The Family Office in the Dodd-Frank Regulatory Environment: New Risks & Requirements

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April 15 comes around annually. But in 2012, some wealthy families may have missed another important deadline. On March 31, new rules regarding single-family offices took effect. For the first time, many single-family offices became subject to federal regulation as investment advisors as a result of the Dodd-Frank financial reform legislation, which became law in July 2010.

The Private Fund Investment Advisers Registration Act, part of Dodd-Frank, increased reporting requirements for private advisors. The act required the Securities and Exchange Commission to issue a new and more definitive description of a "family office" that would be exempt from registration as an investment advisor. That definition was issued in June 2011 to become effective March 31, 2012.

Unfortunately, many family offices have been unaware of the new law's impact on them, and don't know whether they are subject to its requirements. They may have been lulled into a false sense of security because they have always stayed under the regulatory radar screen in the past. But the Dodd Frank Act, a sweeping overhaul of Wall Street regulation that aimed to reduce the chance of another financial meltdown like the one in 2008, threw out this exemption for private investors, including family offices and hedge funds. Under the new law, family offices are subject to regulation unless they qualify for the new exclusion.

Protecting Privacy

A family office is a private entity set up to serve the personal and financial needs of one wealthy person or family. The Astor family had a family office in the 1830s. John D. Rockefeller set one up in 1882 to manage his family's wealth. Many other wealthy families followed suit. There are about 3,000 family offices in North America managing an estimated $1.2 trillion, according to estimates by the Family Wealth Alliance LLC, a research and consulting firm in Wheaton, Ill. that studies the industry.

The chief attractions of the family office structure are privacy and control, which led Oprah Winfrey to set up a family office in 2010. Fewer family offices have been created in recent years because of the increasing costs. Instead, many families today have moved to join together in a multi-family office. A multi-family office is viewed as a commercial company, always subject to the registration requirement.

In addition to managing the family's wealth, a modern family office typically performs administrative duties for the family such as taxes and estate planning and provides other services like hiring staff, managing properties and concierge duties. A family office also helps provide cohesion for a family, especially as time goes by and later generations don't recall the founder or sometimes even the original family business. For example, the Laird Norton family in Seattle started in the timber and building supply businesses. Since it sold those holdings in 2006, the family is sticking together. It holds annual four-day summits attended by most of the 385 living members. Laird Norton also educates children about family values and helps each get training and experience to develop the life and career he wants.

The Securities and Exchange Commission has long recognized the unique nature of a family office, which does not hold itself out as a commercial advisor but instead manages only the affairs of one family. So, when the Investment Advisers Act of 1940 required that advisors who manage money for third parties register with the SEC, family offices were generally excluded. The Private Advisor Exemption in the Act gave advisors with fewer than 15 clients an exemption. In practice, even those family offices with more than 15 households were generally left alone by the SEC. But in 2010, the Dodd-Frank act specifically removed the 15-client exemption for private investors, partly because the exemption provided a way for hedge funds to avoid registration.

"The primary goal of Congress [in Dodd-Frank] was to regulate hedge funds," said David Guin, a partner at law firm Withers Bergman in New York who specializes in securities law. Congress offered a safe harbor so

that families could avoid the expense and transparency of registering. It charged the SEC with writing a new definition for a family office that would be excluded from registering, separating those offices that serve a "typical family" from those that start to resemble a commercial advisor.

Good News, Bad News

The good news was that Dodd-Frank provided a way for single-family offices to avoid registering as investment advisors with the SEC. The bad news: some single-family offices did not qualify for the exemption. Unless they made changes in order to qualify, they were required to register by March 31 and become regulated by the SEC.

The SEC issued its final definition of a family office in June 2011. The new exclusion is narrowly drawn. Qualifying single-family offices must serve only family clients who are direct relations. In-laws don't qualify, nor do business partners or other outsiders. However, certain key employees may qualify as family clients. Only family clients and key employees can have ownership stakes in the family office, but key employees may not control the family office, and the family office cannot manage investments for any outsiders. Foundations and charities that have received funding from non-family members must spend that outside money if the family office is to continue handling the foundation's investments.

The SEC's task was to provide a definition of the family office that could not be used by hedge funds. In the final rule, the SEC said: "The definition of family office provided in the rule is designed to limit the exclusion from Advisers Act regulation solely to those private advisory offices that we believe the Advisers Act was not designed to regulate and to prevent circumvention of the Adviser Act's protections by firms that are operating as commercial investment advisory firms."

Downside of Registration

The chief downside of having to register is the loss of privacy for the families involved. Assets are disclosed online on Form ADV, along with ownership structure and key data. The Part II of Form ADV, also available online recently for the first time ever, contains even more information about key personnel, fees, investment strategies, conflicts of interest and the educational and business background of management and key advisory personnel.

