



November 17, 2010

[Via e-mail to: rule-comments@sec.gov](mailto:rule-comments@sec.gov)

U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: File Number S7-25-10

Ladies and Gentlemen:

This letter is submitted in response to the request for comments by the Securities and Exchange Commission (the “Commission”) in Release No. IA-3098 (the “Proposing Release”). In the Proposing Release, the Commission has proposed new Rule 202(a)(11)(G)-1 (the “Proposed Rule”) under the Investment Advisers Act of 1940 (the “Act”) to define “family office” for purposes of the Act. As the Commission points out in the Proposing Release, section 409 of the Dodd-Frank Act creates a new exclusion from the definition of “investment adviser” in section 202(a)(11)(G) of the Act, pursuant to which family offices as defined by the Commission are not investment advisers subject to the Act.

The undersigned are members of the Securities Committee (the “Committee”) of the Business Law Section (the “Section”) of the State Bar of Texas. Please note that the comments expressed in this letter represent the views of the undersigned only and do not represent the views of their colleagues or law firms or the official position of the State Bar of Texas.

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Overview

We appreciate the Commission's recognition that the Act was not intended to apply to the typical single family office because the Act was not designed to regulate the interactions of family members in the management of their own wealth. We are concerned, nevertheless, that the definition of "family office" in the Proposed Rule is not broad enough to include many single family offices. In fact, we believe that the "typical" single family office may not meet the definition set forth in the Proposed Rule. In our view, the Proposed Rule would force many single family offices to (1) incur significant costs and disruption to their business in order to restructure to avoid registration, (2) register under the Act and become subject to a regulatory regime that Congress and the Commission have acknowledged should not apply to single family offices or (3) apply for an exemptive order, which also would be time consuming and expensive for the typical single family office.

In addition, as the Commission emphasized in the Proposing Release, an exclusion for family offices from the coverage of the Act is necessary to respect the privacy of family members. We respectfully suggest that, given the private nature of family offices and the relatively small number of applications for exemptive orders in the past, the Commission may not be familiar with some common features of the typical single family office and its operations, such as co-investment with unrelated single family offices. We would encourage the Commission to provide greater clarity with respect to the types of activities a family office can undertake without being an investment adviser for purposes of the Act.

Our concerns with the Proposing Release include the following:

- *Founder Concept.* First, we believe that the concept of identifying a single "founder" is not practical in many cases. Many single family offices are created by more than one family member; for example the "founders" may include two generations of a family (such as a mother and her sons) or siblings (such as a brother and a sister). Second, we believe that defining family office clients with respect to the original founder is also not workable. For example, in the case of a deceased founder, the relationship of the clients of the family office to the founder may not be relevant. We suggest that a more practical solution would be to require that the clients of the family office be related to the current *owners* of the family office. To prevent abuse, we suggest that for purposes of determining permitted family clients, only material owners who are the lineal descendants of the founders and the descendants' spouses or spousal equivalents be considered. Such approach would correspond to the practical realities of many single family offices we are familiar with, and also satisfy the Commission's policy concerns that the owners of the family office are serving their family members.

- *Family Member definition.* We believe that the definition of “family member” is too narrow. We believe that the owners of the family office should be allowed to advise not only their parents, siblings and lineal descendants, but also their step-parents and their grandparents.
- *Family Entities.* We suggest that charitable trusts managed by a family office should be able to take outside donations. We also suggest that a revocable trust established by a family member should be within the permitted clients of the family office regardless of who the beneficiaries of the trust are.
- *Involuntary Transfers.* We believe that the four month transition period for involuntary transfers is too short. We believe a full year may be needed to efficiently transition a client away from the family office.
- *Key Employees.* We suggest that the definition of “key employee” be extended to include long time employees of the office or of affiliated family businesses, if they are accredited investors. While the grandfathering provisions of the Proposed Rule allow existing employee clients to continue to be serviced by the family office, it does not permit future employees who are not involved in the management or investment functions of the office to become family clients, and we believe there is no valid policy concern to exclude long term employees that are accredited investors. We suggest that the individuals be employed by the family office or a related family business for at least five years before being permitted to co-invest with the family office.
- *Profit Participation.* We recommend clarifying that employees of family offices can participate in the profits generated by family offices in the form of profit interests. The Commission clearly recognizes the importance of offering incentives to attract and retain employees comparable to those offered at other money management firms, and we believe profit participation would not run counter to policy goals of ensuring that ownership and control of the family office remains in family hands.
- *Conduit Club Deals.* We recommend that the Commission clarify that single investment partnerships organized among unrelated single family offices will not cause the organizing family office to be deemed an investment adviser for purposes of the Act. We believe that allowing unrelated family offices to co-invest through “club deals” organized by a single family office does not make the other family offices “clients” of the organizing family office for purposes of the Act. Investors in club deals do not typically pay fees to the organizing family office, and the other participants are not being advised

