not "family clients."**

**3. In order to classify entities that do not have owners in a manner that conforms to the policy of the family office exemption, the Proposal should adopt the concept of a "family-funded entity."**

**A. A "family-funded entity" would be treated as owned by the family in determining whether the family office is "owned" by the family.**

**B. A "family-funded entity" would qualify as a "family client" because it was funded and is controlled by the family, making it unnecessary to determine whether the entity is "charitable," a test that would be too restrictive, too vague and not germane.**

**4. A family office should not fail to qualify due to an immaterial amount of non-family ownership and if the minimum ownership threshold is met then a separate test of family "control" is not necessary. Likewise, the family office should not fail to qualify because it provides investment advisory services to non-family for no charge.**

**A. A family office should not fail to qualify by reason of non-family ownership if that ownership is sufficiently small to ensure that the family maintains control. If the family (including family-funded entities) owns at least 80% of the family office, then a separate "control" test is unnecessary. A trust for the primary current benefit of family members should be considered a permissible owner of a family office.**

**B. A family office should not fail to qualify by reason of providing advice to non-family clients if the family office does not receive any compensation for that advice.**

**5. The "exclusive" restriction in determining the family character of an entity, and the grace period for involuntary transfers, should be changed so that the Proposed Rule does not disrupt commonly used forms of trusts and estate plans.**

**A. For family-funded entities, the "family" connection should be based on the predominant source of funding over the prior 10 years rather than trying to determine whether the entity has been exclusively funded by a single family since its inception.**

**B. For trusts and estates for private individuals, the Proposed Rule should be amended for application to entities with mixed ownership (i) to adopt the concept of "primary current benefit" in qualifying an entity as a "family client" and (ii) to allow an SFO to establish a segregated account holding only a portion of an entity's property and qualifying the segregated account as a "family client" when the entire entity itself could not otherwise qualify.**

**C. For purposes of determining whether a charitable split-interest trust is a "family client," a charitable lead trust should be considered a family-funded entity (provided the family controls the selection of the charitable recipient) and a charitable remainder trust should be considered a trust for the benefit of family.**

**D. The four-month grace period for involuntary transfers should be changed to 24 months, subject to further extension in certain limited cases.**

**6. A former family member who is still treated as a member of the family by the family office should continue to be considered a "family member" rather than "former family."**

<u>Exhibit 2</u>

**Explanation of Recommendations**
**(Submitted by Kozusko Harris Vetter Wareh LLP)**

## INTRODUCTION

Thank you for the opportunity to comment on Investment Advisors Act Release No. IA-3098 requesting comments on proposed rule 202(a)(11)(G)-1 (the "Proposal" or "Proposed Rule") under the Investment Advisers Act of 1940 (the "Advisers Act" or the "Act"). We acknowledge the difficulty of creating a comprehensive rule of general applicability that responds to the various circumstances of numerous family investment structures and addresses the myriad issues created by Sec. 409 of the Dodd-Frank Act and we appreciate that your initial approach is clearly designed to treat the vast majority of traditional family office activities as consistent with the exemption. Before reaching our comments, we want to acknowledge the work of the Private Investor Coalition, note our general support for its recommendations, and make it clear that we do not view our comments as inconsistent with the Coalition's views. Rather, we have attempted to supplement the Coalition's recommendations with information and suggestions related to more specific concerns and existing family office circumstances.

We represent a number of families who asked us to comment on the Proposal, but our comments are not limited to their specific circumstances. We have drawn on our collective experience in working with over 20 families who maintain family offices and with many other families whose business and investment structures could possibly constitute a "family office" subject to the Proposed Rule, though the family has not historically viewed its structure or business as a family office. Our experience is not limited geographically to any one part of the United States and it includes multinational families with domestic US offices and US family members who participate in the activities of non-US structures. The senior partners in our firm have been working with family offices for over 30 years.

You asked for comments based upon empirical data, but as you recognize, empirical data on family offices has been scarce, at least until recently. Our experience includes not only a review of that data as it has become available from time to time, but also the insight and knowledge gained from working closely for decades with our clients and with groups that focus on wealthy families, such as the Family Office Exchange, the Institute for Private Investors, Attorneys for Family Held Enterprises, and the first of the family office groups, International Skye.

It should also be recognized that empirical data is rarely able to capture all of the subtle characteristics of a family office because certain factors resist measurement or seem idiosyncratic. Nonetheless, our experience indicates that there are recurring patterns in family organizations, even if those patterns may not be evident in the published surveys. These patterns should be helpful in fashioning a rule that adheres to the principles underlying the family office exemption and, at the same time, avoids leaving too many family offices outside of the new rule, with no option but to seek recourse to separate requests for relief.

Finally, before providing our comments, we want to applaud the thoughtful effort that went into crafting the Proposed Rule and note, in particular, that our clients and we appreciate your explicit

recognition of the vital importance of privacy in the context of single family offices; and our support for your inclusion of adopted children and step children in the Proposal's definition of family, which recognizes the desire of the vast majority of our clients to treat all of their "children" equally.

## GENERAL COMMENTS

These general comments help to explain and support our more specific recommendations that follow. They are intended to assist the Commission in its efforts to fulfill the Congressional mandate that the new rules take into account the wide range of variations in the organization and management of family offices.

### A. Composition of family office: the family, assets under management, and for-profit motive.

### 1. Multiple generations

A recently published study suggests that the clients of most family offices are not drawn from more than three generations.[1] This is consistent with our experience with multi-generational families. As the family expands, subgroups tend to establish their own offices in order to obtain a greater measure of direct participation or independence from family ties and tensions. The preponderance of three-generational offices may also be consistent with the adage about the loss of family wealth over time: "Shirtsleeves to shirtsleeves in three generations."

Yet for a variety of reasons, we do not believe that this justifies treating the "family" in the "family office" exemption as limited to only a few generations.

- There are, and will continue to be, a number of family offices that fall outside this typical pattern of three or fewer generations. Indeed, we represent several single family offices that serve four or five living generations where the wealth was created at least two generations earlier (for a total of six to seven generations).

- Also, the current empirical data is backward-looking and may be a poor indicator of the future. The typical number of generations in a family office is likely to increase for a number of reasons. In many cases the Great Depression destroyed "old" family wealth and the post-WWII boom created new family wealth that will age over time. Multi-generational wealth planning is also growing in concept and practice. In the last two decades the family office has become a more widely used form of organization,[2] the use of perpetual or multi-generational family trusts has grown,[3] and life expectancies have increased significantly.

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[1] R. Amit, et al., *Single Family Offices: Private Wealth Management in the Family Context,* Wharton Global Family Alliance (Apr. 1, 2008) ("Wharton Study"), pp. 9-10.

[2] See, e.g., Wharton Study, p. 9 (most offices in the study were started in the last twenty years). Family offices were not a visible management model until about 25 years ago when, in the mid-1980's at the urging of the Rockefeller Family Office, Peter White fostered a dialogue among seven other offices and founded International Skye because there was no organized forum for family offices.

- Identifying the generation(s) of the current clients of the office does not address the source of funds. Often, certain of the trusts, charities and non-profits managed by a three-generation office were funded by earlier generations.[4] The scope of the exemption should not inadvertently conflict with this reality.

- Families that continue to work together over more than two or three generations obviously have strong family bonds. While such family offices may be in the minority, they still see themselves as serving a single family and they still fit the principle that underlies the family office exemption. The family office is the mechanism for a single family to invest its own money, and the family members do not consider themselves to be customers of an "outside" investment advisor in dealing with their office.

## 2. <u>Relation to family business</u>

Studies also indicate, again consistent with our experience, that many families with investment offices also own, and sometimes actively participate in the management of, a family business or similarly active asset base.[5] Accordingly, family business participation needs to be considered. For example, many family businesses involve circumstances where a family member or business executive could be characterized as offering "advice" about "securities." This can relate to the business itself, such as discussions concerning potential sales and redemptions of shares by family members and trusts, to guide family shareholders in meeting their own personal goals. In some cases, the "family office" may even be contained within the structure of the business enterprise. The issue can also arise, however, where the owners of a family business have diversified some of their wealth into marketable securities and yet are still relying on the business' executives (whether family members or not) to provide advice with respect to certain investment decisions, such as asset allocation. If these executives are being compensated, the changes made by Congress in repealing the 14-client rule and other exemptions can affect these business executives just as they affect the executives in a classic "family office," even though these family business executives do not see themselves as serving the same role as third-party investment advisors.

