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THE NMS EXCHANGE

IN THIS ISSUE

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Re-Awaken Your Inner Capitalist

The sale of a family business marks a time of celebration, the beginning of an exciting new chapter. Finally, after years, if not decades, of diligent focus, hard work, and delayed gratification, the entrepreneur enjoys a well-earned liquidity event.

For many families, this moment also marks the transition from '*Operating Family*' to '*Financial Family*' as they shed their operating assets and shift their focus from building businesses and satisfying customers to constructing and managing investment portfolios. At this point, a new universe opens, featuring the capital markets, risk analysis, behavioral finance, family office structure, advisor and manager selection, and other compelling topics. This is often the time when capital preservation and stewardship become conscious priorities.

Who could possibly argue with the concepts of capital preservation and stewardship? And why would anyone assert that a family shouldn't simply relax and enjoy a well-deserved break from the rigors of business building?

Well, that's precisely the purpose of this brief piece…

The Trouble with Stewardship

Capital preservation and stewardship are laudable objectives. *Of course* you want to protect the hard-earned proceeds from the sale of your business. Why should you be any less thoughtful about your portfolios than you were with your business? You must invest well, seek solid advice, diversify with prudence, make more good decisions than bad, and generally do your best to ensure there is plenty left over for future generations, right?

Well… yes, but some folks take this too far. Just as chronic over-exposure to essential vitamins can lead to increased risk of cancer, excessive focus on capital preservation can incubate serious problems down the road, problems that accentuate conflict and accelerate the decline that eventually fulfills the '*shirtsleeves to shirtsleeves*' prophecy.

The term '*Stewardship*' refers to a particular feeling of obligation that family members often experience, an obligation to protect the family's wealth, losing and spending as little as possible, in order to preserve purchasing power for future generations. At some level, '*Stewards*' do not consider themselves *owners* of the wealth; rather they believe they are simply *responsible* for it during their time on the planet. They'll take a sip off the top now and then, but their main objective is to pass along the balance to future generations.

This is a fine sentiment, one with which I enthusiastically resonate. For years, I advocated *[Continued on Page 8]*

ABOUT NMS

NMS MANAGEMENT

NMS Management, Inc.
Nancy M. Szigethy
Founder and
Chief Executive Officer

NMS serves as the educational resource for the family office community through the development of an exclusive network of families of exceptional wealth, family office executives and key industry professionals through its established series of meetings. Believing that most successful business ventures are built on trust, and trust can only be developed through relationships, NMS strives to facilitate relationships through its educational meeting platform. As the source of unbiased educational forums, NMS promotes high standards of competence and ethics. As part of its mission, NMS provides access to leading thinkers in the wealth management industry through its content rich programming in a non-commercial setting of peers. NMS is the bridge to the latest investment ideas and information applicable to the family office community.

Socially Responsible Investing: Entering the Mainstream

By Gailen Krug
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Investors are increasingly looking at off-balance sheet risks and the long-term impact of their investment decisions: "Headline Risk", in other words. A common approach is to examine environmental, social, and governance (ESG) criteria as a supplement to traditional investment analysis. If you are skeptical as to the investor impact of ESG principles, consider the following:

- Corporate scandals at companies such as MF Global and the Enron Corporation have brought corporate governance issues to the forefront of Investor concerns. Once soaring in price, these shares are now delisted.
- As recently as August 2012, the SEC ruled on Section 1502, the "Conflict Minerals" provision of the Dodd-Frank Act. Issuers trading on US stock exchanges are required to determine the origin of certain minerals and conduct supply chain due diligence to report to on their use of "conflict minerals" from war-torn regions.

A practical application of ESG is the UN PRI (United Nations Principles for Responsible Investing) which was launched in April 2006 by the UN Secretary-General. In November 2012, this working group issued a discussion paper entitled "Responsible Investment and Hedge Funds". It discusses the six key UN PRI principles and the relationship between the asset owner (investor) and the investment manager across various instruments and strategies. Formal mechanisms to implement, report, and monitor ESG requests are also proposed. Finally, the scope of ESG was articulated along with examples of responsible investment commitments. From an operational perspective, this report issued some key governance-related recommendations:

- Directorship: Ensure competent and independent directors are appointed to the boards of hedge funds. Investors should expect a majority of external directors with the requisite experience, skill set, and educational background.
- Transparency: Enable risk analysis, due diligence and monitoring of portfolios. Support ongoing collaborative initiatives to foster greater transparency such as The Open Protocol (www.theopenprotocol.org)
- Derivatives: Ensure that managers have adequate procedures to mitigate and manage counterparty risks and other risks associated with the use of derivatives. Investors will want to be aware of and understand the impact of OTC-related regulatory changes. For example, the best execution review process should be placed under scrutiny.
- Use of leverage: Investors should satisfy themselves that managers are able to monitor and limit financial leverage, derivative exposure, and counterparty risk.

An investor may wish to prevent investments in the bonds of a country that is subject to, for example, UN Security Council Sanctions.

The ESG movement is moving forward, full (environmentally-conscious) steam ahead:

- The 1000+ PRI signatories represent $30 trillion in assets, composed of 60% investment managers, 24% assets owners, and 16% service providers. More than 85% of signatories have ESG-related investment policies. (Source: www.unpri.org/principles)
- Sustainable and Responsible Investing encompasses an estimated $3.07 trillion out of $25.2 trillion in the U.S. investment marketplace today. (Source: www.ussif.org)

To date, socially responsible investors include public and private pension funds, family offices, individuals, universities, hospitals, corporations, and religious institutions. Reportedly, institutional capital represents the largest and fastest -growing investor type.

Here are Some Common Questions:

How does performance compare with more traditional funds? Would I have to sacrifice returns?

In October 2007, the United Nations (UNEP Group) issued a paper called "Demystifying Responsible Investment Performance" which analyzed 20 influential pieces of academic work and 10 key broker studies exploring links between different approaches to socially responsible investment (SRI) and investment performance. This comprehensive review found that SRI investment strategies are competitive with non-SRI strategies from a performance standpoint**.** (Source: www.unepfi.org)

More recently, an article was published on Bloomberg.com entitled "Return on the Oldest Social Index over the Past 5 Years: 47%" (date: April 30, 2012). It demonstrated that when comparing the performance of the S&P 500 Index versus the MSCI KLD 400 Social Index, that returns were quite comparable: the former had a 10-year return of 49% since 2002, while the latter was close behind, at 47%. The article further states that since 1999, the KLD 400 has outperformed the S&P 500 with an annual return rates of 9.6% and 8.9%, respectively. (Source: www.bloomberg.com)

For more information, several academic studies on socially SRI funds can be found at www.sristudies.org. Several of these peer-reviewed and published studies have been awarded the prestigious Moskowitz Prize, available at www.ussif.org.

Overall, these studies show that it is possible to do good and simultaneously do well.

Does ESG apply to my investment strategy?

Equities and fixed income: Yes. These strategies are more straight-forward, as investors can opt-in or elect out of specific securities based *[Continued on Page 9]*

Trustee Challenges: How Differing Beneficiary Needs Complicate Fiduciary and Investment Decisions

By Michael R. Eisner
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By Sara J. Roupp
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With the increase in estate tax exemptions during 2011 and 2012 (made permanent by the American Taxpayer Relief Act of 2012), as well as the equalization of GST and lifetime gifting limits, many wealthy families have set up additional long-term trusts to benefit their children and grandchildren. With the expected durations of some of these trusts approaching triple digits, one would expect investment policy and strategy to be simple. Trusts with long durations have the ability to sustain much higher risk levels, allowing them to be aggressively invested in potentially higher returning equities and illiquid investments. There are no periods in modern U.S. history where annualized returns over 30 years are negative (from 1926, using the S&P 500 as an equity proxy). *(Figure 1)*

Although past performance is no guarantee of future performance, this fact alone provides Trustees with evidence that over long time periods (greater than 30 years), equities can provide substantially higher returns versus other asset classes, and should be considered for a significant allocation to long-lived trusts. Additionally, according to Ibbotson data, long-term equity returns are generally higher than the worst rolling period returns noted above when long-term government yields are as low as they are today (for example, the 1930-1955 timeframe). Today's investment industry also provides the ability to diversify into global equity portfolios, reducing the risk of long-term underperformance that may occur in any one given market (i.e., Japan).

