In South Dakota, we trust

Thorough but business-friendly regulation has helped the state develop a niche in the growing market for trust companies

By RONALD A. WIRTZ
Editor

When it comes to money, there are many secrets. Maybe nowhere are they more present than in trusts, those ultra-private instruments used by people of means to leave a financial legacy for any variety of beneficiaries, from children to charitable causes.

Trust companies tend to charter in states with regulatory environments that are friendly to parties bequeathing substantial wealth. And on that measure, South Dakota is happy to see its secret getting out. For the better part of a decade, the state has seen a flurry of new charters for private and public trust companies. Though there are few solid measures of such matters, it appears that the state is a national leader—possibly top of the heap—in attracting such firms.

South Dakota has become a trust company magnet mostly because it has configured an attractive regulatory environment for trusts, one that emphasizes asset protection, privacy and other traits coveted by wealthy individuals. Though the state's geographic location is not ideal, neither is it a huge hindrance, as evidenced by the many new trust companies chartered in recent years. But while assets managed or otherwise administered by in-state trust companies have grown to eye-popping levels, the broader impact of this industry on the state economy has been quite modest.

Whom do you trust?

A trust, at its core, is a financial relationship in which one party (the trustor) gives assets to a separate person or organization (the trustee) to be held and managed for the benefit of a third party (the beneficiary). Trusts are created for many reasons: to provide future financial security to children and other family members, for charitable purposes, and for tax savings and improved wealth management.

The trust market is a bit of a data anomaly, despite the huge financial assets involved. Trust companies are regulated by a patchwork of federal and state agencies, and their information is not shared or aggregated at virtually any level. Finding something as innocuous as the number of new trust companies chartered nationwide every year is sheer guesswork unless a person has the time to contact every state (and no one has done it to date, at least publicly).

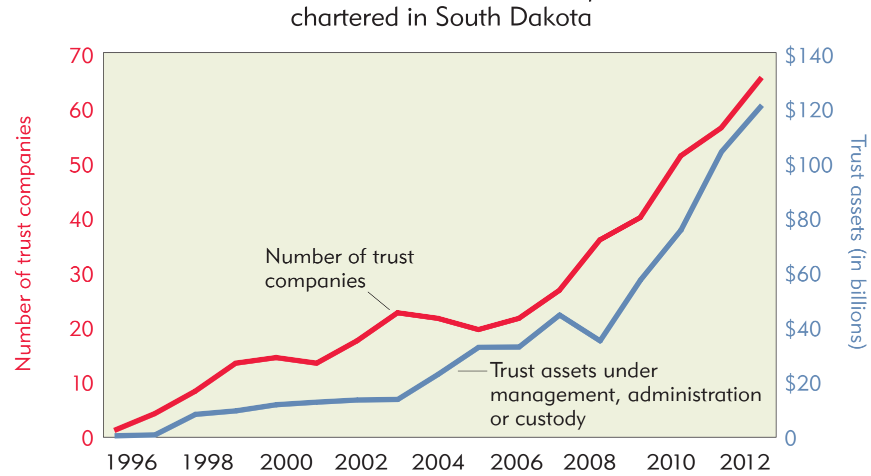
> Openness to trusts [in South Dakota] was kick-started in the second half of the 1990s, when a governor's trust task force began laying a regulatory foundation that was rigorous yet welcoming to trust companies. The task force was crucial in "creating a friendly environment for trusts." —*David Lust, Task Force Chair*

But industry sources widely view South Dakota as one of the best places to charter a trust company, and the state collects a fair amount of data on its homegrown industry. At the end of 2012, there were 65 trust companies chartered in South Dakota, virtually all of them authorized within the past 15 years. Maybe more intriguing is that total trust assets have grown to more than $120 billion (see chart).

South Dakota's trust business dwarfs that of most states. Minnesota, for example, has just three nonbank trust charters, and there have been no new charters since 2005. They have combined assets of a little over $7 billion, the large majority of it with Ameriprise, according to Patrick McLuen, chief bank examiner with the Minnesota Department of Commerce.

Trust busters

Number and assets of trust companies chartered in South Dakota



Source: South Dakota Division of Banking

Banks haven't exited the business, according to industry sources, but neither are they beating down the doors of this financial niche. Bank call data analyzed by the Federal Reserve Bank of Minneapolis show that about 15 South Dakota banks (about one in five) reported "income from fiduciary activities" (which includes trust services) in any year since 2001.

Curt Everson, executive director of the South Dakota Bankers Association, acknowledged that most banks in the state are not involved with trusts. But among larger banks that are, "I get the sense that trust operations are a significant and valued part of the bank's overall operations," he said.