It is important that the Proposal consider this operating business context because the same principle applies as in the distinct "family office" context. Specifically, these families are investing their own money. The new rules should not be hostile to the family business and the

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[3] Empirical studies show a clear increase in the use of perpetual family trusts, and the only debate seems to be over whether the increase is motivated by the advent of the generation-skipping tax or by the opportunity to control assets for longer periods against a variety of other threats. M. Schanzenbach and R. Sitkoff, "Perpetuities or Taxes? Explaining the Rise of the Perpetual Trust," 27 Cardozo L. Rev. 2465 (April 2006).

[4] This is not surprising since in the Wharton Study (pp. 10-12) more than half of the offices ranked trans-generational wealth management as the most important rationale for maintaining a family office, with family unity and governance also ranked highly.

[5] The Wharton Study (p. 6) reported that more than half of the family offices surveyed had some involvement in an operating business.

customary roles of the business' leaders within a family. It would, for example, be very difficult to apply a rule disqualifying an "office" that generates a "profit" if the putative "office" is an ancillary service of the family's operating business. The Proposal should also allow family members who are compensated by the family's operating business to give helpful advice to family members free of charge if it is outside the scope of their family business employment, without being considered compensated investment advisors due to their family business compensation.

### 3. Relation to profit motive

We do not believe that a family office should be required to show, in order to be exempt from registration, that it does not make a profit. Such a test would inevitably be difficult to administer. It would require a review of receipts and cost allocations among the family office and other family organizations and businesses. Such a cost analysis would be meaningless unless the expenses related to investments were isolated from the concierge, personal property administration, tax compliance, education and other non-investment expenses, and thus cost allocations within the office would be necessary as well. Further, a profitability test would necessarily look to more than just past financial results to determine a lack of profit motive. While it seems possible in theory to design and apply a test that is entirely objective and turns merely on financial results, experience with similar issues in the tax law shows that many other factors must properly be considered, leading to a cumbersome balancing of facts and circumstances, expensive audits, and lingering disputes.[6]

More importantly, while a for-profit motive for a family office may suggest a comparison to a commercial enterprise rather than an office fitting the model of a family investing its own money, the logical connection is actually not meaningful. For example, a return above operating costs may simply indicate a need to provide one branch of the family with an economic return for having provided the start-up and working capital for the office. Conversely, the lack of a profit provides no guarantee that the office is not run for commercial purposes since high compensation and other arrangements could be used to siphon off receipts (as we have seen with the so-called non-profit debt counseling services in another context).[7] Moreover, a non-profit entity that clearly is selling investment advice to third parties, such as other non-profits, is not exempt from registration simply for choosing not to make a profit on the advice. In our view, the

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[6] For example, the rules of Code Section 183 permit income tax deductions only to the extent of gross income (thereby denying losses) where the circumstances suggest that an activity is being conducted as a hobby. The regulations state that all of the facts and circumstances must be taken into account and that no one factor is determinative. The regulations then recite numerous factors, including: (i) the manner in which the taxpayer has carried on the activity; (ii) the expertise of the taxpayer or his or her advisors; (iii) the time and effort expended by the taxpayer in carrying on the activity; (iv) the expectation that assets used in an activity may appreciate in value; (v) the past success of the taxpayer in carrying on other similar or dissimilar activities; and (vi) the taxpayer's history of income or losses with respect to the activity. Treas. Reg. §1.183-2(b) (1)(6). While these are seemingly objective factors, they have led to innumerable disputes between taxpayers and the IRS.

[7] In 2006, the IRS and other agencies found widespread abuses by tax-exempt section 501(c)(3) credit counseling agencies and, as a result, Congress enacted legislation to restrain fees charged for those services, to control the ability to steer clients to affiliated for-profit services, and to limit the opportunity for employees to control the fees and other policies of the exempt counseling organizations. M. A. Lehmann, "Major Changes for Exempt Organizations in the Pension Protection Act of 2006," Journal of Taxation (Jan. 2007 WG&L).

key criterion should not be the profit motive but the nature and scope of the clients and their respective family relationships to the office providing the advice.

## B. Structures currently employed by families for ownership and control of family offices are more complex than the Proposal contemplates.

New forms of ownership have proliferated over the last 10 years. It is, for example, increasingly difficult to analogize all trusts to the company form of ownership as if the beneficiaries were shareholders. There are now trusts that do not have beneficiaries and that are not so-called charitable trusts. These non-charitable "purpose" trusts are now permitted under the trust laws of more than half the states.[8] These trusts are not established for particular individuals (as in private trusts) nor for the public good (as in traditional charitable trusts), but instead for a specific purpose, such as owning the shares of a family trust company or the family office.

Family ownership and control of the family office may also be very difficult to measure. While we appreciate that the Proposal does not require direct and categorical family control of the family office, if family control of the family office is to be an essential element of the exemption, we believe that more explicit guidance would be helpful as to what is intended by "family control" in various contexts. For example:

- For federal tax purposes it may be necessary to restrict the ability of one or more family members to remove and replace family office executives, such as a trust company officer, or members of a distribution committee that makes trust distribution decisions.[9] Accordingly, "control" should be measured by a test that does not require family control over all aspects of family office decisions but instead focuses on investment policies and decisions. We understand that under the Advisers Act the current interpretation of "control" contemplates a wide array of circumstances, including when the principal control is over only investment decisions. If "control" in the Proposed Rule is intended to be construed in that manner, we ask that you confirm that control over only investment decisions is sufficient.

- Control exercised by a family may be indirect such as by: (i) controlling an entity that itself owns or controls the family office; (ii) exercising control over the selection of a majority of the members of a board of directors by periodic elections; or (iii) populating the board of directors of a non-profit organization originally by naming family members and then by allowing the board members to name their own successors. Likewise, the purpose trust mentioned above may have no family trustee but instead may have a local commercial trustee (in order to locate the trust in a desirable state jurisdiction) with the family exercising control through the ability to remove and replace the trustee. Again, we believe that the definition of "control" in the Proposed Rule will work if it is construed in a manner consistent with our understanding of the current interpretation of "control" under the Advisers Act.

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[8] See, e.g., Sec. 409 of the Uniform Trust Code which authorizes non-charitable purpose trusts.

[9] See the proposed Revenue Ruling by the Internal Revenue Service (IRS) on private trust companies in Notice 2008-63 of July 11, 2008.

- In some instances, a family office may be owned by trusts. It may be difficult to determine who "owns" a trust, which becomes critical if the exemption continues to require that the family office be "owned" by "family members." The trust may provide for payments to non-family members on the occurrence of a contingency, or there may be non-family beneficiaries of the trust, such as charities, who are beneficiaries but are not the primary beneficiaries. We believe that a trust that is held for the primary current benefit of one or more family members should be considered a "family member" when that status is relevant, including in determining whether a family office is owned by family members.

The Commission should consider these and similar developments in the corporate and trust laws in fashioning rules that turn on whether the family office is "owned" and "controlled" by the family. We discuss immediately below a related point. The Proposal does not take into account the variety of family-funded entities that are not "charitable" but nonetheless should, as we later recommend, be treated as family clients. All of these variations taken together require adjustments in the Proposal that add some complexity, but we believe that this is the inevitable result of the approach taken in the Proposal in which there is an attempt to classify in a specific way each and every natural person, entity or organization that is a client of the office (or that participates in the ownership or control of the office). We note that certain of the Coalition's recommendations take a broader principles-based approach, which certainly has the merit of apparent simplicity.

