The Private Client Yearbook 2013

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Family offices

Rosalyn Breedy outlines the preferred entity for the super-rich

A 'family office' is essentially a private investment facility, although it can also include concierge services, family business administration, and management of philanthropic and other personal interests such as art collecting.

A 'single family office' looks after the wealth and affairs of one individual and their family, whilst a 'multi-family office' serves more than one family.

Some single family offices become multi-family offices when it makes sense to collaborate and share resources with other family offices. Some will then make their offering available commercially.

Note that the term 'multi-family office' is also used by groups of advisers and private banks offering ultra-high net worth individuals wealth management services.

To fully meet their needs, an adviser needs to take time to understand the role, function, antecedents, stage of development and strategy of a family office. They will also need to identify the laws in various jurisdictions that may be applicable now, and potentially in the future.

Objectives

Family offices may present themselves in a number of ways, having developed from differing antecedents. However, their main functions are:

- asset protection – implementing a robust structure to protect from challenge, and wealth preservation through effective investment management i.e. strategic asset allocation, implementation, risk and tactical management which may be performed in-house or outsourced; and
- the management of wealth transfer – especially important at a time when post-World War II entrepreneurs look towards retirement and require estate planning and succession advice. This is expected to affect almost 700,000 companies in the EU.

Family offices are also being set up by serial entrepreneurs who, having listed their main business, wish to invest and grow their cash receipts further. These first generation entrepreneurs typically hire specialist investment teams and value control in addition to gaining privacy and freedom of action. Stewardship is less of a pressing concern but will become so over time alongside the transfer of wealth.

Cost benefit analysis

The management of the protection and transfer of substantive wealth is complex, requiring a dedicated team to do so effectively. When setting up a new family office, it is important to assess whether the family's wealth is sufficient and the affairs are complex enough to warrant the costs of setting up and maintaining a family office.

A family office can be difficult to manage effectively and if not done correctly it can add to the burdens of the family. For example, problems arise where risk is not managed appropriately or where family capital is reduced by taking on high running costs for little benefit.

The founding family members also need to understand the level of commitment and capital that would be required from them on an on-going basis to make it work.

Choice of family office

Very large families with assets worth over £1bn are likely to set up their own single family office for reasons of control, autonomy and privacy. It is unlikely that their needs will be completely met by a third party provider.

Families worth £250m or less are likely to become clients of a multi-family office; although a single family office, with a primary objective of private investment, could just be minimally viable for a family with assets of £100m.

For assets around the £100m, a reduced version can be provided but buying power is reduced and the costs ratio may be less favourable than as a client of a private wealth manager or a multi-family office.

A multi-family office only gains traction with a minimum of £1bn under management.

An administrative family office, which does not major on providing investment capability, may be useful to business owners who have not yet liquidated their main company. This may provide a vehicle with scope to develop as the family evolves from business owners to investment company.

Setting up a family office

Defining the specific objectives of the family office is a vital first step to ensure stable foundations and a structure to properly meet the family's needs.

Questions that need to be asked range from the factual personal information regarding residence, domicile, age, marital status, dependents, occupations, assets (location, value, type) to more aspirational questions regarding values, attitude to risk, goals, culture and wants.

This may need to be done with multiple stakeholders, as the objective is to create a family office that meets the needs of the family now and in the future.

A process is required to manage inevitable inconsistencies and trade-offs. For example, if the primary goals of the family are to preserve wealth for future generations then this means they will need to sacrifice a certain degree of growth as, by definition, they require lower investment risk. In this current economic environment of low growth and high taxation, they may have to reduce their current consumption. In consequence, they may be more likely to outsource their investment process to a wealth manager who can deliver on their objectives, as opposed to hiring an investment team. Conversely, they may spend more on professional advice to reduce fiscal drag.

Structuring the family office

Structuring a family office is critical, and when done well can deliver value to the family for decades. Done inexpertly, it can tie the family up in knots.

In developing a structure for a family, an architecture must be designed which encompasses the family's reasonably foreseeable needs. The office should be built in a modular fashion, so that it can be unbundled when required. No-one can

foresee every eventuality, and flexibility is in itself a valuable characteristic.