Although most financial advisors and trustees know these facts, they may not have the appropriate operational and management structures and policies in place to provide them with the confidence to implement sophisticated investment programs that meet multiple and sometimes competing beneficiary needs. Unless there is a well-considered strategy, uncontrollable competing factors or influences such as the current economic environment, co-trustee conflicts and multiple beneficiary needs, may complicate investment and trust decisions. Further, long term thinking has to be given its rightful place in any such strategy. Many trust environments are very fact specific or situational and defy standard solutions. Accordingly, operating policies must be adaptive.

For instance, many investment allocations are currently influenced by short-term outlooks (3-5 years in this instance), especially so in today's uncertain political and economic environment. With concerns about fiscal cliffs, unsustainable debt to GDP ratios and easy global monetary policy which could ignite inflation, many trusts may be positioned more conservatively than they should be. Even if a long-lived trust is established and invested at the worst possible moment, such as the end of 1928 or 1972, the 30 year annualized returns on equity investments are excellent (8.5% and 12% nominal, respectively and real returns both over 5.5%). Even the worst 30 year annualized real returns since 1926 are greater than 4.4%.

In addition, we have seen a recent trend of grantors adding co-trustees, possibly family members, who may not be investment professionals or, could have adverse interests (a child's trust where the parent is also a beneficiary). This could cause a conflict between trustees, especially if the individual co-trustee has current financial needs that may be at odds with the investment allocation that best suits the ultimate beneficiary.

Trustees face multiple conundrums when dealing with multiple beneficiaries. The grantor may be looking over your shoulder, providing "rear view mirror" advice, especially if short-term results are poor. Additionally, in today's economic environment, certain asset classes, such as high quality bonds and Treasuries, that have historically provided stability and safety to portfolios, may offer no real return for decades. Is this considered a prudent investment?

Although laws now allow trustees to invest for total return and the power to adjust provides more flexibility, there are additional ways to increase the ability to meet beneficiary needs. To provide the best structure for investment policy and decision making, and to act in the best interest of all of the beneficiaries in an unbiased fashion, Trustee(s) should have a well-defined operational and administrative structure and process, subject to any guidance in the controlling document. This may include policies and procedures setting forth the acceptable investments, criteria for loan requests and guidelines for discretionary invasions. Some of the additional requirements if there *[Continued on Page 10]*

There are no periods in modern U.S. history where annualized returns over 30 years are negative.

FIG. 1

Long Duration Trust Returns

Length of Rolling Period	30 Years	40 Years	50 Years
% of Rolling Periods with Positive Returns	100%	100%	100%
Worst Rolling Period Return	8.5%	8.9%	7.7%
Best Rolling Period Return	13.7%	12.5%	13.6%

Source: Dimensional Fund Advisors and S&P Index Services Group

By David Lansky
The Family Business, Consulting Group, Inc.®

Family Dynamics and The Family Office

Families who own or manage a family office do so for many reasons: To perpetuate family wealth for succeeding generations, to leave a legacy, to keep family together, to leverage family philanthropy, or to take advantage of resources that are available for pooled family capital.

Often, these families are able to access tremendous resources, either internally from family members or externally because they can literally hire the best managers and advisors that "money can buy". However, the expertise that they nurture or hire, is often financial or legal, not social or psychological. As a result, many financial families are *experts* at managing family financial capital, and *novices* at managing family human capital and the accompanying family dynamics.

I define Family Dynamics as repetitive and often predictable patterns of interaction among family members, and between family members and the rest of the world. These patterns are affected by family history and current events, communication styles, behavioral patterns, and biological inheritance.

For a variety of reasons, the family office is the perfect stage where family dynamics can be acted out. Although this is not an exhaustive list, below are some of the more prevalent family dynamics that I have observed among families with a family office. While some families may not experience any of the dynamics I discuss, most will recognize at least some of these patterns - and perhaps others - affecting operations and decision making in their family office.

Multigenerational Transmission Process

In most families communication patterns and emotional styles tend to be passed from one generation to the next – what psychiatrist Murray Bowen referred to as a "multigenerational transmission process." For example, the degree of comfort or discomfort family members have with intimacy or open communication, how emotionally reactive family members tend to be, or how conflict is routinely handled, are all family dynamics that may transition across generations. Thus, financial families who collaborate through structures such as a family office are likely to encounter an accumulation of "family baggage", resulting in a repetition or amplification of idiosyncratic - and potentially problematic - family dynamics.

Destructive Entitlement

The amplification or accumulation of idiosyncratic family dynamics becomes even more evident when there are previously unaddressed or unresolved historical hurts, disappointments, or perceptions of injustice in a family. Experiences of injustice tend to be among the most powerful influences passed on to succeeding generations in a family; often becoming resentments in the contemporary life of a family (what has been called "destructive entitlement"). Where there is a dynamic of destructive entitlement, current family members, out of loyalty to previous generations, tend to resist agreements or consensus with others who may be seen as having some involvement with a prior injustice (e.g., "Your father fired my father. Why should I respect or appreciate your views of our family enterprise?"). Whether or not these others were directly responsible for the original betrayal is irrelevant; so long as the others are related to the original perpetrator, they are held responsible for the historical abuses, and legacies of unfair treatment may be sustained through stories that are passed on from one generation to the next.

Destructive entitlement can perpetuate tension in families based on perceptions of unfairness from the past, setting up a cycle of unfair treatment. Victims of unfair treatment in the past feel entitled to ignore or mistreat others in the present, as a result they repeat hurtful behaviors creating more hurt feelings and leading to a dynamic of escalating victimization and victimhood. The very idea of collaboration or peace seems like a betrayal to family members who were initially hurt by unfair practices.

The implications for financial families and their family offices are clear: the experience of injustice in a family may be expressed through tension, poor communication, disengagement and lack of effective collaboration in the family office.

Destructive entitlement can perpetuate tension in families based on perceptions of unfairness from the past, setting up a cycle of unfair treatment.

Diverse Authority

When a family owns an operating company, those parties who have been closest to the company – for example as operators or directors – typically carry substantial authority relative to other family members who may be owners but otherwise lack involvement. In a family office, other than family membership, there are few preconditions for participation and fewer guidelines for the exercise of authority. Consequently, the ownership group may include a diverse mix of equal and potentially competing family voices who may vie for significance, voice, impact or authority, which can in turn exacerbate other long dormant family tensions or dissatisfactions, yet again affecting operations or decision making in the family office.

Imposed Mutuality

Some families are significantly defined or affected by a shared event or experience. Blended families that result from a divorce, families with alcoholism, or families who have recently emigrated are examples of families whose contemporary family dynamics can be traced to one or two fundamental, defining, shared family experiences. The same can be said of multigenerational families with a family office. For these families, the decision to be together in a family office, a decision that affects most family members, was made in the past, perhaps generations earlier, and current participants in the family office did not have a choice in the matter. My colleague Amy Schuman and I have called this dynamic "imposed mutuality". Imposed mutuality can create, intensify or solidify tension in a family when it requires family members to be together who may not enjoy each others' company.

Imposed mutuality may precipitate "psychological reactance", which occurs when one's ability to choose is threatened. Reactance will cause a person to adopt or strengthen a view or attitude that is contrarian, *[Continued on Page 11]*

By James B. Lockhart III
Vice Chairman,
WL Ross & Co

Housing Market Finally Recovering Despite Uncertainty

Six years after housing prices started to fall, we are seeing very clear signs of a broad, but still choppy, housing recovery. At the nadir house prices were down over 30% and depending on the index they are now 5% to 8% above that bottom. That is not to say that there are not many challenges ahead for the housing market.