**C. Structures employed by families for conducting their public-spirited activities are more varied than the Proposal contemplates; the term "charitable" is not susceptible to one definition and may well be construed too narrowly or inconsistently.**

Non-profit organizations such as non-stock corporations lack private-individual owners (directly and indirectly) but are not necessarily "charities" or "charitable." In certain instances the creator of such an organization may have chosen not to seek a federal tax exemption because the costs outweighed the benefits or because the purposes and operations of the organization did not meet certain tax law restrictions. In other instances, the otherwise benevolent purposes of the organization may not have met the definition of "charitable" as that term is used in trust and property law. Thus, some family-funded entities might not qualify as "charitable" under the Proposal, despite the fact that their purposes are public-spirited. Accordingly, using the term "charitable" could introduce uncertainty, and ultimately could result in the exclusion of organizations created and funded by a family to pursue its public-spirited activities, even when the organization is considered to be a "family" entity just as much as a more traditional charitable private foundation.

More specifically, organizations referred to as "charitable" in common usage are not all treated the same under the Internal Revenue Code ("Code") because the generic term "charitable" refers to a variety of organizations that are actually quite different, including:

- Organizations to which contributions are deductible by the donor for all federal tax purposes (income, estate and gift), and that are exempt from income tax on their own

exempt function income, because the organizations are organized and operated exclusively for charitable, religious, educational or certain other purposes, as described in Code Section 501(c)(3);

- Organizations that are entitled to earn income exempt from income tax but as to which contributions may or may not be deductible by the donor for income tax purposes, as in Code Section 501(c)(19) – a veteran's organization; and,

- Organizations exempt from income tax but contributions to which are not usually deductible by the donor for income tax (and definitely not for gift or estate taxes), as in Code Section 501(c)(4) – social welfare organizations.

Not only does the term "charitable" mean different things for different organizations under the tax law, but the tax law terminology does not always match with trust and property law in many cases. For example,

- The term "charitable" is often used to describe all trusts with charitable purposes, including so-called split-interest trusts. In a popular split-interest trust an individual retains a current income-like interest in the trust assets, and after a certain period of time (measured either in years or an individual's life), the remaining assets are distributed to one or more tax-exempt entities. This is commonly described in the tax field as a "charitable" trust, even though for the immediate future only private individuals enjoy the economic benefits and even though the more precise classification is "split-interest" trust rather than "charitable" trust.

- Political action organizations primarily formed to influence legislation or elections are not treated as "charitable" under Code Section 501(c)(3) but may be treated as charitable under trust and property law.[10]

There is a similar lack of a clear and uniform definition of charitable even within the confines of trust and property law, and the results often seem subjective. For trust law in general, "charitable" is not defined in a restrictive manner, but instead is defined only by example. According to the Restatement of the Law, Second, Trusts, "charitable" purposes include the relief of poverty; the advancement of education, religion, or health; and support for governmental or municipal purposes; but also include **"**other purposes the accomplishment of which is beneficial to the community."[11] Thus the term "charitable" is not limited to enumerated purposes, but instead "the common element of all charitable purposes is that they are designed to accomplish objects which are beneficial to the community."[12] It is easy to see how varying

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[10] Scott and Ascher on Trusts, Volume 6, Part 10, Section 38.7.8; Note, "Charitable Trusts for Political Purposes," 34 Va. L. Rev. 988 (1951). Fund for the Study of Economic Growth v. IRS, 161 F.3d 755 (D.C. Cir. 1998).

[11] Restatement of the Law, Second, Trusts, Section 368.

[12] Id. at Comment a.

interpretations could occur in determining whether an entity is "charitable" in this sense. For example:

- Trusts that provide a community benefit such as for public concerts or a community pool are "charitable" under trust law, and yet a trust that pays funds to every member of a community or school regardless of need has been held not to be charitable because, it seems, the benevolence is excessive if money is distributed rather than used to provide public events and facilities of the type towns often support without regard to need.[13] Similarly, according to the Restatement of the Law, Second, Trusts Section 375, a not-for-profit trust was held not to be charitable when it provided for the general purposes of a fraternal organization that was not itself a charitable organization, but a trust for the relief of poor members of such an organization or for needy members or their families was considered charitable.

- Although a trust for the education of the donor's relatives is not charitable, such a trust may give priority to relatives and still be treated as charitable.[14]

- Trusts to exhibit or preserve a donor's art or writings may or may not be "charitable" depending upon a court's view of the public's appreciation of the works or their purported artistic value.[15] Similarly a trust to promote certain ideas is, it seems, more likely to be "charitable" if the ideas seem plausible or otherwise appealing.[16]

As is evident, the term "charitable" can mean many things in a variety of different contexts. Moreover, as explained in our Recommendations at Sec. 3.B below, the determination of whether an entity is "charitable" is not the most relevant standard to use in this context, which is the identification of what qualifies as a "family client" for purposes of the family office exemption.

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[13] Marsh v. Frost Nat'l Bank, 129 S.W.3d 174, 178 (Tex. App. Corpus Christi 2004)(money to be paid to each U.S. adult citizen). See also, Shenandoah Valley National Bank v. Taylor, 192 Va. 135, 63 S.E.2d 786 (1951)(money paid to entire classes in a school).

[14] Restatement of the Law, Second, Trusts, Section 370.

[15] See Restatement of the Law, Third, Trusts, Section 28.

[16] See, e.g., Estate of Lockwood, 344 Pa. 293, 25 A.2d 168 (1942) (upholding as charitable an outright gift to an incorporated spiritualist college); but see Estate of Stephan, 129 Pa.Super. 396, 195 A. 653 (1937) (holding that a trust for the perpetual upkeep of a spiritualist memorial was not deductible as charitable). See also, Estate of Kidd, 106 Az. 554, 479 P.2d 697 (1971) (upholding as charitable a trust funding research to discover scientific proof of a soul that leaves the human body at death).

## SPECIFIC RECOMMENDATIONS

**1. In defining the limits of what constitutes a "family member" for purposes of determining whether a family office is a single family office ("SFO"), and in applying the grandfathering exception, the test should turn on the family relationships among current clients of the office and include all clients who are descended from a common ancestor, instead of asking who were the "founders" of the office.**

**A. The "founders" concept unnecessarily raises a number of issues and unduly restricts the scope of who is in the "family."**

Under the Proposal, the definition of "founder" is relevant because:

- A qualifying "family office" must have only "family clients" and must be "wholly owned and controlled (directly or indirectly)" only by "family members." A "family client" includes, among others, a "family member" and certain trusts or other entities established and funded by "family members," or owned and controlled and operated for the sole benefit of "family clients." A "family member" is defined by reference to the "founders" of the family office; the term "founders" is defined to mean one married couple (or an equivalent relationship); and "family member" is defined as "the founders, their lineal descendants…, and such lineal descendants' spouses or spousal equivalents," as well as parents and siblings of the founders, and certain other relatives of the founders.

- Also, the definition of "family member" determines in part whether the grandfathering exception applies because it refers in part to a "company owned exclusively and controlled by one or more family members" and the definition of a "family office" similarly requires ownership and control by family members.

While the resulting class of permitted clients and owners appears to be very inclusive under the Proposal, we believe that by using the term "founders" the definitional scheme imposes impractical and possibly unintended limitations and, further, places undue weight on a term that has no discrete and commonly accepted meaning. We recommend instead that a "common ancestor" test be used as the basis for determining "family members" in the context of an SFO.

To demonstrate the importance of the distinction between the terms "founders" and "common ancestors," assume the funds now being managed by an SFO originated over three generations (the parents (G1), their children (G2), and their grandchildren (G3)), and assume the family office was first founded by G3. In this scenario, it appears under the Proposal that if the "founder" approach is used and the founders' grandparents are not included in the definition of family members, these funds could not be managed in a single "family office" despite their common family origin. Instead, each branch of G3 would have to establish and maintain a separate "family office" as "founders." Conversely, if the test was whether the clients of the family office were all descended from a common ancestor, the family could have a single family office.

> Example 1: Assume G1 had two children (G2) and each G2 member in turn had two children (G3). Under the Proposal, a G3 member could establish a family office at the G3 level for her spouse, her siblings and their descendants, and her G2 parents, but not for her G2 aunts and uncles or cousins, and also not for her G1 grandparents (or for private trusts or charitable entities funded in whole or in part by those grandparents, aunts and uncles). If, instead, a "common ancestor" approach were used, then a single family office could serve G1 and all of G1's descendants even though neither G1 nor G2 "founded" the family office.