But it used to be that "banks were the only [trust] game in town," said Pierce McDowell, co-founder and co-CEO of South Dakota Trust Co. of Sioux Falls. McDowell started Citibank's trust office back in the early 1990s, which drew clients from around the globe. During that time, "we were lucky to get 100 clients a year, and that was considered a good year." Today, South Dakota Trust is handling about 75 new clients every quarter, McDowell said.

Trust the driver

South Dakota's growth in this high-finance sector "is a combination of several factors, in addition to good old appreciation in the markets," said Bret Afdahl, director of the South Dakota Division of Banking. Some factors are fundamental, generating broad demand for trust business across the United States, like rising wealth, which has been well chronicled for its steep ascent over the past decade or more for those at the top.

Simple demographics also play a role, as the World War II (so-called greatest) generation and the fast-retiring baby boomer generation are increasingly making wealth transfer plans. "It's been described to me [as] the largest transfer

Suffice it to say, there are certain traits that the [trust] industry seeks for its clients, and South Dakota ranks high on many of these qualities.

South Dakota passed a state statute abolishing the [Common Law Rule Against Perpetuities], thereby allowing trusts to be established in perpetuity.

South Dakota is one of the few states without a corporate or personal income tax on investment earnings.

of wealth from one generation to the next in human history," said Afdahl.

High-net-worth individuals also have been investigating trust options more aggressively given the uncertainty surrounding the estate and gift tax exemptions and the year-end federal fiscal cliff that garnered so much national attention. Afdahl said that trust assets under management "jumped quite a bit as there was a rush to establish and fund new trusts at the end of the year."

McDowell, from South Dakota Trust Co., believes that his client base was possibly inflated by fears of change to the $5 million estate tax exemption. It was set to expire at the end of last year but was ultimately extended and indexed to inflation by Congress, with the highest estate tax rate raised to 40 percent (from 35 percent, though lower than the 55 percent rate that would have otherwise kicked in).

But the industry had been growing briskly before any talk of fiscal cliffs. In fact, trust company charters and assets increased steeply during the recession—despite huge losses in financial markets—because wealthy individuals exited equity markets in search of longer-term financial security.

For these myriad reasons, the trust industry is not particularly beholden to the ups and downs of the economy. "There is wealth transmission all the time regardless of whether the economy is booming or in recession," said David Lust, a partner at the law firm of Gunderson, Palmer, Nelson and Ashmore.

Why trust anywhere else?

South Dakota's large share of this growing market is the product of trust-friendly state law and regulation, part of a pattern of widely recognized friendliness to business. Openness to trusts was kick-started in the second half of the 1990s, when a governor's trust task force began laying a regulatory foundation that was rigorous yet welcoming to trust companies, according to state and industry sources.

Lust, the current chair of the trust task force, said that the task force was crucial in "creating a friendly environment for trusts." Afdahl agreed, noting that the task force continues to tweak regulations, and that its importance "cannot be overstated in all of this [trust growth]. ... Every year, we go through and analyze what other states are doing and what we can do better" to remain an attractive location for those considering trusts and trust companies.

"We're always looking for subtle differences," Afdahl added. Without this group meeting every year to make incremental changes to South Dakota trust law, "we would be where most other states are currently at—behind the curve of a fast-moving landscape."

The specific structure of that regulatory environment is hard to describe without getting bogged down in the tedious and often arcane demands of wealth management and related government regulation. Suffice it to say, there are certain traits that the industry seeks for its clients, and South Dakota ranks high on many of these qualities.

According to Afdahl, "It really is a laundry list of things … [but] it all starts with the Common Law Rule Against Perpetuities," which tries to limit the duration of trusts to about 100 years. South Dakota passed a state statute abolishing the rule, thereby allowing trusts to be established in perpetuity. "Many states have not repealed this common law principle and are therefore not even considered for the dynasty trust business," which helps families manage multigenerational wealth.

Not surprisingly, the wealthy tend to pay attention to taxes, and South Dakota is one of the few states without a corporate or personal income tax and no tax on investment earnings. Life insurance is also common in trusts, and the state imposes the lowest life insurance premium tax in the country, according to industry sources.

Confidentiality is also critical to trust clients. "Privacy is a big deal. … Our confidentiality laws are very strong, and this is a very important factor for most ultra-high-net-worth families," said Afdahl. South Dakota is the only state in the country with a "total seal forever" law, which means that all records in any lawsuit are permanently sealed. (Delaware is next best with a three-year seal.)