Twenty-two percent of homeowners in the US are still underwater in their mortgages, owing more than their houses are worth. Serious delinquencies (more than 90 days overdue) are down, but still are very elevated. Subprime serious delinquencies are down to 22% from a peak of 31%. Overall, delinquencies are the peak of 9.7%. On the other hand the troubled FHA program, which can lend up to 96.5%, is still very high at 8.5%. Surprisingly, for the much maligned government sponsored enterprises (GSE), Fannie Mae and Freddie Mac, serious delinquency rates are "only" 3.4 %.

The recovery is being fed by massive government support. The Federal Reserve Board's Quantitative Easings I, II and III including trillion dollar purchases of mortgage-backed securities (MBS) has driven mortgage rates down to extremely low rates. That plus lower house prices has house affordability at near record levels which is finally getting buyers with pent up demand back in the market. Households are deleveraging and credit scores are starting to improve. However, stubbornly high unemployment rates of almost 8% are still a big drag. A new class of multi-billion dollar funds, REO (Real Estate Owned) to Rental, has been started where institutional investors are buying foreclosed properties, fixing them up, renting them out and hoping to sell them at a much higher price three to five years later.

The recovery has been much slower than was anticipated when we put the GSE into conservatorship in September 2008 despite the massive government support of the GSE, the banking system and the housing market. The FDIC has shut down 470 banks. TARP has supported many other banks which are finally starting to do some balance sheet mortgage lending, but the GSE and FHA/VA are still dominating the market. Their market share is now 84%, down from the peak of 95% which was triple their 2006 market share. Of the single family $10 trillion market, the GSE own or insure almost $5.5 trillion in mortgages.

The recovery in the multifamily market has been more rapid than single family, but again it also has been supported by the GSE and FHA which combine for over 63% of the market, down from a peak of 80%.

The single family market has also been supported by the Home Affordable Modification Program (HAMP) and Home Affordable Refinance Program (HARP). The latter, which we at FHFA suggested to the Administration, is starting to help underwater Fannie and Freddie borrowers refinance their mortgages at much lower rates. Also, millions of borrowers with positive equity have been refinancing which has increased their disposable income.

So why has it taken so long and why is the recovery still so uneven? My answer is that despite the massive multi-trillion government support, the government has created too much uncertainty: Dodd-Frank Act, Consumer Financial Protection Bureau, hundreds of new regulations including Qualified Mortgages and Qualified Residential Mortgage rules, lawsuits, consent agreements, Basel III banking rules and, of course, the fiscal cliff/sequester/debt ceiling.

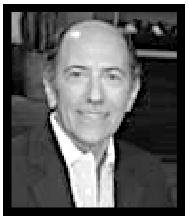
The good news for us investors is that the combination of government support and government-caused uncertainty has produced some very good opportunities for investing in financial services companies and mortgages in the US and Europe. At WL Ross & Co., we successfully managed a Treasury-supported Public-Private Investment Partnership (PPIP) combined with a troubled residential and commercial mortgage fund. We have invested in 13 banks in Europe and the US, including five FDIC-supported transactions. We also have invested in companies involved in single family and multifamily mortgage servicers that also originate mortgages for the GSE. At year end, we sold our largest servicer/originator, Homeward Residential, to Ocwen.

As Fannie Mae and Freddie Mac are so critical to the future of housing finance in the US, the uncertain future of the GSE is still a major concern, which Congress is avoiding. As a believer that the government should not dominate the housing market, I am concerned that Congressional inaction and the GSE return to profitability may lead to a continuation of the status quo. An equal but less likely concern would be to totally do away with Fannie Mae and Freddie Mac. I hasten to add in that scenario their existing debt and MBS would continue to be supported by the US government.

Many people, including myself, are suggesting a half-way point. The idea is much smaller companies with no government support, but the ability to buy risk-based US government insurance for their MBS. Priced properly that would allow for the re-emergence of the private-label MBS market. I would restrict their market share to 20% to 40%. To lessen the cyclicality in the housing market, their market share should drop and the cost of their government insurance should increase when hosing prices increase above long-term trend lines. Creating counter-cyclical brakes for the housing market should prevent excessive housing bubbles which were instrumental in creating the "Great Recession".

As a believer that the government should not dominate the housing market, I am concerned that Congressional inaction and the GSE return to profitability may lead to a continuation of the status quo.

Photo Credit: *Bloomberg News*



Direct Investing from a Family Office Perspective

By Harris S. Fried, CEO, The Fried Family Office LLC

Introduction

My interest in this concept came about as a result of an analysis done on the traditional asset allocation model for an Ultra-Affluent Individual ("UAI") and a Single Family Office ("SFO").

Whether the source or sources of wealth derive from an operating business, whether one remains active in the business, is a substantial shareholder or the investable funds are derived from a liquidity event diminished amounts of real income have become a real and increasingly important concern to the UAI and SFO.

Relevant to the SFO in particular (as they evolve into G-3, G-4, etc.) is the necessary imperative to supplement diminishing amounts or sources of income. This can be addressed by utilizing all of the intrinsic assets of the SFO, to include immediate members of the family, long term advisors to a family and experienced professionals with past or present associations to a family. All these groups can be activated to assist the family members/executives in a new venture. You should be prepared to take advantage of any relationship which has the potential to assist in the success of a venture. Any UAI or SFO will have over the years developed a network of trusted allies to include bankers (investment and private), lawyers, accountants and other experienced advisors. This available pool of talent will become invaluable as the process suggested here evolves.

Analysis and the Decision Making Process Attendant to Making a Direct Investment

Before we get to this stage a considerable amount of old fashioned "soul searching" will have taken place. To be clear I am specifically talking about the acquisition of an operating company. Viewed another way is to put an UAI or SFO in a position to do what Private Equity firms have been doing for them for years but avoid the 2/20 or higher charges and capture other advantages to be more fully addressed below. A well thought out plan can yield higher returns and not only of a monetary sort. Implicit in this discussion is the possibility of developing a new generation (within a family) of entrepreneurs. Assuming that a family has gone through a rigorous internal examination and analysis of whether acquiring an operating business is (based on a variety of considerations) feasible for them.

While this may sound simple it can in fact be a complicated decision, but once made can lead to a whole new universe of opportunities. A fairly typical example of what I am referring to is the creation of a separate standalone private equity vehicle. The ownership vehicle can take many forms to accommodate a variety of issues so careful consideration must be made.

The structure and form of the acquisition vehicle will need to accommodate factors such as taking in co-investors (domestic as well as international), utilization of the vehicle for multiple acquisitions to include possible international acquisitions (if this is part of the strategy), tax considerations and of course of paramount importance is to make sure that whatever type acquisition vehicle is decided upon the SFO should be ring-fenced from any and all types of liability which could conceivably occur.

Of primary concern will be the acquiring entities' basic strategy in terms of what industry sector is to be targeted and what businesses within that sector are most interesting.

I mention this here so as to encourage a more formulated mandate. Alternatively an acquirer may not be as preoccupied with the type of business and more interested in the size of the business, location, projected level of return, etc. From my experience the more specific one can be in terms of what is being sought the easier it will be to identify a list of potential targets. This will save time and make the investment group easier to assemble.

Even if the only decision that has been made is to attempt an acquisition there are a number of good investment banks as well as advisory firms which can be mandated to assist with the identification of potential target companies. If your primary relationship as a UAI or SFO is with a large wealth management group their investment banking division will be able to assist or direct you to a firm which can.

Finding an advisory firm that is active in the space you are seeking to enter can be invaluable for a number of reasons such as being capable of identifying potential target companies and co-investors more readily, doing a valuation of the potential acquisition, structuring the transaction, assisting with any portion of the acquisition price which might require financing as well as recommending management talent which can help implement the acquiring company's new strategy.

Due Diligence, Structuring the Transaction and Making an Offer

The series of steps outlined here will naturally take place when an investor, be it a UAI or SFO, has determined that they intend to pursue the acquisition of an operating business, preferably achieving control on behalf of itself and any investing group.