In addition to being overly restrictive in application, the link back to the concept of "founders" also causes confusing definitional issues.

> Example 2: Assume that all of the G3 grandchildren in Example 1 (who are all either siblings or first cousins of one other) choose to establish a single family office. Is each G3 member, and his or her spouse, treated as a "founder" for purposes of the definition?

Perhaps "yes" but this raises several questions:

- How exactly does one identify a "founder"? It is not apparent what test or factor is to be used to identify the one or two persons "for whose benefit the family office was established." Is it the owner of the service entity (e.g., the corporation) that provides the advice and services (assuming for the moment that there is only one such entity) because that person or persons might also have a significant voice in controlling the office, or is it the oldest living family client, the largest client by account size, or the leading decision-maker or wealth creator in the family? Is the determination made only at the instant the office is created, or must that same person or persons continue to be the "founders" for some material time thereafter? How is the term applied if the founder leaves the office and starts another office?

- If a family member divorces and is therefore no longer a "family member" under the terms of the Proposed Rule, does this same result apply when the divorcing couple are the "founders," so that they could still be "founders" but not "family members" and thus are not themselves permissible "family clients"? If the founders keep their status as permissible family clients after a divorce (which seems literally true as the Proposal is written) why is that result not allowed for others who divorce? If instead the divorce disqualifies the spouse of a founder as a family member but not the "founder," how does one tell at the outset who is the true founder and who is the spouse of the founder?

- Returning to Example 2 above, it would seem that the family office in that Example has more than one founder (or founding couple), and thus may not be exempt as a single family office under the Proposed Rule. It also appears that this adverse result could be avoided if each of the founders had her own legally separate office or if the office were founded by G1. These results seem to turn on thin distinctions that are disconnected from the articulated principles underlying the family office exemption.

- What is the result of a division of the family office, e.g., the not uncommon event of siblings or cousins splitting off and going their own way? If the division is at the G2 level, it seems that this could cause each "family" to shrink by losing one or more of the members of the older generations for purposes of determining who is a "family member" because the "founders" have shifted down a generation and each founded an office. If the concept of "founder" is retained, we recommend that the final rules provide for the tacking of the exemption to successor offices and the carryover of the original "founder" for these purposes. Again, the "founders" concept raises questions that tend to lead to artificial and needlessly complex answers.

**B. "Family" is better defined as those persons who can prove a link to a common ancestor, and limiting the "family" to a maximum number of generations is unnecessary.**

We believe that the issues identified above can be avoided or more easily and fairly resolved if the "founder" concept is not adopted. We recommend instead that the term "family client" be defined by reference to whether the clients of the office at the time in question have a common ancestor.

> Example 3: Assume G1 had two children, and that each generation member in G2 through G4 also had two children. Under a common ancestor test, whether or not G1 is living or had founded a family office, and which of the family members owned or controlled the current family office, would all be irrelevant since all of the current clients of the family office could trace their ancestry back to G1 and would, in fact, be a part of the same family.

This approach would also eliminate the awkward possibility of treating the relationship between uncles/aunts and nieces/nephews differently (on the question of whether such persons are in the same "family") depending upon whether the family office was founded by the nephew/niece or by the sibling of the uncle/aunt who is also the parent of the nephew/niece, as could happen under the Proposed Rule. (See Example 1, above.) We have seen in our practice and understand from others who counsel wealthy families and family offices that the relationship between uncles/aunts and nieces/nephews can be very important to achieving harmony and success in a family culture.[17] In our experience, uncles and aunts are often chosen as trustees, guardians, and other fiduciaries in estate plans because they are "family." Excluding these relationships from a shared family office is therefore troublesome and would require a strong justification.

Using the more inclusive common ancestor approach clearly permits cousins to choose to continue to work together as a "cousin consortium" for the benefit of trusts and other plans for their children and grandchildren. It is clear from studies and our experience that cousins may

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[17] See, e.g., Chapter 16, "The Role of Aunts and Uncles" in James E. Hughes, Jr., *Family Wealth: Keeping it in the Family* (Bloomberg, New York, 2004).

choose to work together as a family, whether or not their ancestors worked together, and this may be especially true where the family owns an operating business or other illiquid asset.[18]

When adopting the common ancestor approach, we do not believe it will be necessary to place a limit on the number of generations involved because family members would naturally self-select in deciding whether they feel sufficient affinity with other family members to seek services from the same family office and, in any event, proof of a common ancestor becomes difficult beyond a certain number of generations, especially for collateral relationships. We expect that there will be a naturally occurring limit, based on our experience and that of others, without the need for a regulatory limitation.[19]

Moreover, where a limit does not naturally occur because a family continues to plan and manage across multiple generations, we believe that there should be no limit imposed by the Proposal. The lack of a limit would be consistent with other aspects of the Proposal, such as the inclusion of stepchildren and spousal equivalent relationships, which are responsive to the reality of how families themselves define their members and how families' wealth is organized and managed. Furthermore, in view of the increasing use of multi-generational trusts, and even trusts that benefit descendants through generations without limit (through the family perpetual trust, as noted in General Comment A), it would be inconsistent to prescribe how many generations are in the "family" for purposes of the Proposal and thereby exclude such trusts from the definition of "family client."

**C. If the term "family" is to be limited to a maximum number of generations, the number should be at least ten generations and minors should not be counted as a generation apart from their parents.**

If the common ancestor approach is adopted to define "family member" but you consider it necessary to limit how many generations can claim to be a single family under a common ancestor, we believe at least ten generations should be permitted so that a group of this size and affinity could choose to be served by one family office, including the trusts and entities the family funds.

This approach also makes it feasible to continue to define entities such as trusts and non-profits by reference to whether they were funded by or for the benefit of "family members." Otherwise vehicles funded by deceased prior generations or for the benefit of young great-grandchildren could often fall outside the definitional limit.

> Example 4: G1, now deceased, funded a Wisconsin perpetual trust for the benefit of all her descendants. G3, now age 85, founded a family office several years ago that plans to continue to manage the trust property and the trust now includes G3's great grandchildren (G6) among its youngest living beneficiaries.

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[18] How such a "cousin consortium" may work together successfully, or not, has been described in detail in Gersick, Davis, et al, *Generation to Generation*, 47-55, 202-219 (Harvard Business School, Cambridge, 1997). See also I. Lansberg, *Succeeding Generations*, 33-48, (Harvard Business School, Cambridge, 1999).

[19] See Wharton Study, pp. 9-10, discussed in General Comment A.1.

Exactly how would this "common ancestor" approach work and what are its limits? For answers we recommend looking to state banking regulatory legislation around the country in which a "family" is defined for purposes of creating special regulatory regimes for private family trust companies serving only a single family. Six generations has tended to be the answer when the legislation limits the number of generations in defining "family" (e.g., five generations but not counting the generation in question, for a total of six generations).[20]

We would recommend that the number of generations be larger to take into account current trends. For example, Nevada's family trust company statute was recently amended to allow ten generations to be included as family.[21] Our recommendation for the larger limit is based on three fundamental points.

First, for the reasons expressed above, we believe a limit is unnecessary. If a limit is deemed necessary, however, then any limit on a family to determine for itself its size for these purposes should be liberal rather than restrictive.

Second, we do not believe a ten-generation limit will open up the family office to abuse as a disguised commercial enterprise because proof of a common ancestor would still be required as would a commonality between the ownership and control of the office and its client base.

Third, based on our firm's experience and client base, and on studies of family businesses,[22] we estimate that about 10 percent of the family offices in existence today would exceed or will soon exceed a six-generation limit. While ten percent is admittedly a small portion, it could be ten percent of several thousand family offices (or affected family investment organizations, whether or not explicitly identified as family offices), so in the near future the ten percent figure could translate into requests for separate relief to the SEC by hundreds of offices if "family" is limited to six generations in the new rules.

