FAMILYWEALTHREPORT

The Dodd-Frank Reforms - The Family Office Implications, Fiduciary Concerns

July 20, 2010

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Legislation overhauling the US financial regulatory system was finally passed by the Senate yesterday and will be signed into law next week by President Obama.

For wealth managers and family offices, the Dodd-Frank Wall Street Reform and Consumer Protection Act is the beginning of a new era that will initially be characterized by much uncertainty.

The heated battle over what type of fiduciary standard the Securities and Exchange Commission will impose and who will be affected has drawn the lion's share of attention and scrutiny.

But family offices are also in the Security and Exchange Commission's cross-hairs, and the final regulations that govern them may not be known for years, legal experts say.

To date, family offices have not had to register with the SEC under the Investment Advisers Act of 1940 if they have fewer than 15 clients.

This key exception has been eliminated by the new law, which goes into effect one year after its passage.

A new exception for family offices is expected, but first the SEC has to come up with a formal definition of a "family office", a process that no one thinks will be completed a year from now.

"There is a real risk there will be nothing in place excepting family offices long after the act becomes effective," said John Duncan, principal for Chicago-based law firm Duncan Associates. "In the meantime, the SEC may temporarily grandfather existing arrangements, but it is impossible to say if it will. Defining what is being grandfathered may be at least as difficult as coming up with the actual definition of family office."

And even when the SEC does get around to a definition, Duncan added, "They are likely to define 'family office' as narrowly as they can, which is unlikely to serve the needs of very many real, typical family offices."

Compliance, Privacy Concerns

Regardless of the final definition, there is little doubt the new law will result in increased regulations and compliance costs for family offices, and some argue privacy and confidentiality will also be affected.

“The industry is already struggling with costs and expenses escalating beyond revenues, difficulty of affording best-in-class talent, and competition,” said Thomas Handler, chairman of advanced planning and family office practice group for Chicago-based law firm Handler Thayer.

“Having government agencies wading through private family financial matters and personal information is highly problematic. One response will surely be to spin off entities from the family office in order to isolate regulatory scrutiny. In other words, a private trust company may help to isolate the impact of custodian regulation and a separate RIA [registered investment advisor] may protect other information resident in the separate family office entity,” Handler said.

What’s more, Handler continued, family offices may be tempted to “jettison financial management in order to avoid registration altogether. This should benefit large investment firms and multi-family offices in particular.”

Kristi Kuechler, president of the Institute for Private Investors, agreed.

“As single family offices face increasing regulation and compliance costs, they may be more likely to outsource the investments from the family office to RIA firms,” Kuechler said.

More Private Trust Companies Seen

An increase in private trust companies because of the new law is also probable, according to Duncan and Jon Carroll, president and chief executive of New York-based Family Office Metrics.

“The exception for family offices structured as regulated private trust companies is not affected by Dodd-Frank,” Duncan said. “It will have an impact, largely by causing families seeking the long term advantages of a private trust company to move more quickly to take advantage of the registration exception.”

“I think you’ll see more interest in families pursuing private trust companies because they have virtually the same goals as family offices,” Duncan said. “But trust companies are regulated by states, so families won’t be escaping regulation. They’ll just be swapping one set of regulators for another.”

While Handler views the new law resulting in “a tremendous loss of privacy and confidentiality” for wealthy families, others disagree.

"Family offices don't pose a systemic risk, and I think the legislators and regulators received good input from family offices and will draw a line in the sand to protect the privacy of families," said industry veteran Jamie McLaughlin.

"I don't think the new law is as big a deal as people think it is," Duncan said. "The legal profession will help families figure out how to create and insure privacy and confidentiality."

"The legislation will not affect asset allocation, cash management, philanthropy, next generation education, or many of the other areas of family wealth frequently within the role of the family office," noted Charles Lowenhaupt, chairman and chief executive of St Louis-based Lowenhaupt Global Advisors.

But, Lowenhaupt added, "No private wealth holder should assume that with this legislation the world is a safer place."