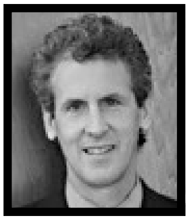
Irrespective of what is developed from the analysis referred to above in terms of where the acquirers will focus their attention due diligence ("DD") will need to be performed.

This should be a multi-layered approach in which at least two components are evident. In the first instance when a company or list of potential target companies is created all relevant public information should be analyzed. This should for the most part be done without advising the potential target that there is an interest in the company.

At this stage the principals of the target company should be investigated to the extent thought necessary to avoid any embarrassing surprises. This type of enquiry can sometimes yield information which may influence whether an offer is to be made and on what *[Continued on Page 13]*

You should be prepared to take advantage of any relationship which has the potential to assist in the success of a venture.

Private Family Trust Companies



By Pierce H. McDowell, Co-Founder, Co-Chairman and Co-Chief Executive Officer, South Dakota Trust Company, LLC

By Matthew Tobin, Managing Director, South Dakota Trust Company, LLC

A notable trend in recent years has been the increasing popularity of Private Family Trust Companies (PFTC). This growth is rooted in multiple factors, including (1) IRS Notice 2008-63, a preliminary release outlining a structure to avoid adverse estate tax consequences; (2) Dodd-Frank and the changes made to the definition of "family office"; (3) an unwillingness of institutional trustees to accept or manage concentrated family held assets; and (4) increasing concern about the use of individual trustees. The emergence of these factors coincided with the enactment of laws and regulatory practices in many states to govern the establishment and operation of a PFTC. All of these factors led to expanding interest on the part of many families and their advisors to consider using a PFTC. Many that have journeyed down this path believe that they have discovered the perfect alternative to the more traditional institutional bank or individual trustee arrangement.

General Introduction

A PFTC is a state chartered entity uniquely designed to provide fiduciary services to members of a family. In addition to serving as trustee of trusts held for the benefit of family members, a PFTC can provide investment advice, tax return preparation, and even serve as a family bank.

A PFTC is distinct from a "family office" in that it can serve as a fiduciary under state law. PFTC's can take on many responsibilities commonly performed by the family office, including investment and financial management, accounting, and recordkeeping. A PFTC can, however, operate separate from the family office, while still relying on it for administrative and back office support through a service contract.

Private family trust companies are utilized for a variety of reasons, but they are usually intended to provide a long term trustee that will adapt to changing family dynamics and have a better understanding of a family's culture, goals, and objectives when making decisions. PFTC's provide flexibility in the administration of trusts while ensuring the permanence and formality of a corporate trustee and preserving family involvement in decision-making.

Jurisdiction

Many states have enacted laws specifically designed to apply to private trust companies. These laws vary by state, but each provides statutory guidance on such things as the application process, capital requirements, operational requirements, fees, taxes, and regulatory procedures. These state laws often reduce the cost of formation and operation of a PFTC.

Some states provide "regulated" private trust companies, while others only offer an "unregulated" option. Regulated trust companies undergo a periodic examination, and are exempt from registration as an investment advisor with the SEC. Unregulated private trust companies are not subject to regulatory oversight, but face other limitations on their activities and may be required to register with the SEC.

When considering a PFTC, it is important for a family to review a state's private trust company laws, trust laws, investment standards, rule against perpetuities, taxes, asset protection, property laws, experience of banking authorities; and corporate filing requirements. The most popular private trust company states are South Dakota (regulated) and Wyoming (unregulated).

Ownership and Governance

PFTC's are organized as either corporations or limited liability companies. They are owned directly (outright ownership) or indirectly (LLC) by family members. More recently, many PFTC's are owned by an "Owners Trust" or "Purpose Trust." These are usually established as dynasty trusts for the sole purpose of owning the PFTC.

PFTC's are structured like any other business entity, including a bank or commercial trust company. PFTC's have a board of directors, officers, and committees. The board of directors oversees the operation of the trust company, and it usually includes family members and at least one independent director. The board of directors is responsible for appointing the officers and committee members. The most common committees include an Investment Committee, Distribution Committee, and Audit Committee.

It is important that a family considering a PFTC give significant thought to who will serve in these capacities and on these committees. Family members may participate in many of the decisions made by the PFTC, subject to certain limitations necessary to avoid adverse income, estate, and gift tax consequences.

Maintaining a corporate agent in the PFTC state allows the family to satisfy the legal and situs requirements. However, many of the popular PFTC states permit a regulated trust company to engage in interstate trust administration, which allows the administration to be performed in any state, including the family office's home state. If the family wishes to take advantage of the PFTC's state's advantageous trust laws, then it may have to outsource the administrative responsibilities to a qualified trust agent in that state.

The illustration on page 15 (*Figure 1*) is a sample organizational structure for a PFTC organized in South Dakota. The dotted line between the family office and the South Dakota Private Family Trust Company represents a service agreement between the two entities. This certainly does not represent the only way to structure a PFTC, but does demonstrate a common approach. For a comparison of the leading PFTC states please see Figure 2 on Page 15.

Primary Advantages

Every family has its own reasons for establishing a PFTC, but some of the primary advan- *[Continued on Page 14]*

Re-Awaken Your Inner Capitalist
[Continued from Page 1]

the notion of stewardship with my clients and staff without reservation. However, after witnessing surprising negative consequences with some families, I have become convinced that unchecked stewardship can inflict unintended damage.

Some family members take the commitment to stewardship so seriously that their worldview begins to shrink inward. They become '*professional clients*', behaving as if their primary mission in life is to protect the principal. This leads them eventually to look at the world through a lens of *scarcity*.

I have actually encountered parents with tens, even hundreds of millions of dollars in the bank, who express fear that their children won't have enough money. And I have known adult children of equally wealthy parents who are vaguely anxious that there will be nothing left for them in the end. Left unchecked, this often-unconscious concern can permeate the family, injecting bitter and acrimonious dynamics into all aspects of life, imposing a prison with velvet bars that poisons each subsequent generation.

The effects of '*Hyper-Stewardship*' may not become apparent for some time; Mr. and Ms. G1, first-generation founders the business, will likely never display the symptoms. And depending upon their involvement with the family's business, the members of G2 might not either. But once a family's operating assets become a distant memory, these negative dynamics can quietly creep into the picture and erode the family's ability to enjoy and sustain their wealth.

> *The trouble is… over the long term, it is nearly impossible for investment portfolio returns to overcome the corrosive effects of family population growth, increased individual consumption, investment mistakes, and taxes.*

Without periodic injections of '*New Capital*', long-term dissolution is inevitable. It's a slow glide path down, and it may take several generations, but family members feel and begin reacting to the threat long before the reality settles in.

Inoculate Your Family with Entrepreneurship.

In sharp contrast to the stewards described above, entrepreneurs, assuming their ventures are moving even remotely in the right direction, tend to view the world through a lens of *abundance*.

We've all encountered people who are flat broke, even in debt, who feel rich as can be. Why is that? How can a person whose only asset is a dream feel wealthier than a family member with ten or even hundreds of millions of dollars in the bank? More important, perhaps, how can *your* family recapture some of that feeling of abundance?

The entrepreneur's perspective focuses outward. He or she thinks about growth, satisfying customers, developing talent, planting seeds for the future. Somehow, in pursuit of external priorities and dreams, their worlds expand, and entrepreneurs find a way to move forward, secure in the unconscious certainty that growth *will* come.

Of course, we're painting a rosy picture here. It would be irresponsible to assert that the act of entrepreneurship can solve a family's problems or by itself snap their worldview into a positive perspective. However, over time, appropriate and well-placed injections of business building *can* help the family combat the negative spiral of a scarcity mindset by bringing fresh assets into the portfolio, shifting the family's focus outward, and illuminating a possible path to long-term sustainability.

In my opinion, every generation should have at least one entrepreneurial experience. This means someone in each generation should launch, run, or at least rigorously participate in operating businesses that can create *new* wealth for the family, wealth that goes beyond portfolio returns.

What Does it Mean to be a Capitalist?

The title of this article refers to '*Reawakening Your Inner Capitalist*'. What does that mean? Aren't stewards capitalists too?