Consistent with existing provisions, we recommend that minors not be counted as a generation distinct from their parents if there is a rule limiting the number of generations that are considered to be a part of one family.[23] We recognize that this could lead to a fairly large group of potential

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[20] See New Hampshire Revised Statutes section 392-B:1, Definitions, and Virginia Code Section 6.2-1074, Definitions. The Subchapter S rules of the Internal Revenue Code section 1361(c)(B) also provide for six generations and a common ancestor approach but use simpler language. "An individual shall not be considered to be a common ancestor if, on the applicable date, the individual is more than 6 generations removed from the youngest generation of shareholders who would (but for this subparagraph) be members of the family. For purposes of the preceding sentence, a spouse (or former spouse) shall be treated as being of the same generation as the individual to whom such spouse is (or was) married."

[21] See Nevada Revised Statutes section 669A.040 to section 669A.080.

[22] Studies on family businesses report that a small but notable portion of family businesses have survived through many generations, e.g. the Du Pont family held a material role in its namesake company for over 150 years. See Lansberg at 29. This holds significance for family offices since as we noted earlier at General Comment A.2, families that have offices often also have a stake in a family business, so the two spheres overlap.

[23] Advisers Act Rule 203(b)(3)-1(a)(1)(i) (a minor is not counted as a client distinct from the parent).

clients, even without spouses, siblings, and collateral descendants, yet it would still be a manageable number as the private trust company experience indicates.

> Example 5: Assume G1 had two children, and that each member in generations G2 through G8 also had two children. Under these assumptions, G5 (the great great-grandchildren) would have 16 members, G6 would have 32, G7 would have 64, and G8 would have 128. If the four oldest (and hence smallest) generations were deceased, there would be a total of 240 living family members in the surviving four generations before counting spouses. Of course, the youngest generation (G8) would be likely to include minors, and members of older generations may be deceased, so a more realistic client count would be approximately 100-150 even if we assume that all of these descendants are in fact clients of a single office (rather than dispersing at younger generations). We are aware of a number of family offices serving in excess of this number of clients currently, and it appears to be an easily manageable process since the interests of so many of the clients are substantially similar or even identical and the clients have chosen to preserve their family affinity.

**2. Resource sharing and the use of overlapping directors and other personnel with another SFO should not cause an SFO to be at risk of losing its exempt status because of a claim that each office is also serving the clients of the other, and thus has clients who are not "family clients."**

This question arises because to qualify under the Proposal each family office is permitted to have only "family clients," which is specifically defined to limit the exemption to single family offices rather than multi-client family offices. As a result, questions may arise when clearly distinct families have a legally separate office for their respective family, but share personnel, space, and research, and have overlapping directors and other decision makers. In such cases there is seemingly a risk that the clients of each office would be treated as the clients of both offices.

We believe there should be a bright line test to apply in determining whether, in these circumstances, there are separate "single family" offices for purposes of qualifying for the exemption. That is, it should be sufficient to qualify as separate SFOs where distinct families have separate legal structures, employment relationships, client relationship responsibilities and accounting, regardless of whether the offices share space or employ persons who work in both offices. While this may seem purely hypothetical, it is a source of concern because of the adverse consequences that would befall an SFO that discovers it does not qualify as a family office because of its sharing arrangements with another office. Such sharing arrangements already exist among family offices, and as the wealth management field becomes more complex and more expensive to address adequately, such sharing arrangements are expected to increase.

In another context, the SEC has held that overlapping management or operations are factors that may show common control of two companies. The SEC has held that two companies having the same directors suggests that the same person or persons holds the power to select the board of directors of each and implies common control,[24] and has separately held that factors indicating

[24] Transwestern Mutual Fund, Industry Fund of America, SEC No Action Letter (Oct. 19, 1979).

control include whether there are "interlocking directors and officers, together with share ownership" and whether there is "actual domination and operation."[25] While these decisions arise in very different contexts, they suggest that the SEC might apply a facts and circumstances test to determine whether sharing arrangements of the sort described here would result in the aggregation of the two family offices and thus the disqualification of each as a "family office" under the Proposed Rule.

We recommend that guidance be provided to confirm that each office will be treated as separate as long as it has direct legal responsibility for performing duties solely for its own family, has no direct client duties to the members of the other family under the relevant governing documents and local law, and maintains a separate legal structure and separate employee and third party contractual relationships and accounting.[26] We see no reason to impute responsibility from one office to the other if the clients of an office would not be able to do so, e.g., in a legal complaint for failure to perform.

**3. In order to classify entities that do not have owners in a manner that conforms to the policy of the family office exemption, the Proposal should adopt the concept of a "family-funded entity."**

A basic rationale for the family office exemption is that family offices should not be required to register because their clients are (or are related to) the creators /owners of the service provider, the family office. In other words, family offices are essentially providing investment advisory services for the family's own assets.

**A. A "family-funded entity" would be treated as owned by the family in determining whether the family office is "owned" by the family.**

We propose that the "ownership and control" test under Sec. 275.202(a)(11)(G)-1(b)(2) be revised to read:

> "(b) *Family office*. A family office is a company (including its directors, partners, trustees, and employees acting within the scope of their position or employment) that:
>
> … (2)(i) if it has owners, is owned (directly or indirectly) by individuals or entities that could qualify as family clients; or (ii) if it has no owners, is a family-funded entity; and"[27]

We further propose that a definition of "family-funded entity" be added to the final rules in 275.202(a)(11)(G)-1(d) as follows:

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25 The First Australia Fund, Inc., SEC No Action Letter (Oct. 8, 1987).

26 We have included a new "Miscellaneous" section in our redline to the Proposed Rule. Included among the proposed miscellaneous provisions is language addressing resource sharing.

27 As described in Sec. 4.A and 5.A below, we recommend further refinements to the concepts of family-funded entity and ownership thresholds.

"'*Family-funded entity*' means a company (whether organization, entity or trust) that has no owners (whether direct or indirect), the assets of which are attributable to contributions by family members, and over which family members have the authority to exercise control (whether directly or indirectly); for this purpose: assets shall be considered attributable to contributions by family members if at least 80% of annual contributions over the last 10 calendar years were made by those qualifying as family members at the time of the contributions, but if a company has been in existence for fewer than 10 years, contributions shall be tested over the company's existence; assets contributed by one or more family-funded entities shall be considered as contributed by family members; and a family's ability to remove or replace a fiduciary who controls a company shall be considered control of the company."

Subparagraph (b)(2) of Proposed Sec. 275.202(a)(11)(G)-1 requires that, to qualify for the exemption, the family office must be "wholly owned and controlled (directly or indirectly) by family members." However, as suggested in General Comment B, above, this approach should be modified so that it applies to entities that are in fact not "owned" by anyone.

We are aware of a number of families using family-established non-profit entities (e.g., a purpose trust or a non-profit organization)[28] to own the interests in their family office. We are also aware of situations where family entities that would otherwise be required to register are themselves non-profit corporations, and of situations where family offices are inside an unregulated trust company through which the trust company owns its own shares (somewhat as a subsidiary might own its parent in a circular fashion). Such structures are not "owned," whether directly or indirectly, by or for any individuals. Thus, these family offices would not qualify as "owned" by family members, yet they should still be treated as family offices for purposes of the Proposed Rule.

To that end, employing the concept of a "family-funded entity" would be true to the principle underpinning the Proposed Rule and would accommodate the wide variety of structures that families use to organize their family offices. If this concept were adopted, then in structures where an entity has no private ownership, whether because it has no owners itself or because it is owned by an entity that has no private owners, the entity would nonetheless qualify as family related provided that it otherwise meets the relevant criteria (that is, that it is funded and controlled by the family).

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[28] Purpose trusts are creatures of statute (See, e.g., Uniform Trust Code, Section 409), and have no private or public beneficiaries or equitable owners. Instead, purpose trusts are permitted to accomplish purposes, such as owning the stock of a corporate entity. Similarly, a non-profit, non-stock corporation has no direct or indirect private owners, but instead is formed to accomplish non-profit purposes including simply managing assets (e.g., a homeowner's association or historical site).