Startup capital costs are also low in South Dakota. Afdahl said that many states "view trust companies through the bank lens and require $1 [million] to $2 million in capital, which is very difficult for a startup company." In contrast, South Dakota requires just $200,000 for private trust companies, "and we are at or near the lowest minimum."

Trust our soundness

But trust friendliness should not be confused with deregulation or riskiness, according to Afdahl, Lust and other industry sources. For example, like banks, trust companies pay annual fees to the state to support examiners (currently five) who analyze trust companies for financial soundness.

"It's a matter of balancing the ability of new companies to form versus the costs of failure," Afdahl said. "As I tell the Legislature every year … we are taking on some degree of risk with every [trust] company that we charter." That risk might entail the cost of closing down a trust company and the associated harm to the state's reputation. Since 1996, only one trust firm in the state has failed—a public trust company that went under in 2003 and "was somewhat complicated to resolve, but mostly just very slow moving." The matter was finally resolved just last year, Afdahl said.

But the nature and consequence of risk is "fundamentally different" for a trust company than for a bank, Afdahl pointed out. The assets that are managed or administered by a trust company "are not on the balance sheet of the trust company like loans are on a bank's balance sheet." The trust company itself is independent of the assets, so the financial health of a trust company is not tied directly to market fluctuations. If the asset value of a trust goes down, it's the trust beneficiaries who suffer. The trust company "will have explaining to do, and may lose some business" in terms of client fees, Afdahl said, but the trust client absorbs the market loss.

The trust market has also been evolving, with new types of trust companies often offering specific, scaled-back services rather than the full service (including asset investment) that has been traditionally common. As a result, South Dakota has seen a spurt of public trust companies offering administrative and custodial services (see sidebar on page 14 for more discussion), and state regulators have adjusted accordingly, Afdahl said. Because public and private trusts are fundamentally different, "we are now asking more of our public companies [in terms of regulations] and are charging them more in supervision fees."

This past fall, Afdahl said, the state finalized new regulations and capital requirements for public trust companies. "While representatives of the public trust companies weren't necessarily happy about the new, tougher regs, they did understand the division's rationale and did actually testify in support of the new rules."

Location, location, location?

Despite the gargantuan pile of assets now being managed or administered by trust companies in South Dakota, their growing number has made only a modest economic impact in the state.

Many new (typically public) trust companies do not directly handle asset investment and management services; these tasks are often performed by firms and advisers that already have a relationship with the client before the creation of the trust. Even for in-state trust companies that do manage investments, trust assets are not lent to businesses and households, which means that the concentration of trust businesses in the state doesn't have near the financial spillover as banks and other financial institutions with similar capital.

Afdahl estimated trust company em-

Continued on page 14

Trusts from page 13

> "We're a little more sophisticated than people give us credit for."
> —*Pierce McDowell*
> *South Dakota Trust Co.*

ployment at not even 100. That's not a lot, even in a small state like South Dakota. But trust company employment has grown 80 percent since 2009. Trust companies also contract for attorneys, accountants, marketing firms and other labor, rather than putting them on payroll. Much of the work related to trusts—whether by a trust company or contract labor—tends to be highly skilled and well compensated. In a place like Sioux Falls, home to more than 50 trust companies, the cumulative effects on employment and business vitality can be considerable. Similarly, there are nine trust firms in Pierre, a city of just 13,000, which gives this small city a little financial cachet.

One might think that being in the middle of flyover county far from the affluent coasts would be a huge hurdle for new trust firms. McDowell, from South Dakota Trust Co., acknowledged that "it takes a lot of work to spread the word" that South Dakota is the locus of smart-money trusts. "I go into board rooms today, and there are a lot of people that are still provincial" in their decisions about where to go for trust services. "You kind of accept it and move on."

In the past, if you mentioned South Dakota, "you'd get laughed out of the board room," McDowell said. "But quietly, we're making great inroads. If someone is achieving success, someone else is going to see it. We're a little more sophisticated than people give us credit for."

Lust agreed that not being close to either coast "is somewhat of a barrier. … You're a long, long way away" from big client pools and many of the financial firms that ultimately manage trust assets. But wealthy individuals "depend on their experts" to tell them where to do business, and that's why South Dakota can compete with other trust-friendly states like Delaware and Nevada, according to Lust.