Well, technically speaking, I suppose *every* investor is a capitalist. Any person who risks capital with the expectation of positive returns probably qualifies at some level, but not in my book.

In contrast to a '*Steward'* who adopts a defensive and largely passive approach based upon diversified investment portfolio returns, our '*Capitalist'* concentrates the power of his or her assets – *money, time, sweat, and/or relationships* – to create *new* assets, to expand their family's portfolio with value that simply didn't exist before.

Our definition also draws a distinction between '*Capitalist*' and '*Entrepreneur*'. Entrepreneurs risk time, talent, and relationships – *and often other people's money* – to build businesses. Capitalists risk these assets too, of course, *but they commit their own money as well*. Thus, according to our definition, all capitalists are entrepreneurs, but not all entrepreneurs are capitalists.

This may feel like splitting hairs, but these distinctions are important because they contribute to a distinct worldview that leads to specific behavior over time. Families of wealth are uniquely qualified to act as capitalists, and I assert that over the long term, many would be better off if they did.

Carefully Nurture Your Inner Capitalist…

Let's get something straight. I am not suggesting that you should abandon the philosophy of stewardship; quite the contrary, in fact. Stewardship and capital preservation are essential, the stars of the show. You owe it to yourself and to your family to maintain a prudent, well managed and diversified approach that will preserve spending power for future generations. However, this doesn't mean your approach should be purely defensive.

> *You can and should be a steward and a capitalist at the same time.*

In fact, if you have multigenerational aspirations, that is the only prudent approach.

The key is to carefully inject a small element of entrepreneurship into your affairs and then develop it carefully over time. *Don't fall into the Financial Family Trap.* Gingerly bring operating assets back into the fold, and keep the spark of business alive in order to avoid the poison of hyper-stewardship.

Despite its numerous long-term benefits, capitalism is a most dangerous game, so I recommend that you follow a few defensive guidelines:

- **Start Small** – *Do not leap back into a scenario where major, illiquid operating assets dominate your asset base.*

Some family members take the commitment to stewardship so seriously that their worldview begins to shrink inward.

Carve out a tiny initial allocation to direct investments in operating business and real estate. Over time, you may decide to make a more major commitment, but it would be absurd to take big risks early on.

- **Take Your Time** – *Do not rush this process*. You have multiple generations to get this right, so do your homework thoughtfully and make sure you have the resources required to tilt the probability of success in your favor. It would not be unreasonable for the initial search/incubation period to take years.
- **Seek Solid Advice** – *Do not try to do this on your own*. Expert advisors exist along all dimensions of the entrepreneurial challenge. Make prudent use of them, but don't let their fees get out of control.
- **Be Extremely Selective** – *Do not buy into the first business or business plan that comes your way.* It is far better to miss out on a few good opportunities than it is to invest in a stinker. Sourcing operating assets requires careful planning, hard work, disciplined focus, and a ruthless ability to say no. You will likely make thousands of phone calls and kiss dozens of frogs, but in the end, it's worth the extra effort.
- **Establish a Culture of Capitalism** – *Do not encourage a passive mindset in your family.* At the very least, make sure everybody works. No one should depend entirely upon portfolio returns over the long term. Family members should support themselves and contribute to the pool whenever possible. Help your children and future generations recognize that they have the power to expand their portfolios, to live their lives from a perspective of *abundance* not *scarcity*.
- **Teach Them to Fish From an Early Age** – *Do not expect your children to learn how to become entrepreneurs on their own*. Over time, your family's '*Human Capital*' will prove more valuable than its '*Financial Capital*'; invest yourself accordingly. As with stewardship, a capitalist mindset requires extensive training and is best nurtured from an early age.
- **Never Give Up the Ghost** – *Do not fall into the seductive trap of the Financial Family.*

The sale of a family's operating business marks the beginning of an exciting and well-deserved new chapter. But it need not mark the end of an era. Capitalism and concerted entrepreneurship likely built the foundation upon which your family's success stands today. By all means, preserve your capital for future generations, but keep your inner capitalist alive and well. Your children, their children, and generations yet unborn will thank you for the gift of abundance.

Socially Responsible Investing: Entering the Mainstream

[Continued from Page 2]

on compliance with ESG criteria. Investors can also engage with corporations and debt issuers via meetings and (proxy) voting to promote improved ESG performance.

Global Macro: Yes. Emerging and frontier markets may have less developed legal and regulatory protections relating to management of ESG issues and thus warrant a higher degree of attention.

Mortgages, asset-backed securities, specialized credit: Yes. An ESG lens would focus on potential issuer conflicts of interests, fair lending laws, collection practices and the collateralization of such loans.

Event-driven or distressed-investing: Yes. Awareness of ESG issues in this milieu is key here, where it is common to see bankruptcies and operational restructurings (social risk) or coercion in distressed investing situations.

Private Equity: Yes. While the structure of ownership and governance differs for private equity, the underlying asset in which they invest is the same – a company.

Foreign Exchange and Supranational debt: Yes. A strategy taking positions in sovereign debt or currencies could have the potential to affect the fortunes of a vulnerable economy, especially if the same strategy is widely pursued by too many managers. An investor may wish to prevent investments in the bonds of a country that is subject to, for example, UN Security Council Sanctions. Last, an investor may want to avoid strategies that could be seen as exploiting the sovereign debt of a developing country.

Commodities: Yes! The commodities asset class is fundamentally linked with ESG issues. When commodity prices go up, a portfolio can generate healthy returns, but the flip side is that rising prices are bad news for people if they have to pay more for food and energy. For example, in the food sector, ESG criteria are material due to a range of catalysts: growth of consumer demand, new market segments, rising commodity prices, product innovation, and climate change.

How would ESG principles be applied to my portfolio of funds?

- Negative screens: One could exclude certain types of securities, like those associated with weapons, tobacco, or gambling.
- Positive screens: Preferences are bestowed to companies with positive characteristics, such as investment in renewable energy or product safety. Admittedly, positive screens are subject to criticism, as some portfolios may include a fast-food chain that uses pesticide-free meat (investing in environmental sustainability) while others denounce the same chain for being a fast-food outlet (societal health concerns).
- Shareholder advocacy: Shareholder resolutions are a powerful way to encourage corporate responsibility and discourage company practices that are unsustainable or unethical. This can be achieved via direct communication with company management or proxy voting.
- Integration: Examination of ESG factors within a portfolio, for example inclusion of carbon emissions in the analysis.

How can ESG requirements be implemented in my portfolio of funds?
ESG can be implemented in various ways, typically via 1 - side letter, 2 - Investment restrictions embedded in offering documents (LPA, PPM), and/or 3 - Binding commitments or a formal policy with defined consequences for breach.

What are some of the challenges in implementing ESG criteria to a portfolio?

Differing values: Within any given pool of investors, there will be competing sets of values or weighting of issues. Following the example of the fast food chain above: should one be more concerned with environmental issues or public health issues? Or both? Or neither?

Transparency: It can be difficult to monitor positions that violate SRI guidelines with the accuracy required. What type and frequency of ESG monitoring is to take place? How is the investor to resolve breaches in compliance? What degree of due diligence is required for corporations that use supply chains?

Change in circumstances/significant events: A famous example of this would be BP. Prior to the oil spill in the Gulf of Mexico, BP shares were held by many SRI vehicles, including the Dow Jones Sustainability Index (DJSI), which designated BP as a "Sustainability Leader" in the years before the spill. Following April 2010, however, the index reportedly sold its BP shares, citing "the foreseeable long-term effects on the environment and the local population – in addition to the economic effects and the long-term damage to the reputation of the company". ESG screens would have to be capable of detecting these types of breaches, even in the case of lower-profile incidents.

Conclusion:

Not just an esoteric concept, socially responsible investing has officially made its way into the mainstream. Investors can choose their degree of participation without having to pay more to align their values with their allocations of capital.