**B. A "family-funded entity" would qualify as a "family client" because it was funded and is controlled by the family, making it unnecessary to determine whether the entity is "charitable," a test that would be too restrictive, too vague and not germane.**

We propose that the definition of "family client" in Section 275.202(a)(11)(G)-1(d)(2)(iii) be revised to read:

> "(d)(2) *Family client* means:
>
> …(iii) any family-funded entity;"

In the Proposed Rule, "family client" is defined to include a "charitable foundation, charitable organization, or charitable trust, in each case established and funded exclusively by one or more family members or former family members." As noted in General Comment C, above, the terms "charity" and "charitable" are not susceptible to a single definition. Rather, what is "charitable" can be defined in multiple ways, each dependent upon the purpose for which the question is asked (that is, the context), and as such, there is a substantial risk that the term will be construed too narrowly or inconsistently.

The difficulty in using "charitable" is that the focus becomes whether the entity's purposes and operations are charitable as that term has historically been defined in other contexts. That inquiry, however, is not germane to the rationale for exempting a family office from registration, which is based on the family ties between the office and its clients and the paradigm of the family investing its own money. To verify this connection where the client is not an individual or owned by individuals, the inquiry should focus not on what the client-entity does (whether charitable or not) but on whose money funded the entity. Whether an entity with no owners is charitable is just not a relevant question in this context. Instead, the question for an entity that lacks owners is whether it is funded and controlled by the family. If so, just as with a traditionally defined charity, with regard to that client the family office would be viewed as if it were simply investing assets in which the family is the stakeholder.

While, as explained above, we believe our concept of a "family-funded entity" is a more explicit and therefore clearer approach, we also would accept the Coalition's recommendation that the definition of "family client" include "foundations, charitable trusts, charitable funds, and other charitable or non-profit organizations established or controlled, directly or indirectly, by persons one or more of whom are a family client" since this includes "non-profit organizations." That language is likely sufficient to cover most of the circumstances of which we are aware.

**4. A family office should not fail to qualify due to an immaterial amount of non-family ownership and if the minimum ownership threshold is met then a separate test of family "control" is not necessary. Likewise, the family office should not fail to qualify because it provides investment advisory services to non-family for no charge.**

**A. A family office should not fail to qualify by reason of non-family ownership if that**

**ownership is sufficiently small to ensure that the family maintains control. If the family (including family-funded entities) owns at least 80% of the family office, then a separate "control" test is unnecessary. A trust for the primary current benefit of family members should be considered a permissible owner of a family office.**

In recommendation 3.A, above, we introduced the concept of a family-funded entity to the Proposal's definition of "family office." Now, we recommend a revision to our proposed new definition to respond to your request concerning the propriety of non-family ownership. Specifically, we recommend that the definition of "family office" be modified to read as follows:

> "(b) *Family office*. A family office is a company (including its directors, partners, trustees, and employees acting within the scope of their position or employment) that:
>
> … (2)(i) if it has owners, the interest in its net revenues is at least 80% owned (directly or indirectly) by individuals or entities that could qualify as family clients; or (ii) if it has no owners, is a family-funded entity; and"

We believe that some outside ownership should be permitted while still considering the family office to be owned by family members and meeting the family office definition. We believe that not more than 20% outside ownership is a reasonable amount, if the 20% is measured as a percentage of the net revenues of the family office. Moreover, if at least 80% of the family office is owned by the family (including family-established entities) then we do not believe that a separate test of family "control" is needed because the family will exercise control through its minimum 80% ownership interest. Moreover, if the family's ownership were measured according to its ownership in an office's net revenues, the definition would be consistent with the intent to require family ownership and control and would avoid any need to require that the office not be operated for profit.

In assessing whether the family ownership percentage test is satisfied when one or more trusts own a family office, which is a common form of ownership, the question arises as to who "owns" a trust. We suggest that the Proposed Rule be revised to provide that a trust be considered a permissible owner if it is held for the "primary current benefit" of one or more family members. We define the term "primary current benefit" and discuss its application in Sec. 5.B., below.

**B. A family office should not fail to qualify by reason of providing advice to non-family clients if the family office does not receive any compensation for that advice.**

We propose that the language of Rule 203(b)(3)-1(b)(4) be incorporated into the Proposed Rule's definition of family office in Sec. 275-202(a)(11)(G)-1(b) so that following subpart (b)(3) the definition provides:

> "For all purposes of this Section 275-202(a)(11)(G)-1, a family office is not required to count as a client any person for whom the family office provides investment advisory services without compensation."

We believe that the policy of the Advisers Act is clear, that if an adviser limits itself to providing investment advisory services for no compensation, then the adviser shall not be required to register as an investment adviser. This is set out in Section 202(a)(11) of the Advisers Act which defines an "investment adviser" as "any person who, for compensation, engages in the business of advising others…." This policy is also clearly expressed in Rule 203(b)(3)-1(b)(4) which provides that in counting clients for purposes of the now-repealed Section 203(b)(3) exemption, "[an investment adviser is] not required to count as a client any person for whom [the investment adviser provides] investment advisory services without compensation."

We believe that it is appropriate to incorporate the language of Rule 203(b)(3)-1(b)(4) into the Proposed Rule to ensure that a company that would otherwise qualify as a family office (i.e., among other criteria that it has only family clients) will not fail to qualify as a result of its providing investment advice, for no compensation, to a person who may not fit within the definition of a "family client." Examples of such persons to whom a family office might provide investment advisory services for no compensation include:

- A pension plan or deferred compensation plan offered by a family office solely for the benefit of employees of the office. Typically a family office does not charge employees or their pension or deferred compensation plans for any investment advisory services offered to those plans. But these plans appear not to qualify as "family clients" under the Proposed Rule. Consequently, even if the family office received no compensation for providing investment advice to a plan, the family office would not qualify for the family office exemption and would be required to register as an investment adviser.

- A key employee who retires (perhaps after decades of working for the family office). Although the Proposed Rule permits a family office to advise a former key employee about investments existing as of the key employee's retirement, if the family office advised the key employee as to new investments it would lose its status as an exempt family office. A former key employee, other than as to pre-existing investments, would not be a "family client" under the Proposed Rule. Consequently, even if the family office received no compensation for providing investment advice to a former key employee, the family office would not qualify for the family office exemption and would be required to register as an investment adviser.

- A widow or widower (or surviving spousal equivalent) of a key employee. Upon the death of a key employee and after the involuntary transfer transition period, the widow or widower (or surviving spousal equivalent) of the key employee would not be a "family client" under the Proposed Rule. Consequently, even if the family office received no compensation for providing investment advice to the widow or widower (or spousal equivalent), the family office would not qualify for the family office exemption and would be required to register as an investment adviser.

- In General Comment A.2 above we describe how, at times, while there is not a formal family office, what are arguably investment advisory services are instead offered to family members by employees of the family's operating business. In these cases, the employee offering the investment advice does so for no compensation since doing so is

outside the scope of her employment and is not a condition for that employment. Such an employee would not be required to register as an investment adviser under the Advisers Act as long as she provided the advice for no compensation. (Advisers Act Section 202(a)(11).) However, if the family business is considered a "family office" under the Proposed Rule, then the employee's provision of such advice to someone who is not a family member (such as a non-family executive of the operating business), although not for compensation, would cause the family business to fail to qualify as a family office and potentially require it to register as an investment adviser.

**5. The "exclusive" restriction in determining the family character of an entity, and the grace period for involuntary transfers, should be changed so that the Proposed Rule does not disrupt commonly used forms of trusts and estate plans.**

**A. For family-funded entities, the "family" connection should be based on the predominant source of funding over the prior 10 years rather than trying to determine whether the entity has been exclusively funded by a single family since its inception.**

In the definition of "family client" in Proposed Rule 202(a)(11)(G)-1(d)(2)(iii), certain entities will qualify as "family clients" only if they are "charitable" and only if they are "established and funded exclusively" by one or more family members. In Recommendation 3.B above, we propose that the use of the term "charitable" is too narrow, and suggest that the term "family-funded entity" is more appropriate to accomplish the goal of the exemption.

Additionally, we believe that insisting upon the "exclusive" funding of the entity by family members is impractical.