Fiduciary matters

Congress has given the Securities and Exchange Commission the authority to establish a fiduciary duty for brokers and dealers and modify the fiduciary standard for investment advisors.

But what the SEC will actually do at the end of its six month review period and how it will affect wealth managers and family offices is still uncertain.

"We have clearly advocated for the SEC to require anyone calling themselves an investment advisor to be subject to the Fiduciary Standard as defined in the Investment Advisers Act of 1940 and are supportive of the great work being done by The Committee for the Fiduciary Standard," said Mel Lagomasino, chief executive of GenSpring Family Offices.

"Frankly, we think it is confusing for investors when different 'advisors' are subject to totally different standards and play very different roles; it makes it difficult for an investor to know who they are actually dealing with."

But one of the industry's most prominent senior executives took a contrarian point of view.

In an opinion piece first published on Thursday by Reuters, Tim Kochis, chairman and former chief executive of Aspiriant, wrote: "I strongly believe that imposing a strict fiduciary standard on every firm and individual, in all circumstances, would be a big mistake.

"It is important to distinguish sales efforts, the execution of transactions and the brokering of trades from the giving of advice," Kochis went on.

"Imposing a fiduciary duty (putting the client's interest first) is unrealistic in the sales environment or when brokering an investment between two customers, one a buyer and one a seller. Where both parties are clients, which client's interest must the financial institution put first?"

According to Kochis, “legislating a new regime where all financial services are fiduciary would be impossible to put into practice."

A “better solution,” he argues, “would be to require firms and individuals to affirmatively declare, with clear acknowledgement by the consumer, when they are acting not in a fiduciary role. Absent that, their activities would default to a presumption of fiduciary conduct. When appropriate, consumers would then be put on notice to be wary.”

Accordingly, some firms would need to install separate personnel, compensation systems, and even separate facilities “to avoid any misunderstanding about whether a fiduciary duty applies or not.”

Imperfect Solution

Handing off the decision to the SEC in the first place was “a complete abdication by Congress to set down a common standard,” maintained wealth management and family office expert Jamie McLaughlin.

"They had their opportunity and by doing what they did we will have an imperfect solution,” McLaughlin said.

In fact, he predicted that the broker-dealers and insurance companies would “outlobby” the advisor community and ultimately “prevail” when the SEC made its final decision.

Leslie Voth, president chief operating officer of Pitcairn, the Jenkintown, Pa.-based multifamily office, was slightly more optimistic.

“It remains to be seen what the SEC will do in imposing a fiduciary standard on the broker-dealer community,” Voth said. “We can only hope it is both enforceable and clear.”

Family offices are likely to now come under a new federal fiduciary standard, said John Duncan, principal for Chicago-based law firm Duncan Associates.

Noting what he described as the SEC’s “historically rigid approach of narrowly defined and restrictive rules governing the institutions it supervises,” Duncan pointed out that a new SEC fiduciary standard is likely to influence state legislatures and judges who are defining fiduciary duties in other contexts, such as those of trustees.

“If that happens, substantial recent progress in obtaining greater flexibility for trustees, such as allowing conflicts of interest as long as they are disclosed and the results are not unfair, may be rolled back to some degree,” he said.

More Financial Planning Seen

Another potential consequence of a fiduciary standard is that advisors may be required to perform a financial plan in order to make optimal solution

recommendations, said Sophie Schmitt, senior analyst for Aite Group, the Boston-based research firm.

“Financial planning yields a document that proves that advisors have analyzed a client’s needs, goals and financial situation,” Schmitt said. “This document could also list the products that clients and advisors ultimately agree to implement. This type of audit trail would be an effective way to ensure that advisors are offering products based on an in-depth understanding of their clients’ needs.”

The challenge with designing a fiduciary standard, she said, “will be in deploying one that the majority of advisors today can follow based on their skill-level and product knowledge, while still realizing a real improvement in the investment recommendations and advice they provide to clients.”