



Limiting Freedom From Wealth:
The Impact of New SEC Rules on Families and
Single-Family Offices in the United States

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Overview

Providing family members with freedom to live their lives and to self-actualize without feeling the burdens of wealth is the most important benefit that a single-family office can deliver. Yet, under rules adopted by the Securities and Exchange Commission (SEC) in June 2011, many single-family offices will no longer be able to offer that promise to clients. In fact, the rules issued under the Dodd-Frank Wall Street Reform and Consumer Protection Act pose the most significant institutional challenges in history to U.S. families of wealth and family offices. The provisions threaten the privacy of the family's wealth and, with that, the ability of every family member to achieve freedom from wealth¹ and live life on their own terms.

Equally as important, the rules represent an unprecedented governmental intrusion into the single-family office industry. Based on our experience with families of significant wealth over more than one hundred years, we believe families will have great difficulty complying with the new rules. Every U.S. single-family office must now choose between registration with the SEC and reorganization in ways that change how the family office has operated and the benefits the office can offer to family members. Neither registration nor technical modifications to operating procedures and documents will solve the issues fundamental to the family's well-being: privacy and independence.

This white paper provides a high-level overview of the practical implications of the legislation and rules. It focuses on the significant new restrictions governing how family offices can deliver any investment-related advice—a core function of any family office—confidentially and free from governmental interference. It observes that in effect, the legislation and rules will require registration by any family office serving those functions needed by individual family members. Finally, this paper will outline some of the options available to families who now have a single-family office or are now considering the creation of a single-family office.

¹Charles Lowenhaupt and Don Trone are co-authors of the book, *Freedom From Wealth*, which will be published by McGraw-Hill in Fall 2011.

Situation Analysis

On June 22, 2011 the SEC adopted a new rule, 202(a)(11)(G)-1, under the Dodd-Frank Wall Street Reform and Consumer Protection Act. That act repealed the so-called “Private Adviser Exemption” of the US Investment Advisers Act of 1940, but said that any “family office” would be exempt if it is a “family office” as defined by the Securities and Exchange Commission. The rule as adopted sets out the SEC’s definition of “family office” for purposes of the Dodd-Frank Act. In effect, if a family office qualifies as a “family office” under the rule, it has no obligation to register with the SEC. But if it does not qualify, it must register with the SEC and becomes regulated by the SEC. That poses a significant challenge for a family office: Whether and how to design itself to qualify as a “family office” under the rule.

SEC registration and regulation is generally seen as undesirable by family offices. That is because of the administrative burden that accompanies SEC regulation and because of the public nature of SEC filings. Registration with the SEC makes public a number of aspects of a family’s wealth portfolio. That disclosure carries the threat of publicizing a family’s wealth (either larger or smaller than generally believed). As a result of the new rule, family offices are being urged by their advisors and professionals to reconsider their structure and to consider appropriate modifications to avoid registration and regulation.

No matter how carefully the rule is read and no matter how many technical modifications are made, the new rule effectively makes it unlikely that a single-family office in the U.S. can be well run and avoid registration with the SEC.

The new rule goes to the heart of the operation of the traditional single-family office. Unless those using the family office are limited to certain categories, the single-family office offering investment advice will be required to register with the SEC. The categories of those using the office are generally limited to family members and key employees of the family office, certain trusts benefitting family members, and charities or foundations exclusively funded by family members.

The Challenge Facing Family Offices—and Families

Almost all single-family offices will be required to determine whether they need to register. The reason is that almost all single-family offices see giving investment advice as one of their primary purposes. For many family offices, investment advice is the *only* function; for most others it is a core function.

Confidentiality and secrecy are also central objectives of most single-family offices. The classic family office manages a family's wealth in a discreet environment in private and without interference. Increasingly, families want their financial affairs managed under the radar, secure from gossip, press and the threats of extortion and other crimes.

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A well-run family office navigates the shoals of family dynamics, offering every member of the family an opportunity to lead life as he or she wants. Achieving freedom from wealth requires that each family member feel independent and capable of self-actualization. The family office must be objective in its advice, unconflicted in its approach, and operate with the highest standards of professionalism. To deliver this level of advice, a family office should align the family's interests and the interests of the office and its employees.

In fact, the rules effectively make it impossible for a family office to serve its core functions, which include delivering investment advice, maintaining confidentiality, and following practices that ensure objectivity and alignment with the family's interest. Under the new rules, a traditional single-family office simply cannot offer family members freedom from wealth and independence and the opportunity to self-actualize—without the significant drawback of submitting to SEC registration and public scrutiny.

“The new rules and restrictions seem to have little foundation in common sense,” said Michael Hutchinson, Principal at the Hutchinson Consultancy and former *homme d'affaires* of the Guinness family. “They destroy the very foundation and the *raison d'être* for most single family offices. They in effect pull the rug away from the smaller SFO. Such structures will no longer be able to fulfill the roles that the patriarch/matriarch/family originally wished for them.”

The Implications for Freedom from Wealth

Under the new rules, any gift made by any family member must be removed from the asset base of the family office or the office is disqualified. It does not matter whether the gift is outright or in trust and whether it is for a loyal retainer, a dear friend, a distant relative, or an entity that doesn't qualify. Consider the gift of Huguette Clark recently reported in *The New York Times*: She gave more than \$400 million to a nurse and a museum. If she had a family office, if there had been other members of the family, the gift outright or in trust would remove substantial assets from the family office or require registration with the SEC. That is a significant departure from the rules and assumptions that have existed for decades.