> Example 6: Assume a so-called charitable trust was established 50 years ago by a distant relative who is not a "family member" under the definition in the Proposal. Assume as well that this charity has for the last 10 years been funded significantly and exclusively by "family members" who are clients of an SFO and that this funding revived the dying charitable organization. Finally, assume that 5 years ago the same family contributors caused this charitable trust to be converted to a corporate form by causing the transfer of substantially all of the trust's assets to the new charitable organization pursuant to local court approval.

We submit that the charity in this Example should qualify as a "family client" even though it was not established and funded exclusively by the "family" of the SFO. Families will rarely be able to verify the source of every contribution over the entire life of a charity that was established by prior generations, and the source of such funding many years ago seems to be no more than marginally relevant to the question at hand.[29] Even recently formed charities may inadvertently flunk an "exclusive" test due to the acquisition of funds from other smaller foundations with similar purposes, or the custom of asking all board members to make a personal contribution as a

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[29] Such precise information would rarely if ever be relevant for federal tax purposes, so it is unlikely to have been maintained for such long periods.

demonstration of interest, including friends and professionals called to the board from outside the family.

A better approach is to consider as “family-funded entities” and thus “family clients” those entities that are primarily (not exclusively) funded by family members by using a test of whether family members contributed at least 80% of annual contributions over the last 10 calendar years of an organization or, if fewer, over the life of the organization. For these purposes, when an organization funded by a single family is converted from one form to another by a transfer of substantially all of the organization’s assets, there should be tacking of the contribution history and qualification as a “family client,” since technically the new entity is not “funded” by the family.[30]

**B. For trusts and estates for private individuals, the Proposed Rule should be amended for application to entities with mixed ownership (i) to adopt the concept of “primary current benefit” in qualifying an entity as a “family client” and (ii) to allow an SFO to establish a segregated account holding only a portion of an entity’s property and qualifying the segregated account as a “family client” when the entity itself could not otherwise qualify.**

In the Proposed Rule, in referring to trusts or estates the definition of “family client” includes only those trusts or estates that exist “for the sole benefit” of one or more family clients. This is not a practical approach and is contrary to many estate plans, particularly those of wealthy individuals. This definition could easily cause a family office to be disqualified from the exemption due to a relatively modest amount of property passing to a non-family client. Consider the following:

- It is not unusual for a trust or estate to pass property to a broadly supported charity such as an educational institution (e.g., one’s alma mater). Under the Proposal’s definition, regardless of how modest the charitable gift the trust or estate would not solely benefit family and hence could not be a family client.

- It is not unusual for an estate plan (a will or trust) to provide for friends and more distant relatives who will undoubtedly not be considered “family members” under the final rules, however that term is ultimately defined.

These provisions for non-family almost always fall within one of the following categories:

- To pay a share of the residuary to non-family after certain dollar amounts have been set aside for family, such as passing the rest of the estate’s net assets to charity after providing specific dollar amounts for family.

- To pay specific dollar amounts to non-family before the residuary passes to family, presumably the simplest provision to manage in this context, but still contrary to the

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[30] We have included a new “Miscellaneous” section in our redline to the Proposed Rule. Included among the proposed miscellaneous provisions is language addressing the tacking of contribution history.

estate administration practice of not distributing assets to any beneficiary before it is possible to determine that the estate has sufficient assets to first pay taxes, claims, debts and expenses as required by law.

- To pay to non-family an amount that is a percentage of the total federal estate values (e.g., 40% of the adjusted gross estate) in which case it would ordinarily take several months to determine the amount, and that amount would still be subject to adjustment in many cases due to an IRS audit of the asset values reported on the estate tax return (typically filed 9-15 months after death and often not resolved for an additional 18 months or so).

- Certain split interest trusts by which a non-family charity receives current annual or other periodic payments for a term of years or the duration of specified lifetime(s) with the remainder passing to family, or the reverse where the charity receives the remainder after the annuity period.

- To provide for non-family a contingent remainder that takes a present interest only upon the happening of a remote event (e.g., if all family members die in a common disaster).

- To include charity or other non-family members as mandatory or discretionary beneficiaries from the inception of the trust or upon the trustee's determination that the family beneficiaries are well provided for, or have for a specified reason forfeited their right to, or priority in, distributions.

We believe that the definition that depends on the concept of "sole benefit" for the family should be revised as follows:

- The term "sole benefit" should be replaced in Proposed Rule Sec. 275.202(a)(11)(G)-1(d)(2)(iv) by the concept of "primary current benefit," so that subsection (d)(2)(iv) is revised to read:

  "(d)(2) *Family client* means:…

  (iv) Any trust or estate existing for the primary current benefit of one or more family clients; for these purposes: a revocable trust shall be treated as held for the primary current benefit of the person entitled to revoke the trust and thus own the trust property; unexercised powers of appointment shall be assumed to remain unexercised; any contingency will be assumed not to occur if it is unlikely to occur based on the then prevailing facts and circumstances (including actuarial probabilities); and for a charitable split-interest remainder trust, the remainder ultimately passing to charity shall be ignored."

- In many instances, while it would not be practical to distribute such assets early to non-family, it would be possible to segregate assets within a trust, estate, or other entity so that assets being held for later distribution to non-family are not managed by

the family office. This concept could be incorporated into the Proposal by adding the phrase "or segregated family account" to the proposed definition of (d)(2)(iv) described immediately above, so that the first sentence of (d)(2)(iv) reads "Any trust or estate, or segregated family account, existing for the primary current benefit of one or more family clients…"

- The adjustments described below should be made in the Proposal insofar as the Proposal addresses involuntary transfers.

**C. For purposes of determining whether a charitable split-interest trust is a "family client," a charitable lead trust should be considered a family-funded entity (provided the family controls the selection of the charitable recipient) and a charitable remainder trust should be considered a trust for the benefit of family.**

In Recommendation Secs. 3.A and B, above, we proposed that the concept of a "family-funded entity" be employed in determining family ownership and the scope of a "family client." In that context, consider a private foundation created by a matriarch who provides all of the foundation's funding, and where the board of directors is occupied by a number of the matriarch's children. Since this entity's funds originated with the family (and thus the family is the economic stakeholder) and the family controls its decisions, this entity clearly qualifies as a "family-funded entity" as we describe it and thus would be a "family client."

What if, however, instead of a private foundation the matriarch decided to create a charitable lead trust with her children as trustees? A charitable lead trust is a type of split interest trust in which the "front" or "lead" interest is paid to one or more charities, usually selected from time to time by the trust's grantor or the family-member trustees, and after a certain period of time, the "back" or "remainder" interest is paid to the grantor's family. In most cases during the lead term, the family controls which charities receive payments from the trust and thus during that time the lead trust is the functional equivalent of a family's private foundation. Under our recommendation, the charitable lead trust would be a "family-funded entity," and thus a "family client" during the lead term because under our concept of "primary current benefit," (1) the remainder interests would be ignored and only the lead interest would be looked at in determining whether there are owners; and, (2) because the family can change the charitable recipients at will, there would be no owners during that term. We have included a provision confirming this construction by providing in our redline of the Proposed Rule that "a charitable split-interest lead trust shall be considered a family-funded entity during the period that assets may be distributed to charity if the trust would otherwise qualify as such an entity and if one or more family members controls the selection of the charitable recipient."

A similar result would obtain for a charitable remainder trust because, by applying the concept of "primary current beneficiary" described above, the family's retained interest during the non-charitable term would qualify the trust as a "trust held for the family."

**D. The four-month grace period for involuntary transfers should be changed to 24 months, subject to further extension in certain limited cases.**

Four months for a transition period upon an involuntary event is too short. This is particularly true for transfers by reason of death, which by its nature is an unscheduled event that makes a new fiduciary responsible for a host of matters, such as determining the extent of any claims, debts and taxes and the fair market values of property, sometimes without the benefit of prior preparation or knowledge. We recommend instead a period of 24 months and an extension if the family cannot transfer the funds during that period as a result of restrictions in place due to third parties that are beyond the family's legal control.

- Twenty-four months is a more practical period than four months and has been used in the Internal Revenue Code as a post-mortem grace period.[31] The longer period would still accomplish the goal of requiring that those who no longer qualify as family members move to other investment advisers so that the single family office does not morph into a multi-client family office.