There are other disadvantages as well, including substantial costs to set up books, records and procedures in the way that the SEC requires. Also substantial are ongoing compliance and recordkeeping costs. Registered advisors are subject to SEC examinations, with SEC personnel able to sift through all their financial information and records.

In its ruling the SEC cites an estimate of $25,000 to $35,000 for a family office to hire a consulting firm or law firm to determine if it meets the definition of a family office. If it does not, the consultant may be able to advise the family on how to restructure to meet the requirements. The options include saying goodbye to nonfamily clients, outside investors and nonfamily owners or outsourcing investment activities.

Defining the Family

There's another option as well. A family office could write to the SEC asking for an individual exemption. "The SEC has a long history of exempting family offices even though they did not meet the requirement," Guin said. Going back to the 1940s, a family office might write to the SEC and say: I have more than 15 clients but I don't think a family office is the type of thing the SEC should regulate. Thirteen family offices have obtained individual exemptive orders, according to the SEC. The SEC has not acted on a request for three and a half years, Guin said, perhaps waiting for the registration issue to be clarified. The SEC said if a family office previously got an exemption, it can continue to rely on it.

Even a family office that qualifies for the new exclusion will be under increased scrutiny, says Thomas J. Handler, who specializes in family office clients at the law firm of Handler Thayer, L.L.P in Chicago, thanks to the recent focus on "rich" Americans. The Internal Revenue Service has assembled a "wealth squad" to focus on individuals with $10-$30 Million in minimum net worth and incomes over $1 million. In 2011, the IRS audited 12.5 percent of individuals in that group, compared to 8.4 percent in 2010, Handler said. Last year the SEC did more audits of RIAs than they normally do. "They will audit more RIAs this year than last year," he said.

Handler's firm got three new multi-billion dollar clients in the past year, largely because of this law.

And the problem is even greater than it seems at first glance, Handler says. The definition of the family office that allows for the exclusion is only one issue, he said. Family offices have been noncompliant with federal and state securities laws in several areas. "The message is given that we now have specificity in this law," he said. The broad law in the past was not enforced. Now the very specific law signals more rigorous enforcement, Handler said.

Ongoing Compliance

Once a family office has determined that it meets the exclusion, it must keep records of all the information required to qualify. If the SEC shows up at the door, the family office must be able to prove that all clients are family clients and that all owners are family owners. At a minimum this requires birth certificates for all clients, trust beneficiaries and foundation donors and the family tree with birth certificates for dead ancestors.

The family office will also need a list of key employees who qualify for inclusion in the family office and a list of key employees involved with investments. The office also needs a compliance program, a chief compliance officer, an ethics policy and a risk assessment. It should also have a compliance statement from an attorney. Every year, this statement should be reviewed and updated.

Restructuring

If a family office does not meet the new definition, experts say that most families will reorganize in order to do so. "Very, very few families will actually register," Guin said. This change in regulation can serve as an opportunity to clean up the family records and make certain that the office is in compliance with all federal and state securities laws.

It is a good idea to review the family office's liability insurance policies as well. Ronald Fiamma, director of private collections at Chartis private client group, an insurance carrier, sees an increased insurance risk for family offices due to the new regulations. In the past, those who ran family offices were unlikely to buy liability coverage to protect themselves from lawsuits by family members. "They figured they would work things out and they wouldn't expect a family member to sue them," Fiamma said.

Perhaps that was never true but it certainly isn't true now, he said. "The regulatory environment has changed drastically and there is demand for more transparency." Suppose someone decided to put the family office assets with Bernie Madoff? "If a family member is set to inherit $10 million at age 21 and the family office manager improperly manages the account, he can lose his fortune," Fiamma said. Maria Treglia, a professional liability specialist for Program Brokerage Corporation, agrees. In the past, family offices believed liability insurance for directors and officers was a waste of money, she says. "Dodd-Frank has lifted the veil of privacy." She's also seen more interest in privacy insurance.

Do Something!

Doing nothing about these new developments is not an option. Some family offices have decided not to

Family Office Exclusion

To qualify for the newly defined family office exclusion, a family office must have:

Only family clients. The family members must be in linear descent from a specific family member, living or dead, no more than ten generations from the youngest generation. The family includes adopted children, current and former stepchildren, foster children, children in legal guardianship relationships and current and former spouses (or spousal equivalents).

Certain current (and in some cases former) key family office employees, defined as an officer, director, trustee or general partner can also meet the definition of family clients.