or served in a traditional way by the organizer. Club deals are generally intended to increase scale and leverage, and meet investment minimums. In addition, we suggest that a transition period be introduced to allow club deals that may not comply with the family office rule to be restructured or wound down, which will be highly challenging in a limited window prior to July 2011.

Family Clients

A. Founder Concept Generally

The core of the Proposed Rule is the definition of “family client,” since under the Proposed Rule a family office can have no clients other than “family clients.” We agree with this concept, as well as the Commission’s proposal that a “family client” must be either a “family member” or a “key employee.” Nevertheless, we respectfully disagree with the proposal that “family member” be defined with reference to a single “founder.”

The Proposed Rule defines “founder” as the “natural person and his or her spouse or spousal equivalent for whose benefit the family office was established...” We respectfully advise the Commission that many family offices are not “founded” by any one individual (or by an individual and his or her spouse) but by a family itself, e.g., by a mother and her sons, by siblings, by a group of family members, etc. The Commission’s approach – which requires identifying a single individual or a couple who created the office – does not account for the practical realities of how many family offices are created. As a result, the identification of a single individual may be an arbitrary determination and in turn result in an overly restrictive and awkward determination of who may be a family client. At a minimum, we respectfully suggest broadening the scope of the “founder” to include multiple individuals (and their spouses) to the extent this was the case, but that the “founders” still be members of the same immediate family, i.e. those with a parent-child or sibling relationship.

A broader point is that, even in situations where identification of one or more founding individuals is feasible, many existing family offices no longer serve the founding generation. In many cases, the founding generation has died, the wealth has transferred and the ownership of the office has transferred to the later generations. In these cases, the current ownership and control of the family office is more relevant to the family members served by the office than any predecessor generation or deceased founder. We note that, for example, under the Proposed Rule a family office could not advise the parents or siblings of the daughter in law of a founder. If the daughter in law and her husband (the founder’s son) owned and ran the family office, it seems to us that the exclusion of the family of the daughter-in-law would be an inequitable and unnecessary result. From a policy standpoint, any such advisory relationship is still very much family-to-family, and consistent with the purpose of the family office exclusion.

The above facts appear even more inequitable and unrealistic when other situations are considered. The second or third generation may have increased the family wealth exponentially through shrewd stewardship so that the very character of the office – its size and sophistication – originates with the younger generation, not the older one. In other cases, the younger generation may in fact be *managing* the office and making investment decisions on a day-to-day basis. In certain cases, next generation family members are educated for the purpose of returning to run the family office. We respectfully submit that family members of the generation owning and running a family office should be allowed to become clients of the family office without the family office having to register under the Act.

To address these realities, we recommend the following:

- Define “family client” with reference to the current “material owners” of the family office, not the founders of the office
- Define “material owner” as one that owns at least 10% of the voting equity of the family office
- Require that all material owners be lineal descendants of the founders (including the spouses and spousal equivalents of the descendants)
- Define the founders as those immediate family members who initially organized the family office

The Commission has emphasized that a core principle of prior family office exemptive orders and of the family office exclusion in section 409 of the Dodd-Frank Act, is that family offices serve family members, who are in a position to protect their own interests and unlikely to need the protection of the Act. To the extent that the Commission maintains the requirement that equity ownership of the office be held solely by family members (which we recommend), defining family clients with reference to the material owners of the family office is consistent with this policy. To prevent abuse, we suggest that the final rule should limit owners to the lineal descendants (and their spouses) of the original “founders” of the office and provide that family member clients must be related to one of the material owners of the office. For this purpose, we believe that material ownership should be quantified as 10% or more, which is consistent with concepts of control under the securities laws. The clear benefit of the foregoing approach is that it would allow the material owners of the family office to provide advice to their family members, even if those family members are not strictly descendants of the founder or founders.

