Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1839
Date: August 01, 2011
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Jim Weller: SEC Adopts a Final Rule Defining a Family Office**

"With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act on July 21, 2010, many family offices may be faced with the possibility of regulation by the Securities and Exchange Commission. A family office that will not qualify for the family office exclusion under the final rule has a couple of options.

First, the family office can seek an exemptive order from the SEC or restructure the family office to fit within the final rule. Second, private trust companies, also known as family trust companies or exempt trust companies, are becoming an attractive vehicle for addressing the multi-faceted trust and wealth management needs of wealthy families.

*Accordingly, some families may consider establishing a state chartered or licensed private trust company to handle investment management functions, and thereby avoid the new federal registration requirements for the family office.**[i]** In essence, such a decision would involve a trade-off of federal regulation for state regulation."*

Now, **Jim Weller** provides **LISI** members with an update on important developments impacting family offices.

James P. Weller, JD, LLM is President of **Greenway Capital Advisors, LLC**, a provider of trust administrative services to private trust companies and family trustees, in Houston, Texas and Las Vegas, Nevada. Jim has served as Senior Vice President and Trust Manager of Citibank in Phoenix, Arizona, Senior Vice President and Head of Trust and Investment Management at Bank of America in Phoenix, Arizona, and Senior Vice President and Director of Wealth Advisory Services at Bank of Oklahoma in Tulsa, Oklahoma.

Jim has written numerous estate and tax planning articles. His book titled Tax-Smart Wealth Planning was published in 2006, and you can learn more about it at www.graduategroup.com.

Before we get to Jim's commentary, members should take note of the fact that six new podcasts were recently posted to the **LISI** homepage. The fourth podcast that we would like to bring to the attention of members is by **Bob Keebler** and is focused on the Paschall case. In this podcast, Bob discusses the importance of the Paschall descision.

Now, here is Jim Weller's commentary:

EXECUTIVE SUMMARY:

Family offices are established to provide a variety of services that are customized to meet the administrative, financial, and wealth management needs of current and future generations of wealthy families. These services typically include investment management services that would be highly regulated if offered to the general public. Historically, however, most family offices have operated in an environment relatively free of regulation of investment functions due to the private adviser exemption under the Investment Adviser Act of 1940. With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act on July 21, 2010, many family offices may be faced with the possibility of regulation by the Securities and Exchange Commission.

FACTS:

Under the Dodd-Frank Act, the private adviser exemption will be repealed on July 21, 2011.[ii] The repeal of the private adviser exemption targets investment advisers to private funds such as hedge funds.[iii] Recognizing that the repeal may impact many family offices, Congress amended the Investment Advisers Act of 1940 to create an exclusion specifically for a family office. [iv] For purposes of the exclusion, Congress delegated the task of defining a family office to the SEC. Congress instructed the SEC to adopt a definition consistent with its previous exemptive orders, and one that also recognizes the range of organizational, management, and employment structures and arrangements employed by family offices.

Much uncertainty has surrounded how the SEC will define a family office. On October 12, 2010, the SEC issued Proposed Rule 202(a)(11)(G)-1, which provides a definition of a family office.[v] Comments to the proposed rule were invited. The proposed rule generated a high level of interest and concern as evidenced by the ninety-four (94) comments submitted. After giving due consideration to the submitted comments, the SEC on June 22, 2011 adopted and released a final rule that provides definitive guidance for determining if a family office will continue to be exempt from registration.[vi]

COMMENT:

Definition of a Family Office

The final rule defines a family office as a company that only has family clients, is wholly owned by family clients and is exclusively controlled, directly or indirectly, by one or more family members and/or family entities, and does not hold itself out to the public as an investment adviser.[vii] The major change from the proposed rule is that the final rule replaces the requirement that the family office be wholly owned by family members with the requirement that it be wholly owned by family clients. Family clients, as discussed below, will permit in certain instances non-family members to hold ownership interests in a family office. Control is defined as the power to exercise a controlling influence over the management or policies of a family office other than a power that results strictly from being an officer of the family office.[viii] By adding the word "exclusively" to the control component of the "wholly owned and controlled" requirement, the final rule prohibits the sharing of control with individuals and companies that are not family members or entities.