Foundations and other charities funded exclusively by family clients, estates of family members or key employees, certain trusts, and entities owned solely by the family. Collective investment vehicles used by family offices such as investment partnerships often have outside (nonfamily) investors. In that case, you can hire someone else to manage the partnership or buy out nonfamily partners.

Grandfathering: Those who are officers, directors or employees of the family office who invested with the family office before Jan. 1, 2010, as well as a registered investment adviser who provides investment advice to family and invests in transactions on the same terms as the family office need not register if he performed those duties before Jan. 1, 2010.

Family owners. Must be wholly owned by family clients and exclusively controlled by family or family entities.

No holding out to the public as an investment advisor.

register, attorneys say. "How are they ever going to find out?" some ask. Easy. A disgruntled family member or an employee or former employee. "We try not to be fear mongers," Guin said. "But you should be prepared." And untangling the family finances from those of non-family members and contributors to family foundations and charities, might prove a sticky job.

Nonqualified clients should be informed that the family office can no longer handle their investments. Suppose the family office manages money for a brother-in-law of one of the members. "You may have to heartlessly kick the brother-in-law out," Guin said. Or you can tell him that the family office can no longer manage his money and that you will recommend someone else. Another option is to set up a separate RIA for non-qualified clients.

Suppose the brother-in-law refuses to leave? The family office may have to negotiate with him to arrive at an acceptable buyout price. The other option is to liquidate the investment, which might mean selling at an unfavorable time and family members could suffer financially. It also raises fiduciary issues. "The problem with needing to come into compliance is that it may be difficult to do this very quickly," Guin said.

If the family office has a charity or foundation with outside contributors, the SEC is giving them until Dec. 31, 2013 to spend the outsiders' contributions. Those who don't qualify for only this reason – family foundation with outside money – can qualify by spending that outside money, Handler said.

Upside of Registering

Every family office should have a legal advisor reviewing its structure to make sure it qualifies for the exclusion. The SEC may disagree and order the family office to register but without penalties.

Some large family offices serving multiple generations may be amenable to registering. Okabena, the family office of the Dayton family in Minneapolis, decided to register with the SEC in 1994. The office, incorporated in 1967, now serves the third to sixth generations of the Dayton family. In 1994, Okabena already exceeded the 15-client rule, according to Christine Galloway, CEO. Registering with the SEC was the first task handed to Galloway when she joined the company.

Understanding the requirements was the biggest problem, she said. But today the prospect of registering for the first time is more onerous because, beginning in 2004, the SEC required compliance officers to do much more in regulation. The person who originally took care of compliance for Okabena spent about five percent of her time on that. Now compliance takes 50 to 60 percent of that employee's time. But Galloway isn't sorry her firm registered. "We adopted the SEC as an infant," she said. "Those registering today have to adopt it as an adolescent or young adult." Many family offices are trying to avoid registering in any way possible, "but we believe being regulated by the SEC has made us a better structured, more professional organization."

Options for Family Offices

1. Take advantage of the family office exclusion if eligible and operate on an unregulated basis.

2. Restructure to qualify for the exemption by saying goodbye to any nonfamily clients, outside investors, or nonfamily owners.

3. Stop managing money and outsource family office investment activities to an external chief investment officer.

4. Seek an individual exemption from the SEC based on the family office's particular circumstances. Estimated cost for legal fees: $200,000 or more.

5. Establish a private trust company, typically regulated by state banking departments and providing effective privacy, to manage the family's affairs. Estimated cost: several hundred thousand to several million dollars.

6. Outsource all family office activities, including investments, typically through an arrangement with a commercial multifamily office.

HUB International thanks the following resources for their contribution to this white paper.

Ronald Fiamma
Vice President/Director, Private Collections
Chartis Private Client Group
New York City, NY
Ron.fiamma@chartisinsurance.com

Christine Galloway
President & CEO
Okabena Company
Minneapolis, MN
http://bit.ly/NMUBXw

David Guin, J.D.
Partner
Withers Bergman
New York, NY
David.Guin@withers.us.com
http://www.withersworldwide.com/people/david-guin

Thomas J. Handler, J.D, P.C.
Partner
Chairman, Advanced Planning & Family Office Practice Group
Handler Thayer, LLP
Chicago, IL
thandler@handlerthayer.com
http://www.handlerthayer.com/handler_bio.html

Matthew Tobin
Managing Director
South Dakota Trust Company, LLC
matt@sdtrustco.com
http://bit.ly/Lsrwf1

Maria Treglia
Senior Vice President, Professional Liability
Program Brokerage Corporation
New York, NY
MTreglia@programbrokerage.com
http://www.pbctreglia.com/

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