In conclusion, enabling our clients to incorporate ESG/SRI mandates in their portfolios is one of our firm's top priorities and goals. We have a growing list of interested clients coupled with Compare the performance over the past 10 years of the S&P 500 Index versus the MSCI KLD 400 Social Index, the oldest socially responsible investing index. It is described by MSCI as being designed "to provide exposure to U.S. companies that have positive environmental, social and governance characteristics." According to data compiled by Bloomberg, the KLD 400 has returned 47 percent since 2002 -- not too shabby. Yet that isn't quite as good as the S&P 500, which has returned 49 percent.unparalleled global coverage of hedge funds. The rapid growth of SRI in recent years is the best evidence that sustainable and responsible investing results in competitive returns – and it is here to stay.

Trustee Challenges: How Differing Beneficiary Needs Complicate Fiduciary and Investment Decisions
[Continued from Page 3]

are multiple co-trustees might be managed by a co-trustee delegating matters not involving the exercise of judgment or discretion to a corporate co-trustee. For example, an individual co-trustee may wish to assign recordkeeping responsibilities to a corporate co-trustee and retain an oversight role of these functions. Other predetermined investment strategies and multiple trustee roles and responsibilities can also be defined at the beginning of the relationship and spelled out in one of the following documents:

- Investment Policy Statements setting forth the asset allocation guidelines for the trust
- Structured Delegation of Investment Authority by Co-trustees which grants the Corporate Trustee the ability to manage and realign the investment portfolio based upon pre-determined criteria
- Memorandum of Understanding of Co-Trustees outlining the respective responsibilities of multiple trustees
- On occasions when the trust permits an individual co-trustee to assume responsibility and hold a non-traditional investment in the trust, a process can be put in place for the co-trustees to authorize and monitor the investment. A Corporate co-trustee may be granted the administrative non-fiduciary responsibilities.

The ability to build a broadly diversified portfolio can help alleviate competing needs. If some aspect of the portfolio must produce a certain level of current income, allocations to income producing investments (such as bonds, MLPs and high dividend paying stocks) could be offset by higher return potential, illiquid assets such as private equity and real estate. Properly vetted hedge funds can also play a role in smoothing out the long-term ride for a risk adverse co-trustee, grantor or beneficiary.

Now that we have an understanding of some of the operational and administrative challenges, let's look at an example:

John names you and his long-time friend Bob co-trustees for a trust set up for the benefit of his five year old grandchild Tess. The trust has provisions that allow distribution of income or principal invasion for the benefit of his 35 year old daughter Mary (Tess' mother) pursuant to an ascertainable standard. Bob is a good friend of the family but has no investment or administrative background. The trust will break on Tess' 45th birthday.

Unfortunately, soon after the trust is set up, Mary loses her job and requests distributions to meet daily living expenses for her and her family. How do you adjudicate fairly between Tess and Mary, to meet Mary's current needs, while providing a real long-term rate of return for Tess? What is the right investment strategy to help you meet these competing goals? What is the maximum amount you should consider paying Mary and what policies should you have in place to help Bob and you make these decisions.

First, considering what you know about equity markets and long-term rates of return (noted above), you should have confidence that a strategy with significant allocations to assets which deliver equity like returns should provide the trust appropriate long-term growth. A clearly written Investment Policy Statement setting acceptable assets,

Properly vetted hedge funds can also play a role in smoothing out the long-term ride for a risk adverse co-trustee, grantor or beneficiary.

guidelines and risk parameters, reflecting the long-term nature of investing will allow for confidence even in difficult markets. Additionally, a Delegation of Investment Authority by Bob to you will give you the ability to manage and realign the investment portfolio according to the guidelines initially established. This should help reduce some of the administrative burden of trying to link Bob in every time rebalancing occurs or a new strategy is added.

Second, given the confidence of a clear and concise long-term investment strategy, distributions to Mary can be considered, without fear of harming Tess' long-term well-being. Setting maximum distribution rates using a long-term view (30 years, not just 3 to 5 or 10 years) generally provides for a reasonable level of payout, even in today's low rate environment. If the current income level generated by the assets is not enough, the power to adjust could be incorporated to increase distributions. Again, history shows that even if Mary is drawing income for a period of time when markets are down significantly, the longevity of the trust should work in Tess' favor to provide significant capital appreciation when she turns 45.

In a worst case scenario, Trust loans, backed by strong policies defining interest rates, payment structures and duration can aid Mary during a difficult period, while protecting Tess' interest. These policies should be discussed upfront between co-trustees, clearly laying out roles and responsibilities in determination of terms and amount of the loan. The loan can be considered a fixed income asset in the trusts asset allocation, allowing the trustee to rebalance accordingly. Once Mary gets reemployed, she can pay off the loan with interest, making Tess' interest whole.

Conclusion

A well-defined investment strategy and operational structure, clearly written policies and a thorough understanding of roles and responsibilities between co-trustees and other fiduciaries form a strong foundation in managing the competing needs of multiple beneficiaries. These principles will provide trustees with the confidence to implement sophisticated investment programs that will have the ability to meet the financial objectives of different beneficiaries, even if the needs for each individual are completely different and occur over different timeframes. Combined with thoughtful, quantitative and qualitative analysis of available investment opportunities over short and long time horizons, these processes form a strong foundation for proper fiduciary standard of care while ultimately allowing long-lived trusts to serve their multiple purposes.

Family Dynamics and The Family Office

[Continued from Page 4]

and will increase resistance to persuasion. When people feel they do not have a choice or that choices are limited, they tend to do two things – they push back, and they spend much of their time thinking about how to remove whatever constraints they believe are being imposed. For example, when family members are informed they have no choice about how their assets will be invested, they may react with anger and resistance. Typically, people who feel they have no input at best will lack commitment; at worst will work hard to unwind plans that have been made. All of this will be observed when family members who believe they lack voice or choice interact with the family office or with other family structures they have inherited.

Imposed mutuality can have a significant impact on the success of transitions in the family office as well. Next generation family members often find themselves inheritors of a *dream* as well as of *assets*: The dream of family investments that will keep family together, or of keeping a business in the family, or of shared philanthropy. Moreover, they are often inheritors of that dream without having had any choice in the matter. "Do I really want to be tied to my siblings or my cousins for the next 50 years?" Transfer of a dream requires the ability to adopt that dream and then to adapt it to current circumstances of the family as it actually is. This takes lots of communication and interaction. Remember, when plans are made and people feel they do not have a choice, they will react by trying to increase their ability to have voice. Family dynamics such as communication style, emotional reactivity or histories of injustice in a family can interfere with a family's process for working through these complex transitions.

Conflict Avoidance and Triangulation

Paradoxically, a family dynamic that emphasizes conflict avoidance for the sake of peace in the family or in the family office may exacerbate challenges that are already present. The belief that tensions could cause a split in relationships that may already be somewhat fragile often leads people to avoid talking about matters that could potentially lead to conflict. But not talking about something does not cause it simply to go away. Avoiding these matters simply ramps up tension when family members are together, and increases the likelihood of triangulation.

Triangulation refers to a situation in which conflict between family members is managed independently by any or all of them by talking to third parties. The third party then becomes a sounding board, relieving some of the tension and dissipating negative emotion in the short term. But when conflict in a family becomes chronic or recurrent and when triangulation is a frequent coping tactic, it will simply make some problems worse, inappropriately involving some parties in the difficulties of others, standing in the way of creative efforts at resolution and producing dilemmas for everyone involved.

A "Closed System"

Financial families are very private families, and – not surprisingly - are perhaps most private about their inner workings, relationships and dynamics. Privacy, while beneficial in many ways, also poses a threat when it leads a family to become a "closed system". When a family is a closed system, the family members are insulated from potentially corrective information or experiences that might be had through exposure to or discussion with external resources. Accordingly, when family dynamics or communication styles affect family collaboration or operations in a family office, change or resolution of these family dynamics will be all the more difficult because a closed system lacks opportunities for external comparisons or correction.

Money
Finally, because of the opportunities that wealth provides, the choices that wealthy individuals are exposed to, attitudes and concerns about entitlement, and the individual differences that develop in perspectives about money; financial wealth has a tendency to act as an accelerant of all of the emotional processes noted above.