Given that location is not an insurmountable obstacle, the surprising part might be that other states are not competing for this business. "It's probably a function of [state] culture" and the environment that state lawmakers choose to create for any type of business, said Lust. The best places for trusts and businesses in general, he said, "are usually one and the same." f

Money, and more money: Public and private trusts

South Dakota sees a strong increase in public trust companies that provide noninvestment services

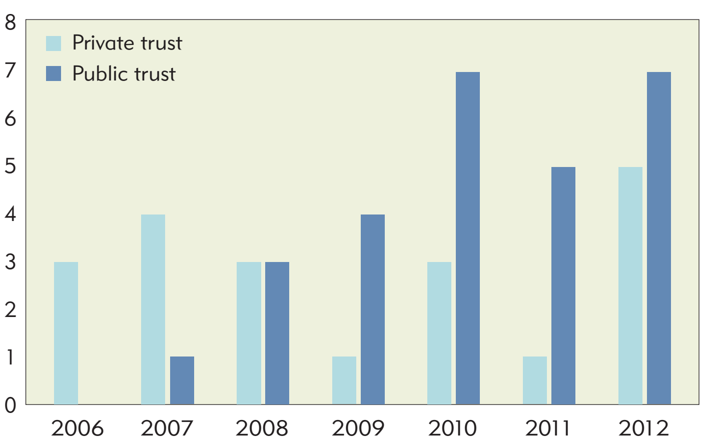
Strong privacy rights for trusts and trust companies make it difficult to deduce much from the robust growth in these firms in South Dakota. But one notable trend surfaces from their mere registry with the state: In recent years, there has been a notable increase in public trust firms.

Trust companies come in two basic forms: public and private. In a nutshell, private trust companies are family-based and have been the core of trust business until fairly recently. They are limited to a single family lineage, but often include multiple generations. A private trust company does not act for unrelated families or accept outside business. In general, these companies are not required to provide as much regulatory capital as public companies and do not have to establish the same in-state presence so long as the trust company allows state trust regulators to conduct efficient examinations.

The circumstances surrounding the creation of a private trust are many, and they are often unique to the family. In terms of the wealth required—well, as the saying goes, if you have to ask how much money you need, you don't have enough.

"The general rule of thumb I have heard several times is that a family needs $200 [million] to $250 million in assets to make a [private] trust company worthwhile from a cost perspective," said Bret Afdahl, director of the South Dakota Division of Banking. "Having said that, we do have families with less assets that chose to establish their own [private] trust company for other reasons," many of which are specific to South Dakota's regulatory environment for trusts (see main article).

A public trust company, in contrast, resembles a traditional bank trust department in some ways; it solicits and accepts new accounts from unrelated families or individuals who typically have much less wealth. Think of it as the retail trust business.



Public vs. private trust companies
Annual new registrations

Source: South Dakota Division of Banking

Public trust charters have increased dramatically since 2007 (see chart) and now represent 60 percent of all trust companies in South Dakota. But rather than replacing private trusts (which have continued growing), public trust companies appear to be carving an entirely new niche.

Many of these public trust companies are serving people interested in self-directed independent retirement accounts, according to Afdahl. These financial vehicles allow an individual to make his or her own investment choices for a retirement plan. However, the Internal Revenue Service requires that a qualified trustee or custodian hold the IRA assets on behalf of the IRA owner.

Enter public trust companies, many of which are playing administrative and custodial roles for individual trusts and do not invest or otherwise manage trust assets. "We have had a lot of interest from groups interested in doing [this] work," Afdahl said.

He added that self-directed IRAs also allow individuals to invest in nontraditional assets such as real estate, precious metals, business ownership and other assets that cannot be held in traditional retirement accounts and have become more common since the financial crash in 2008.

This custodial role distinguishes independent, public trust companies from many bank trust departments, which typically manage assets and offer a full slate of other services. "They [banks] want to manage assets. They don't want nonmoney assets," according to Pierce McDowell, co-CEO of South Dakota Trust Co., a public trust company in Sioux Falls that provides administrative trust services. The firm administers more than $9 billion in assets, but it does not invest or otherwise manage those assets. "In our world, I don't see a lot of banks competing with us."

And it might be hard to imagine, but Afdahl said—and the South Dakota market is showing—that new public trust companies are serving a previously neglected class of customers a cut below the uber-wealthy.

"We consistently hear from applicant groups that the larger institutions do not provide the same level of customer service to people in certain net worth categories," said Afdahl. Big trust companies and banks "want the ultra-high-net-worth customers, but do not show as much interest in or provide the same level of customer service to those below the very upper crust. This has provided an opportunity for smaller companies" to pursue clients in different markets nationwide from their headquarters in South Dakota.

—*Ronald A. Wirtz*