Definition of Family Clients

Under the final rule, family clients include:

1) any family member;

2) any former family member;

3) any key employee;

4) any former key employee provided the investment advice he or she is receiving from the family office is limited to those assets under the investment advice of the family office at the time of the termination of employment and any additional investments that the former employee was contractually obligated to make prior to the termination of employment;

5) any non-profit organization, charitable foundation, charitable trust, including charitable lead trusts and charitable remainder trusts, whose only current beneficiaries are other family clients and charitable or non profit organizations, or other charitable organization, in which the funding held in such organization, foundation, or trust came exclusively from one or more other family clients;

6) any estate of a family member, former family member, key employee, and subject to the limitation on investment advice in (4) above, a former key employee;

7) any irrevocable trust in which one or more other family clients are the only current beneficiaries;

8) any irrevocable trust funded exclusively by one or more other family clients in which other family clients and non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations are the only current beneficiaries;

9) any revocable trust of which one or more other family clients are the sole grantor;

10) any trust in which a key employee is the only person with investment authority, and each settlor or other person who has contributed assets to the trust is a key employee or the key employee's current and/or

former spouse or spousal equivalent, who at the time of contribution holds a joint, community property, or other similar shared ownership interest with the key employee; or

11) any company wholly owned, directly or indirectly, exclusively by and operated for the sole benefit of, one or more other family clients, provided that if such entity is a pooled investment vehicle, it is excepted from the definition of an investment company under the Investment Company Act of 1940.[ix]

A couple of observations should be made regarding family clients. First, the final rule's expansion of the types of irrevocable trusts that qualify as family clients, other than trusts created by a key employee, focuses on who the current beneficiaries are, and it disregards contingent beneficiaries. Second, in recognition of the nature of a revocable trust, it is irrelevant who the current beneficiaries are as long as one or more family clients are the sole grantor. However, once a revocable trust becomes irrevocable, it will have to meet the requirements for irrevocable trusts in order to remain a family client.

Definition of Family Members

Family members are all lineal descendants, including by adoption and stepchildren, of a common ancestor, and such lineal descendants' spouses or spousal equivalents, provided that the common ancestor is no more than ten (10) generations removed from the youngest generation of family members.[x] The final rule adds foster children and an individual who was a minor when another family member became his or her legal guardian to the list of family members.[xi]

Most notably, the final rule replaces the proposed rule's concept of the founder of the family office as the yardstick for determining family members with the more flexible concept of a common ancestor.[xii] A family office can choose a common ancestor, who may be living or dead. In addition to designating a common ancestor, the final rule gives a family office the ability to redesignate a common ancestor to reflect the reality of a family as it evolves and changes over time.[xiii] The common ancestor approach is more in line with the designated relative approach that some states with private trust company laws use to determine the family members of a single family.

The flexibility afforded by the ability to redesignate a common ancestor is evidenced by the following example in the final rule:

> G1, who is deceased, founded a business and placed his fortune into a trust for the benefit of his heirs G4 founded a family office to manage that wealth for the ever growing number of family members descended from G1, and G1 was treated as the common ancestor for purposes of which family members the family office could advise under the exclusion. At the time G4 created the family office, current clients extended as far as G4's great-grandchildren (or G7). Over time the family grows and additional generations are born. Eventually, to allow the family office to serve later generations that would otherwise extend beyond the 10 generation limit, the family office redesignates its common ancestor to an individual in G3.[xiv]

Ownership of a Family Office

Besides adding "exclusively" to the control component of the "wholly owned and controlled requirement", two major aspects of the ownership component under the proposed rule were clarified by the final rule. First, as mentioned above, the Dodd-Frank Act instructed the SEC to adopt a definition of a family office that is consistent with its previous exemptive orders, and one that also recognizes the range of organizational, management, and employment structures and arrangements employed by family offices. The proposed rule fell short of the instruction from Congress by providing little guidance on whether or not ownership structures frequently used by wealthy families such as family trusts and family owned holding companies meet the "wholly owned requirement." As pointed out above, the final rule requires that a family office be owned by family clients rather than family members, and it expands the definition of the family clients to include a variety of trusts and wholly owned family companies. Second, the proposed rule failed to recognize that providing an ownership interest in a family office as part of a compensation package may be an effective way to attract and retain professionals outside of the family. The final rule permits key employees to own a non-controlling stake in the family office.[xv]

Involuntary Transfers to Non-Family Clients

It is always possible that assets being advised by a family office can involuntarily end up in the hands of a non family client through an event such as divorce. In the case of an involuntary transfer to non-family clients, a family office can no longer provide investment advice without forfeiting the exclusion from registration. The final rule has extended the grace period under the proposed rule for a family office to continue to provide investment advice to non-family clients before having to transition the assets to another investment adviser from four (4) months to one (1) year.[xvi]

Key Employees

Under the final rule, a key employee is any natural person who is an executive officer, director, trustee, general partner, or person serving in a similar capacity of the family office or its affiliated offices, or any employee of the family office or its affiliated offices who as part of his or her regular duties participates in the investment activities of the family office or its affiliates, and has been performing such duties on behalf of the family office or its affiliates, or substantially similar function on behalf of another company for at least twelve (12) months.[xvii] A key employee also includes a key employee's spouse or spousal equivalent who shares a joint, community, or other ownership interest with the key employee.[xviii] Although the proposed rule included an executive officer in the definition of a key employee, it failed to provide a definition of an executive officer. The final rule defines an executive officer as the president, any vice president in charge of a principal business unit, division, or function, and any other officer or person who performs similar policy making functions.[xix]