Managing Family Dynamics
Families who best manage family dynamics in the family office do so by developing processes that enable the family to be *self aware*, *self-correcting* and *continuously evolving*.

While each family is unique and would benefit from a strategy tailored to its specific situation, there are a number of elements which I believe should be considered as part of every family's strategy to manage family dynamics in the family office. Taken together, these elements can form a "platform" for the effective management of family dynamics.

Self Awareness
Families who wish to manage their family dynamics will frequently look to one or two problem situations and address these directly, for example, "conflict between cousin Jim and uncle Harold" or "poor communication between Dad and Aunt Jane." While these matters certainly need to be addressed directly, it is not sufficient in the long term to focus on one or two matters as they come up. If change is to persist, family members must be encouraged to look inward, to reflect critically on their own behavior, to identify the ways they often inadvertently contribute to the family's challenges and problems, and then change how they act.

Personal and Systemic Responsibility
Self awareness should lead to a shared understanding of and responsibility for the repetitive patterns that underlie challenges as a family, both from a broad systems perspective (for example, "as a family we triangulate rather than speak directly to each other", or "we have a history of painful relationships that have not been addressed") AND from an individual perspective, for example, "I prefer to avoid conflict and not address important issues directly" or "I can do a better job of listening to others".

Family Vision
Beginning with a commitment to self awareness and honest self appraisal, family leaders or the family as a whole should come together to discuss and develop a vision as to how family relationships could be more productive and satisfying. The vision should be broad, aspirational, and transformative – "We will communicate openly and welcome diverse viewpoints."

Eventually this vision needs to be communicated to, understood, revised and accepted by the family as a whole. Family vision can evolve over time and may be best realized if it is eventually documented in written form in a family constitution or charter. It is then incumbent upon family leaders to commit to and to lead the family toward the agreed upon vision. This might require bringing in third parties to assist in developing tactics or programs that will provide corrective learning experiences, for example on Effective Communication or Managing Attitudes of Entitlement. Family leaders need not be experts in these matters – yet, they do need to accept and implement a transformative vision.

Safe Communication Culture and Regular Family Meetings
Self awareness and developing family vision require creation of a safe communication culture in which individuals can be honest, open and take personal responsibility without fearing a backlash of criticism, judgment or humiliation. This in turn requires opportunities for family members to talk to each other directly and productively. *Regular family meetings*, which focus on listening to, and understanding diverse perspectives are essential elements in managing problem dynamics. Meetings between individual family members may be necessary as well. This does not mean that family members should be encouraged indiscriminately to "get things off their chest". It does mean that the family will benefit from structured opportunities for collaboration in sharing, understanding and problem solving. Listening well and non-defensively are critical elements in creating an environment where people can reflect upon and understand how they contribute to family challenges and how they can develop corrective solutions.

Commitment to Fair Process
As noted earlier, family dynamics are likely to be manifest when decisions need to be made by the family at large and if there are perceptions of injustice or lack of fairness surrounding those decisions. Usually, most decisions can be accepted by most people if the process by which those decisions were made is viewed as "fair". Fairly derived decisions are far more likely to be sustainable and to preserve the quality of family relationships. This requires a commitment to fair process as family works together. Some elements of fair process are:

- Voice for all in the decision process
- Clarity and transparency in the decision criteria
- Consistency in how criteria are applied across different decisions
- Adaptability of the decision to actual circumstances and ability to change over time
- Broad commitment to fairness

"Consent Of The Governed"
The US Declaration of Independence includes the following language:

> *"...to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed..."*

Consistent with my discussion above regarding *imposed mutuality*, families who are concerned about the impact of family dynamics in their family offices would be well advised to understand and attempt to integrate this view in their approach to family matters: *That the best governed organizations derive their legitimacy from consent of a properly educated constituency.*

Family dynamics are least likely to intrude or to be problematic when family members believe that their opinions matter. This should not be interpreted to mean that any

Usually, most decisions can be accepted by most people if the process by which those decisions were made is viewed as "fair".

and all opinions will be implemented – rather that the family will strive to properly educate its members as to matters at hand, and that when properly educated, a person's voice will be heard and given due consideration. When consent is not possible after education, due consideration and implementation of fair decision processes, then consistent with the theory that choice is an essential quality of well functioning family offices, family members should be helped to understand the exit options that are available.

Team Learning

By working collectively to address family relationship patterns that affect the family office, family members not only develop solutions to specific matters but they learn something else at least as important: *they learn how to learn together*. All of the steps discussed thus far – self awareness, personal and systemic responsibility, family vision, safe communication culture, regular meetings, fair process, and consent of the governed – contribute to development of a *platform* that will be fundamental to the other topic areas that need to be addressed by family: financial education, ownership responsibility, leadership succession, etc. Thus, by working as a team and learning together the family will at once enhance family dynamics AND prepare for future tasks.

Feedback and Enhancement Options

Finally, successful families – and family offices –continuously change by adapting to current circumstances and by preparing for future transitions. Families who are most successful at managing family dynamics make regular feedback and opportunities for enhancement a fundamental element in the platform they develop for enhancing their work together. This can be as simple as encouraging family leaders to ask "how am I doing?" or as sophisticated as creating surveys that tap family concerns which are then paired with thoughtful plans to enhance performance; I have seen both methods used successfully in different family offices.

Since families can be closed systems, external advisors who understand families and family dynamics are an essential element in creating a viable enhancement platform. These advisors can help to identify dynamics of which family members may be less aware ("a fish in the water doesn't know it's in the water until it's OUT of the water") and can provide new information that allows external comparisons.

Conclusion

Although family dynamics are frequent stumbling blocks for families and their family offices, family members and family office executives do not need to be experts in order to manage these matters well. Rather, what is required is a basic understanding of how these dynamics may be rooted in the fundamental nature of the family office, commitment to developing a family platform that enables continuous learning and enhancement, and working with selected external advisors who can help to develop tactics to address specific family needs.

Direct Investing from a Family Office Perspective

[Continued from Page 6]

basis. Where possible seek information of a more personal nature on the principals of the business. Personal recommendations in my view are far more valuable than scraps of information gleaned from social networking sites.

It is not unusual to hire a private investigating company to complete a thorough investigation. Searching someone on LinkedIn or some other social media site constitutes minimal DD and should not be relied on. Real DD would involve record checks of the principals of a company, etc. and a review of the books and records of a company, its main suppliers and customers (and contracts with them) should be done by professionals with in depth experience in such activities.

To get to the point where a company would be willing to make available for inspection pertinent books, records, customers, contracts, suppliers, etc. the potential acquirers will in all likelihood have to issue a Letter of Intent or Interest. This letter will need to give some indication of the financial wherewithal of the acquirers if any proposal is to be taken seriously. There is no commitment here generally other than to keep whatever information which is obtained confidential.

If an investment bank, legal advisors, accountants, etc. are engaged any mandate should be clearly established so that your advisors are clear on what type and to what depth information should be provided. It is only with hard, reliable information will you be able to make an informed decision to proceed. Anything short of a comprehensive DD is irresponsible and could result in disaster for not only your family's interests but those of your co-investors. If your family is taking a leadership role in this endeavor all the more reason for the DD to be done by professionals. If critical information is not being made available or you are being asked to make a very quick decision walk away.

After this first stage of DD is completed and a decision to proceed is made an offer to purchase can be drafted in conjunction with investment bankers, legal advisors as well as other advisors.

This letter will put the company on notice that someone is possibly interested in acquiring the company. Certainly prior to the issuance of this letter less formal communications can be had with the management, large shareholders and other interested parties. These type discussions are often had between the acquisition group's advisors and the company. Where possible the prospective buyers should assume a behind the scenes role to avoid a price spike or competitive bid, which often can't be avoided once a company is put "in play".

It is imperative at this stage to have in place an investor group, a channel for additional financing to the extent any will be required and the locus and form of the acquisition vehicle.

While the DD process can in some cases be very time consuming and complicated given the nature of a business do NOT approach this exercise lightly.