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The new rule also will considerably limit the kind of trust which can be written and managed by the family office if it will benefit a non-family member, whether a devoted nurse, a former mistress, an influential teacher or a friend. In effect, the office and the family itself are given high stakes in how a family member gives or devises his or her estate. The rule forces the office and its staff into a critical investment in the disposition of assets by a member of the family. Objectivity is impossible here. A conflict of interest is potentially created between the staff and the family's well-being. Moreover, the seeds of family discord are nurtured. Because one family member can effectively destroy the family office, the new rules open the door to the tyranny of an individual family member.

Under the new rules, a family member must limit those to or for whom a gift is made. And any advice given by the family office will necessarily recommend against any such gift that threatens the operation of the office. That conflict could very well curtail a family member's freedom. The objectivity and alignment of the office are, at best, challenged.

The new rules also constrain a family member who wants to play a leadership role in the community through public or charitable board engagement or trusteeship. Traditionally, that person would turn to the family office for support and advice. He or she might ask the investment experts in the office for informal or even formal recommendations. This is now dangerous, and it may possibly subject the office to SEC registration and regulation. Deprived of the advice of the trusted advisors in the family office, many people will be unwilling to enter the fiduciary arena. In many cases, this will limit the family member's options and the individual's opportunity for self-actualization.

At the same time, similar limitations may now be imposed on a family's strategic investing and philanthropy. If a family or family member wants to fund a new charitable organization or business, the family may offer a contribution fully expecting to engage others over time. But under the rule, if the strategy is effective and another person not a family member contributes or invests,

any investment advice offered by the family office must cease. Strategic partners, as well as capital partners in the organization or business will change the operating assumptions immediately. Even a “family-owned business” will be prohibited from relying on the office for advice if the business has any non-family shareholders.

The new rule also governs involuntary transfers. If a transfer is made by a family member to a non-family member, the qualification as a “family office” will cease. Now the business affairs of a family member must be closely monitored to ensure that a family entity will not end up in the hands of a non-family member. That’s important not only because of potential for the “outside eyes” of the non-family member, but also because of the likelihood that registration will be required of the *entire* family office.

The implications are again significant. If a family member has an interest in a family investment entity, a creditor of the family member taking possession of the entity will destroy the exemption from regulation unless the creditor’s interest can be bought in quickly. The creditor can hold the entire family hostage, demand substantial payment for its interest if only to keep the office from falling out of qualification. To avoid this possibility, business affairs of all family members must be carefully monitored by the single-family office. Terms of any family investment vehicle must be very restrictive. The office and its staff effectively have a stake in every debt of every family member. The family office must monitor and limit the business affairs of all family members.

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—Michael Hutchinson, Principal at the Hutchinson Consultancy

So any family office trying to maintain confidentiality and give investment advice must carefully limit the rights of family members to make gifts, to engage in leadership roles, and to enter business transactions freely. Where is the freedom to live life in that construct? And what happens to alignment of the interests of employees and family members? Although an employee of the family can be a customer of the family office under certain circumstances, the employee will have no capacity to leave an interest to his or her own family. At best, the employee is forced to think in terms of his own lifetime, while taking care of a family whose perspective is over many generations.

The entire family office, staff, advisors, and board will be incentivized to give advice to maintain qualification as a family office, whether or not it is in the best interest of the individual family member being advised. As a result, there can be neither alignment nor objective and trustworthy advice. What family office can function responsibly without those?

What Families Should Do

There are a number of option families and single-family offices must consider in light of the new rules. They include the following:

1. Set clear standards for what can and cannot be done by family members. The family office can institutionalize the rules required to limit the behavior and freedom of family members. These would include limitations on what gifts can be made outside the family unit, what advice family members can seek from the family office, in what ways charitable gifts may be made, what business and other engagements the family members can enter into. The family office can effectively declare that freedom to live life is not the client's prerogative and that individuality must be sacrificed for confidentiality.
2. Register with the SEC, thereby foregoing the confidentiality altogether. This may make the most sense in family offices serving many generations and many members of a family. Most multi-family offices growing out of a single-family, whether Rockefeller or Pittcairn, have likely done this long ago. Once registered and regulated, the family office can give family members complete freedom. For many family offices, the costs and exposure of registration may be intolerable.
3. Consider the use of different structures and operations, such as private trust company, or a free-standing but captive investment advisory operation. Advisors are trying to develop alternative structures and there may be many, any of which could involve considerable complexity, cost and uncertainty. These options will all require careful advice and guidance from attorneys well-versed in these matters.
4. Avoid U.S. jurisdiction to the extent possible. Any family that can establish a family office outside the U.S. should do so. In fact, the legislation and rules reinforce the notion that the U.S. is not friendly to substantial wealth holders. It may be difficult (but not impossible) for a U.S. family effectively to avoid the rules by locating its office outside the U.S.
5. Outsource the investment process to an independent investment advisory firm. Electing this option will require setting explicit standards governing how investment advisory services will work and what role the family office will play in providing or coordinating those services. Specifically, the family office must be prohibited from giving any investment advice that may require registration. The standards must be strictly followed to avoid to avoid SEC registration.
6. Place the entire single-family operation in a company fully registered with and regulated by the SEC. Such a company can operate several single-family offices under one umbrella, making each family anonymous within the entire construct.

The model of single-family office that has existed for many years will no longer be capable of delivering family members freedom from wealth. In essence, the classic U.S. single-family office cannot now exist. As a result, it is now critical for any single-family office or anyone considering establishing a single-family office to seek expert advice and counsel. It is simply no longer possible to provide investment advice from a single-family office without sacrificing some privacy or compromising best practices and standards designed to encourage individuality and self-actualization.

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