Two other aspects of the final rule regarding key employees merit comment. First, the requirement that a key employee retain investment control over assets in a trust he or she has created in order for a family office to provide investment advice to the trust may cause estate tax concerns. However, there are no provisions in Internal Revenue Code §2036, §2037, and §2038 that would pull trust assets back into the grantor's gross estate at death because of the retention of the right to control the investment management of the trust. Second, in addition to receiving direct investment advice from a family office, a key employee may receive indirect advice such as through a family office advised private fund.[xx]

Non-Profit Charitable Organizations

As mentioned earlier, the final rule treats certain charitable organizations, trusts, and non-profit organizations as family clients. Recognizing that some charitable organizations and non-profit organizations may have accepted funding from non-family members, the final rule provides a grace period for preserving the family office exclusion. Under the grace period, a family office has until December 31, 2013 to transition non-family client funds to another investment adviser.[xxi] To rely on the grace period, a non-profit or charitable organization may not accept any additional funding from non-family clients after August 31, 2011, except for funding that fulfills any pledge prior to August 31, 2011.[xxii]

Multi-Family Offices

Under the proposed rule, the family office exclusion would only be available to single family offices. The final rule retains the proposed rule, and as a result, no multi-family office is eligible for the family office exclusion.[xxiii] For purposes of the exclusion, it is unfortunate that the final rule does not draw a distinction between multi-family offices that have non-family clients and are operating as a commercial business, and families with common goals and interests that have formed a family office to pool resources and assets for the sole purpose of providing services to the owners' family members. The latter should arguably be eligible for the family office exclusion.

Conclusion

The final rule becomes effective sixty (60) days after publication in the Federal Register.[xxiv] For a family office operating under existing exemptive orders, the SEC has indicated that it does not intend to rescind those orders even if their scope is broader than the final rule.[xxv] A family office that will not qualify for the family office exclusion under the final rule has a couple of options.

First, the family office can seek an exemptive order from the SEC or restructure the family office to fit within the final rule.[xxvi] Second, private trust companies, also known as family trust companies or exempt trust companies, are becoming an attractive vehicle for addressing the multi-faceted trust and wealth management needs of wealthy families.

To that end, a private trust company is an entity authorized under state law to provide trust and fiduciary services to a single family, and it is prohibited from soliciting business from the general public. A chartered or licensed private trust company is supervised by the state in which it is located, and due to this supervision, it falls outside of the definition of an investment adviser under the Investment Advisers Act.[xxvii]

Accordingly, some families may consider establishing a state chartered or licensed private trust company to handle investment management functions, and thereby avoid the new federal registration requirements for the family office.[xxviii] In essence, such a decision would involve a trade-off of federal regulation for state regulation.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Jim Weller

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H.R. 4173 § 403, 111th Cong. (2010) (Enacted); S. Rep. No. 111-176, at 38-39 (2010) (Conf. Rep.); H.R. 4173 §409(a), 111th Cong. (2010) (Enacted); SEC Release No. IA-3098; File No. S7-25-10 (Oct. 12, 2010); SEC Release No. IA-3220; File No. S7-25-10 (June 22, 2011).

CITATIONS:

[i]
Rashad Wareh, *Financial Reform Knocks on the Family Office Door*, Trusts & Estates, August 2010 at 48.
[ii]
H.R. 4173 § 403, 111th Cong. (2010) (Enacted).
[iii]
S. Rep. No. 111-176, at 38-39 (2010) (Conf. Rep.).
[iv]
H.R. 4173 §409(a), 111th Cong. (2010) (Enacted).
[v]
SEC Release No. IA-3098; File No. S7-25-10 (Oct. 12, 2010).
[vi]
SEC Release No. IA-3220; File No. S7-25-10 (June 22, 2011).
[vii]
Id at 45-46.
[viii]
Id at 47.
[ix]
Id at 47-49.
[x]
Id. at 49.
[xi]
Id. at 11.
[xii]
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[xiii]
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[xiv]
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[xvi]
Id. at 14.
[xvii]
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Id at 47.
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[xxi]
Id at 18.
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[xxiii]
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[xxiv]
Id at 1.
[xxv]
Id at 36.
[xxvi]
Id at 40.
[xxvii]
15 U.S.C. §80b-2(a)(11)(A) and §80B-2(a)(2)(C) (2010).
[xxviii]
Rashad Wareh, *Financial Reform Knocks on the Family Office Door*, Trusts & Estates, August 2010 at 48.