B. Family Member definition.

Regardless of whether the Commission agrees with our recommendation that family member clients be defined with respect to the current owners of the family office, we respectfully recommend expanding the definition of “family member” to include other close relatives. We

agree with the Commission's position in the Proposing Release that parents, step-children and adoptive children of the founders should be permitted family clients. In addition, we believe that common sense dictates that step-parents and grandparents of founders (and of founders' lineal descendants and spouses) should be included.

C. Family Entities.

With respect to family entities, we strongly suggest permitting charitable entities managed by a family office to be able to take outside donations. We note that limitations on donations to charities managed by a family office would not be socially beneficial, and could be severely disruptive to the operations and aims of charities managed under family office umbrellas. In addition – from a policy standpoint – we note that the assets of the charity are the *charity's*, not the outside donors anymore, and believe that the securities laws have far less interest in the origin of the donations relative to the charity client itself. To the extent that the Commission is concerned that such an exception would be a “slippery slope” towards a commercial advisor relationship, we would suggest requiring that the charity be fully controlled by family members. In addition, some limit on outside donations (e.g., less than half) seems sensible.

We also respectfully recommend that a revocable trust established by a family member should be a permitted “family client” during the lifetime of the grantor regardless of who the ultimate beneficiaries are. In the case of a revocable trust, the family member grantor maintains full control over the trust, the grantor often receives the income during his or her lifetime, and the assets in trust only pass to the beneficiaries upon death. As a result – during the lifetime of the grantor - the trust and effectively the grantor are the clients for all practical purposes. Upon death of the grantor, consistent with the Proposed Rule, we recognize that any assets transferred to non family clients could not be managed by the family office, subject to a transition period, as discussed below.

D. Involuntary Transfers.

With respect to involuntary transfers generally, we recommend extending the four month transition period to one year. Based on experience, we believe a full year would be needed to efficiently transition a client away from the family office, and that the four month proposed rule is too short.

E. Key Employees

Key Employees as Clients; Importance of Co-Investment.

The Commission requested comment on whether the final rule should allow family offices to advise key employees of the family office. Specifically, the Proposing Release asks if family offices rely on access to co-investment opportunities to attract talent. We respectfully

advise the Commission that the answer to both of these questions is unequivocally yes. In our experience, family offices rely on their ability to offer unique investment opportunities to attract talented employees (as discussed below, key incentives to attract employees also include performance related incentives, such as profit participation). As a result, we believe it is critical to include key employees within the definition of “family client,” since healthy, stable and successful family offices reinforce the family office exception and diminish the need for the protections of the Act.

Definition of Key Employee

With regard to determining “key employees,” we believe that long term employees that are not involved in the investment process should be allowed to invest with the family office if they are accredited investors. Congress clearly grandfathered as clients accredited individuals who, *at the time of investment*, were employees and were advised by the office as of January 1, 2010. While appropriately focused on grandfathering existing clients as of the current date, inherent in this concept is that a number of employees (past and present) are served by family offices, whether or not involved in the investment process or serving as executive officers of the office. Accordingly, we respectfully recommend extending the “key employee” definition to include certain additional real world “key” employees of families and family offices on a going forward basis: accredited long time employees of the family office or of affiliated controlled family businesses. (We note the grandfathering provisions would not explicitly cover employees of family businesses even if they are current clients of the family office). For the foregoing purposes, we suggest that “long time” be defined as five years or more. In both cases, many such long time employees will be trusted business and investment confidantes of the family principals and are often viewed and treated akin to family; in the case of family business employees who are talented operators, they are more appropriately employed at affiliated operating companies and not formally by the family office. Nevertheless, the opportunities and services made available to such long term family employees through the affiliated family office can be an important benefit and retention tool for such individuals.

As a practical matter, including long time employees avoids an awkward situation of having certain more recently hired employees (investment professionals or executive officers) being “under the tent” but leaving long-time loyal family employees “outside of the tent.” We agree with the requirement that any such individuals be accredited investors to lessen the need for the protections of the Act and provide a more meaningful practical rationale for excluding non-accredited individuals from family office co-investment opportunities. It is worth pointing out that a key distinction between the individuals we recommend including – long time family office or affiliated business employees – and the grandfathered clients is that the grandfathered employee clients could conceivably include any accredited employees or former employees (so long as they were employees at the time of investment and served as of 1/1/10).