Assuming for the sake of discussion here that the DD process is completed to the acquirers' satisfaction and a price is agreed on both parties can move to a contract for the purchase and sale of the business.

As mentioned above it is becoming increasingly important that the acquirers establish the most efficient vehicle to acquire the target company or make an investment.

This decision should to the extent possible anticipate what the medium to long term intentions of the investing group will be such as making multiple acquisitions, the importance of having the ability to attract international investors as well as make acquisitions on an international basis.

Also to the extent possible tax considerations of each investor should be addressed and how a co-investor can extract themselves from the investment if it becomes necessary prior to a re-sale of the business in whole or in part. This can to an extent ameliorate a lock-up like period. To the extent possible an element of liquidity should be incorporated so as to attract co-investors more easily.

In determining the type, location and other particulars of an acquisition vehicle try and keep the vehicle as flexible as possible especially with the view to having international investors brought into the investor group. Ideally the vehicle should make it possible to make acquisitions on an international basis and bring in investors who may be based outside of the US. These concepts are fairly well established but given changes in relevant rules and regulations the choice of how to structure the vehicle may need to be modified accordingly.

I would like to add here that careful consideration will need to be made with regard to introducing new management and the concept around which the "new" enterprise will move forward. Inherent here will for example be the introduction of cost cutting programs, supply chain efficiencies, market share growth, new product development to name a few. The idea here is to build on what is being bought with a coherent and workable plan in place and to the extent possible ready to be implemented as soon as the new owners have control of the company. Think of this as a pure Private Equity play where improvement in the old business will be necessary to enhance everyone's investment over a relatively short period of time.

The difference here as alluded to above is that you are in control. You will have the authority to make decisions and information will in all cases be available to you on a real time, first hand basis, never filtered or delayed. These are proving to be real attractions for this sort of investing versus traditional alternative investments. Many families have had experiences over the past several years even when significant investments have been made they have found themselves sidelined when critical decisions are to be made. In addition to other advantages derived from direct investing this with some investors has become critical to its asset allocation decision.

It will probably be expedient for all concerned if an industry or group of companies is identified where ideally the investors can leverage experience gained either in a family's original business or newly gained expertise. To the extent downtime can be eliminated and a new strategy implemented the sooner the new investment should begin to pay off.

Execution

At this juncture with the decision having been made to proceed with the acquisition and with all of the major components as outlined above in place the parties are ready to execute. This is essentially a legal process but the day-to-day requirements of running a business will very quickly become evident.

Conclusion

I have tried to cover a broad range of issues in a short paper so please consider this effort at best a summary of the many issues and considerations which will need to be made.

A word of caution. The concept described herein is not for the faint hearted, inexperienced or those unwilling to work as hard as they ever have before to make the acquisition work.

The thesis presented here is best sustained if sufficient capital both of the human kind as well as the financial kind are readily available and in adequate supply. In determining whether to really do this consider carefully if the acquisition makes business sense and can be integrated into an asset allocation model-evaluating carefully the risk tolerance-whether a UAI or SFO is behind the acquisition. When I say the acquisition should be sustainable from a business prospective, think Private Equity because the original acquisition should be a preview of what the organization created for this acquisition is capable of. Whatever might be the nature of the acquisition through the introduction of new owners and at least to some extent new management the business is going to be put on a growth trajectory not seen under recent ownership or management. Look for ways to make the enterprise scalable.

The question of size will invariably arise. Size in terms of revenue, profit, EBIDTA as well as other benchmarks. Midsize companies will in most cases be the sweet spot. You should be looking at companies where revenue will be in the millions otherwise this type of investment may simply not be worth the effort. In the scheme of things if one is to invest considerable amounts of time and money one should anticipate sizable returns.

If the company isn't projected to show meaningful returns within a 3-5 year period consider carefully whether the deal is worthwhile doing.

On the positive side what a direct investment brings is an opportunity for a UAI or SFO to demonstrate in a fairly public way financial acumen, which it should possess without question. Also the investment being discussed will, as mentioned earlier, allow for control of the business entity.

Private Family Trust Companies

[Continued from Page 7]

tages include:

- Permanent trustee that can adapt to changing family dynamics over time;
- Consistency and continuity of a trustee that is knowledgeable about the family;
- Enhanced flexibility and control over decision making;
- Ability to participate in investment and asset management process;
- Increased liability protection for decision makers as compared to acting in an individual capacity;
- Better decision-making with respect to closely held and family owned assets;
- Greater control over trustee fees and costs;
- Enhanced privacy; and

- Ability to integrate the next generation in administration of the family enterprise.

Other Considerations

Some other things to consider when deciding whether to start or how to structure a PFTC include:

- The start-up and operational expense;
- Family tolerance for independent parties to participate with family members in the decision-making process;
- Intra-family privacy concerns (although these are usually addressed in the PFTC's operating structure and policies);
- Although the IRS has issued several Private Letter Rulings and Notices with regard to PFTC's, the IRS has not yet issued final guidance with respect to the formation and operation of a PFTC; and
- Consideration of the removal of existing trustees in order to move family trusts into the PFTC.

Conclusion

The PFTC has become a popular and useful vehicle to provide trust administration to ultra high net worth families. There are many issues to consider when deciding whether to create a PFTC, but once the decision to do so has been made, it is important that it be properly structured to avoid adverse tax and estate consequences. Once operational, the PFTC has proven to be an accepted and valuable alternative to an institutional bank.

FIG. 1

South Dakota PFTC - Sample Organization Structure

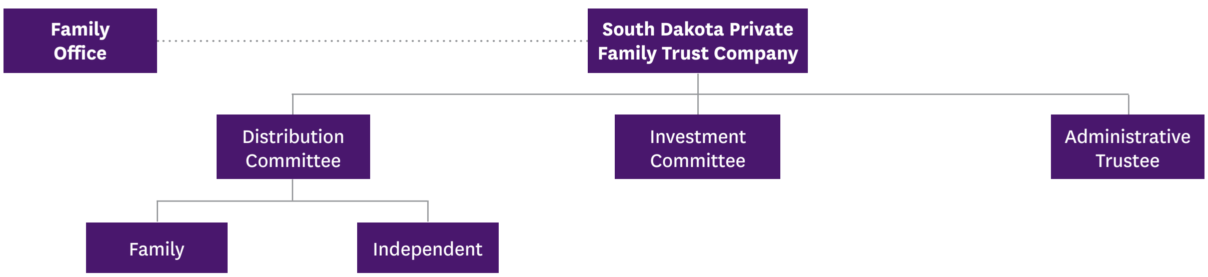


FIG. 2

Comparison of the Leading PFTC States

	New Hampshire	Nevada	South Dakota	Wyoming
Unregulated PFTC	No	Yes	No	Yes
Regulated PFTC	Yes	Maybe	Yes	Yes
PFTC Capital Requirement	$500,000	$300,000	$200,000	$500,000
Rule Against Perpetuity (RAP)**	Suspension of Rule Against Alienation (*Murphy* case)	Term of Years State (Not a *Murphy* case state)	Suspension of Rule Against Alienation (*Murphy* case)	Term of Years State (Not a *Murphy* case state)
Purpose Statute (i.e. Dynasty Trust Holds PFTC)	Yes	No	Yes	Yes
Directed Trust Statute	Yes	Yes	Yes	Yes
Trust Protector Statute	Yes	Yes	Yes	Yes
State Income Tax	5% Dividends & Interest	No	No	No
State Insurance Premium Tax	125 basis points	350 basis points	8 basis points	75 basis points
Self-Settled Statutes (Asset Protection)	Yes	Yes	Yes	Yes
Reformation/Modification Statutes	Yes	Yes (10/1/09)	Yes	Yes
Decanting Statute	Yes	Yes (10/1/09)	Yes	No
Privacy	Public	Public	Total Seal for Trust Matters	Public
Accredited State Banking Department***	No	No	Yes	Yes

*Alaska and Delaware are boutique trust states, but are not generally PFTC states. ***Conference of State Banking Supervisors (CSBS)*

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