- In some instances it may not be possible to distribute out or otherwise segregate family and non-family funds, such as by re-registering accounts that are restricted by agreements with third-parties. It would be desirable in such cases to allow the family office to continue to qualify so long as it could demonstrate that a transfer is blocked by circumstances beyond its control.

**6. A former family member who is still treated as a member of the family by the family office should continue to be considered a "family member" rather than "former family."**

On a policy level, we believe it is preferable to permit a former family member who is still considered "family," by family members who are clients of the family office, to continue to be considered "family" rather than "former family." This question is most acute if the issue arises by reason of death or divorce and the children of the relevant marriage (and related trusts) remain clients of the office. The question also arises in the case of stepchildren who have been accepted and raised as members of the "family" and continue to be treated that way even after their biological parent divorces or separates from the "family member" who is the office's client.

We believe that the best way to address this would be to permit an individual who would otherwise be considered a "former family member" to continue to be considered a "family member," as to such individual and the children and other descendants of such individual, if the family office elects to continue working with such individual as a client of the office. A family office would not continue to work with an individual unless the family itself considered the individual to be a "family member."

This would permit a spouse (or spousal equivalent) who has divorced or otherwise separated from the family member with whom the relationship existed (or the widow or widower of a deceased family member) to continue to be treated as a family member. If you desire to limit the

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[31] Code Section 1361(c)(2)(A)(ii) and (iii) (permitting an otherwise unqualified trust to continue as an S-corporation shareholder for a two year period beginning from the date of death of the shareholder whose death triggered the transfer to the trust).

potential expansion of the class of potential family clients in these circumstances, the continued characterization of the spouse as a family member could be limited solely to the spouse (as distinct from any derivative determination of family status by those claiming through the spouse who would otherwise not be considered family members, such as any children from a later marriage).

> Example 7: Assume "X" is a family member, and "Y" marries X. Assume further that Y has a child "A" from a former marriage who is 3 years old at the time of her marriage to X. X and Y have 2 children together ("B" and "C") but then divorce after 18 years of marriage. Following the divorce, Y remarries and has a child "D." During the marriage, the three children, A, B and C, were raised together and consider themselves siblings. B and C naturally view their mother Y and their step-sibling A as "family."

Under the definition of "former family member" in the Proposal, Y and A each will be a former family member following Y's divorce from X. This makes Y no longer a permissible client for new investments despite the fact that Y is the parent of 2 family members. It similarly makes A no longer a permissible client for new investments despite the fact that B and C consider A a member of the family. In many instances, X and other family members may have funded trusts for the combined benefit of A, B and C, as well possibly as trusts exclusively for A's benefit. Under the Proposed Rule, such trusts for the benefit of A, B and C would not be exclusively for the benefit of "family members" and hence the family office would have to cease providing investment advice with regard to new assets contributed to such trusts, despite the fact that they are also for the benefit of family members.

Finally, we believe that, in order to foster harmony within families, it would also be best to permit the family office to determine whether a future descendant (e.g., a post-divorce child of Y) should be considered a family member. We understand, however, that you might want to exclude a post-divorce child of Y, such as D, from being considered a family member.

Exhibit 3

**Redline of the Proposed Rule Incorporating our Recommendations**
**(Submitted by Kozusko Harris Vetter Wareh LLP)**

**PART 275 – RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940**

1. The authority citation for Part 275 continues to read in part as follows: **Authority:** 15 U.S.C. 80b-2(a)(11)(G), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b 6(4), 80b-6a, and 80b-11, unless otherwise noted. * * * * *

2. Section 275.202(a)(11)(G)-1 is added to read as follows:

**§ 275.202(a)(11)(G)-1 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, 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 until the later of:~~for~~ ~~four~~ (i) twenty-four (24) months following the transfer of assets resulting from the involuntary event and (ii) where distribution or segregation of assets which are the subject of such a transfer is not possible within twenty-four (24) months due to circumstances beyond the control of the company, the earliest date that such distribution or segregation can occur;

(2) (i) If it has owners, the interest in its net revenues is at least 80% owned (directly or indirectly) by individuals or entities that could qualify as family clients; or (ii) if it has no owners, is a family-funded entity~~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.

For all purposes of this Section 275.202(a)(11)(G)-1, a family office is not required to count as a client any person for whom the family office provides investment advisory services without compensation.

(c) *Grandfathering*. A family office as defined in paragraph (a) above 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) A company meeting the description contained in (b)(2) above~~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 subsection (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) *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.

(2) *Family client* means:

(i) Any family member;

(ii) Any key employee;

(iii) ~~Any charitable foundation, charitable organization, or charitable trust, in each case established and funded exclusively by one or more family members or former family members~~ Any family-funded entity;

(iv) Any trust or estate, or segregated account, existing for the ~~sole~~ primary current benefit of one or more family clients; for these purposes: a revocable trust shall be treated as held for the primary current benefit of the person entitled to revoke the trust and thus own the trust property; unexercised powers of appointment shall be assumed to remain unexercised; any contingency will be assumed not to occur if it is unlikely to occur based on the then prevailing facts and circumstances (including actuarial probabilities); and for a charitable split-interest remainder trust, the remainder ultimately passing to charity shall be ignored.

(v) Any limited liability company, partnership, corporation, or other entity wholly owned and controlled (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more 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;

(vi) Any former family member, provided that from and after becoming a former family member the individual 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 time that the individual became a former family member, except that a former family member shall be permitted to receive investment advice from the family office with respect to additional investments that the former family member 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 family member; or

(vii) 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.

(3) *Family-funded entity* means a company (whether organization, entity or trust) that has no owners (whether direct or indirect), the assets of which are attributable to contributions by family members, and over which family members have the authority to exercise control (whether directly or indirectly); for this purpose: assets shall be considered attributable to contributions by family members if at least 80% of annual contributions over the last 10 calendar years were made by those qualifying as family members at the time of the contributions, but if a company has been in existence for fewer than 10 years, contributions shall be tested over the company's existence; assets contributed by one or more family-funded entities shall be considered as contributed by family members; and a family's ability to remove or replace a fiduciary who controls a company shall be considered control of the company."

*(4)* *Family member* means:

(i) a common ancestor, any lineal descendant (including by adoption and stepchildren) of such common ancestor, and any spouse (or spousal equivalent) or former spouse of such common ancestor or of any such lineal descendant; and

(ii) ~~the founders, their lineal descendants (including by adoption and stepchildren), and such lineal descendants' spouses or spousal equivalents;~~

~~(ii) the parents of the founders; and~~

~~(iii) the siblings of the founders and such siblings' spouses or spousal equivalents and their lineal descendants (including by adoption and stepchildren) and such lineal descendants' spouses or spousal equivalents~~ an individual who would otherwise not constitute a family member due to divorce or other similar event but

who, after such an event, continues to be treated as a member of the family by others who do so qualify.~~.~~

(~~4~~5) *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.

~~(5) *Founders* means 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) *Key employee* means any natural person (including any person who holds a joint, community property, or other similar shared ownership interest with that person's spouse or spousal equivalent) who is an executive officer, director, trustee, general partner, or person serving in a similar capacity of the family office or any employee of the 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, provided that such employee has been performing such functions and duties for or on behalf of the family office, or substantially similar functions or duties for or on behalf of another company, for at least 12 months.

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

(e) *Miscellaneous*.

(1) For purposes of (b)(1) above, a company shall not fail to qualify as a family office merely because that company shares resources with another company that provides investment advice so long as the former company:

(i) has direct legal responsibility for performing duties solely for its family clients under applicable governing documents and local law, and

(ii) maintains separation of accounting, legal structure, and employee and third party contractual relationships.

(2) For purposes of (d)(3) above:

(i) a charitable split-interest lead trust shall be considered a family-funded entity during the period that assets may be distributed to charity if the trust would otherwise qualify as such an entity and if one or more family members controls the selection of the charitable recipient; and

(ii) tacking with respect to contribution history shall be permitted in the event of a transfer of substantially all of a company's assets to another company.