Ownership and Control

A. Generating a Profit

In the Proposing Release, the Commission asked whether a family office should be permitted to generate a profit, as opposed to only charging fees designed to cover costs or compensation of employees. We strongly recommend that the final rule permit family offices to earn profits. We believe that it is fundamental to the successful and efficient operation of any investment platform, including family offices, to have incentives aligned through the generation of fees (both management and performance fees) borne by family clients. We also note that explicitly permitting profit generation avoids the numerous and potentially costly interpretative issues that arise as to whether a fee or payment is in fact an indirect profit “compensation” (versus expense reimbursement). We emphasize that ultimately if family clients are unhappy and/or believe that the fees charged by a family office are high or unwarranted, family clients can “vote with their feet” and will have any number of commercial investment advisory alternatives at their disposal.

B. Employee Profit Participation

While profit generation is clearly permitted by the Proposed Rule, we believe that the Commission should clarify that employee participation in profits is permitted. The Commission notes in the Proposing Release that “[r]equiring that the family office be wholly owned by family members alleviates any concern that we may otherwise have about the profit structure of the family office, because any profits generated by the family office from managing family clients’ asset only accrue to *family members* [emphasis added].” The foregoing appears to us to imply that the Commission is contemplating that all profits in fact must accrue to family members (not non-family employees), yet it is a dominant feature of family offices in our experience - and vital to recruitment efforts we believe - that investment professionals are compensated based on performance. We note that in its discussion of the definition of “key employees” in the Proposing Release, the Commission recognized that family offices need to provide incentives “to create positive investment results at the family office under terms that could be available [to employees] as employees of other types of money management firms.” We respectfully advise that arrangements tied to performance are the single most common such incentive. For a family office, such arrangements vary but often take the form of a bonus (or participation in a bonus pool) based on performance of underlying investments, with the bonus or bonus pool ultimately funded by fees generated by the family office. Such arrangements may also take the form of a direct profits interest in the family office. We remain very concerned that under the Proposed Rule such arrangements could create uncertainties for family offices and their compensation structures, particularly for those family offices that legitimately earn performance fees and also compensate top investment professionals on performance metrics. Accordingly, we would

strongly recommend that the Commission clarify that employee profit participation in the family office (as opposed to ownership) does not violate the ownership requirements of the rule.

We stress that permitting employee profit participation can in our judgment co-exist as a policy matter with the ownership requirements of the family office (requiring 100% family member ownership), since the family office entity providing investment advice to family will still be wholly owned and controlled by family members and family members will be exercising ultimate supervisory authority with respect to all employees. If the Commission was concerned that a family office could use profit interests or participation as a disguised way of transferring economic ownership, the Commission could adopt some features common to profits interests plans, such as caps (e.g., 15-20% of total profits) or requiring that such interests be fully forfeitable (at no cost) in the event an employee's relationship with the office ceases.

C. Certain Activities Not Conducted for Purpose of Generating a Profit: Conduit Club Deals

While family offices may be managed to generate a profit by charging fees, we recognize that certain activities must be structured to not charge fees so as to not run afoul of the Family Office exclusion to the Act. These include conduit club deals among unrelated single family offices. We would encourage the Commission to provide some additional clarification in this regard.

Conduit Club Deals Generally

Conduit club deals, which are commonplace among family offices, typically involve one family office organizing a group of unrelated family offices to invest together in an investment that would be otherwise too large for any single family office. A critical function of the club deal is that aggregation of capital enables family offices to gain scale in order to meet investment minimums of hedge funds or private equity funds. By virtue of the magnitude of capital at the disposal of family offices, such deals are often organized with between 3-5 other family offices in our experience.

In a typical conduit club deal, the organizing family office sets up a special purpose partnership to hold a single investment, with the organizing family office serving as the general partner that manages the partnership. The general partner typically does not receive any fees or special compensation for serving as general partner; however, the general partner is reimbursed for its expenses to cover out of pocket costs, including lawyers and accountants. In addition to the absence of more traditional fees in such context, the other participants in a club deal do not resemble "clients" in any common sense way: the other family offices (highly sophisticated parties) obtain access to all of the same materials provided to the organizing family office, they do their own due diligence and their participation is entirely voluntary. As result, the club deal simply serves as a conduit for family offices to obtain access to investment opportunities with an

organizing family office being reimbursed for costs. Importantly, such structures are economically efficient and socially beneficial, as they permit efficient capital allocation where certain artificial constraints (e.g., investment minimums) may exist.

We do not believe that the intent of the Proposed Rule is to prohibit such structures among unrelated single family offices. Nevertheless, we urge the Commission to clarify that a family office that organizes a club deal for other family offices is not an investment adviser because the family office is not providing advice for compensation. We point out that Rule 203(b)(3)-1(b)(4) under the Act recognizes that a person to whom investment advisory services are being provided without compensation is not a client. We believe that neither the partnership nor the family office partners of the partnership would be clients, but that the Commission should clarify that expense reimbursement does not equal compensation for purposes of the Act. We recognize that – alternatively - organizing family offices could register under the Advisers Act or obtain an exemptive order from the Commission. The reality however is that these are very impractical and/or cost prohibitive solutions for deals that are typically organized on an expeditious basis and/or represent a very small portion of any one family office’s overall capital. A third alternative would be to hire a registered investment advisor to serve as general partner but such an approach would result in meaningful and unnecessary costs -- economic loss – in order to structure within the rules where the advisor serves no legitimate purpose.

Like the broader exemption for family offices required by Congress, we do not believe the conduit club deal is the type of arrangement that Congress designed the Act to regulate. The ostensibly problematic features of such a deal – a GP role for the organizing family office and expense sharing mechanism through the partnership – are simply creatures of the conventional legal framework required to organize such deals and are not in place to facilitate any substantive business or advisory role for the organizing family office vis a vis the other participants. Accordingly, we respectfully recommend that the Commission clarify that there are no issues under the Act for conduit club deals between family offices which are (1) not organized by any one family office acting in an advisory capacity and (2) not organized for profit (i.e., no fees, and solely expense reimbursement mechanisms to cover outside costs). If the Commission was concerned about creating an exception that was broad, we could see a few other sensible requirements that would not hamstring the disproportionate number of club deals in our judgment: limitations on the identity of participants (e.g., other family offices that meet the Family Office Rule, or solely “qualified purchasers”) and/or on the size of such deals relative to total capital of an organizing family office (e.g., club deals represent no greater than 10% of capital of organizing family office).

Grandfathering; Transition Period Issues

Whether or not the Commission adopts a carve-out for conduit club deals, we would also strongly recommend that the Commission either grandfather existing club deals in place (given

their frequency and significance) or, at a minimum, adopt a realistic transition period to enable family office organizers of conduit club deals to restructure any such deals that would result in the organizing family office running afoul of the final Family Office Rule. If the Commission were to determine that organization of any club deal were a problem, or if the Commission were to promulgate only very narrow exceptions, we emphasize that such a transition period would be even more critical. So long as family offices were otherwise in compliance with the Family Office Rule, we suggest a transition period extending one additional year (until July 2012) to restructure existing club deals.

Based on our experience, family offices are likely to have significantly greater flexibility to restructure their on-going “client” base to address the final Family Office Rule, since in most cases the applicable family members are in control of the entities (including investment partnerships) falling under the family office umbrella. In contrast, many club deals by definition involve third party investors with disparate interests who, in the aggregate, will hold significant if not majority ownership of the vehicle. As a result, despite serving as the nominal GP or managing member, the organizing family office is likely to have fewer rights to force any restructuring, such as substituting general partners or altering fee or expense sharing arrangements to ensure it is able to meet the requirements of the Family Office Rule. Moreover, the investment vehicle in question was likely set up to address certain specific requirements or features of an underlying investment or investment fund in mind, and changes in the club deal vehicle may have implications at the underlying fund level that require additional input, screening or consents. Additionally, investments made through a club deal often cannot be unwound quickly because of extended “lock up” periods required by hedge funds and private equity funds. Accordingly, we believe it will be an undue hardship, inequitable and entirely unrealistic to expect family offices that have organized conduit club deals (and which would otherwise be in a position to comply with the final Family Office Rule) to be in a position to rapidly restructure or wind down such deals to comply with the final rule.

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We appreciate the opportunity to comment on the Proposing Release and respectfully request that the Commission consider the comments and recommendations set forth above. The undersigned are available to discuss them should the Commission or the staff so desire.

Respectfully submitted,

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