The effective lawyer will use a wide range of legal vehicles across relevant jurisdictions, including trusts, foundations, companies, partnerships (limited liability, family limited, general/limited), funds (authorised and unauthorised) and contracts. A key strategic decision will be to consider whether the investment management entity needs to be authorised.

It is a common misconception that family office structuring is all about tax planning. Whilst it is important to ensure that a family office structure is tax-efficient, planning opportunities in developed economies relate principally to reducing the production of income unless needed, looking more for capital gains, gifting to the next generation in a planned manner and using entrepreneurial reliefs.

Choice of jurisdictions for a family office structure will be linked to its structuring objectives and the location or domicile of family members.

There are three basic building blocks to consider when deciding on the structure of a family office: protection, management and legacy.

Protection

The two biggest risks to a family's capital are divorce and being sued by creditors. In some countries, wealthy families may risk potential expropriation of assets. It is important for the lawyer to address these risks and put in place lawful asset protection structures such as trusts and foundations and requirements for beneficiaries to obtain pre-nuptial agreements.

Management

It is necessary to understand and comply with laws relating to anti-money laundering, bribery and tax avoidance. There will be fiscal and regulatory compliance burdens on families and the structure should not be overly complicated for little commensurate benefit. Planning is needed to ensure that a structure will be well managed, which impacts the resources required, roles and responsibilities.

Legacy

A key question is 'what does the family want to be known and remembered for?' This will affect the charitable giving strategy and whether a philanthropic foundation is needed. It affects the culture of the family office: how staff and advisers are treated; reputation management; next generation education; business investments and acquisition of chattels. The issue of legacy raises important questions. Should the current generation spend, give away the family capital or act as stewards for future generations? The answer will affect the investment strategy, whether or not family members are expected to work and the aims and objectives of the family office.

Resourcing the family office

The resources required by a family office depend on the range of activities and the extent those activities are handled in-house or outsourced.

Where the key activity is to act as a private investment office, the following resources will typically be needed:

Investment

A Chief Investment Officer (CIO) will develop and implement an asset allocation strategy, having also day-to-day tactical management and reporting responsibilities.

The CIO will need investment analysts to research individual asset classes and support the CIO in choosing opportunities, managers and funds to implement the strategy. The investment team will need system support for research, trading and risk analytics.

Accounts will need to be set up with custodians, trading platforms and reporting processes put in place.

Risk management

Legal support is needed post-structuring to evaluate whether or not financial services authorisation is required, and if so to undertake that process. They will identify the legal, regulatory and fiscal obligations of the family office, manage and ensure compliance.

The lawyer will advise on corporate, commercial and financial services matters such as buying and selling companies, reviewing custody, collateral, brokerage, administration, investment management and investment opportunity agreements, and fund documents.

Appropriate employment contracts, compliance policies and processes for hiring, retaining, rewarding and exiting staff will be required.

A legal adviser will also be required in the event of any events requiring proactive risk and reputation management, such as crisis management.

Financial reporting

A qualified accountant is often retained to oversee and validate the financial reporting process and tax compliance.

Administration

The organisation of investment committee meetings, managing the philanthropic foundation or charitable giving, corporate filings and relations with the family clients need to be administered and co-ordinated.

The key challenge surrounding resources is the acquisition and retention of talent.

Proven high performers will have concerns about the impact on their career and remuneration, and they may find certain family office environments less stimulating than they would wish. Families who value privacy also sometimes prevent their employees from making the contacts they need to help the family and to keep the staff engaged.

Families need to be careful to ensure remuneration arrangements do not conflict with their stated aims. For example, rewarding an investment team on a high-return performance will not drive the behaviour required to provide a carefully managed wealth preservation strategy with low volatility.

UK law and regulation

Financial Services Authority authorisation

Currently, under section 19 the Financial Services and Markets Act 2000 (FSMA) any person who carries on a regulated activity in the UK must be authorised by the FSA or exempt as an Appointed Representative or under some other exemption. Breach of section 19 FSMA may be a criminal offence and punishable on indictment by a maximum term of two years imprisonment and a fine.

The family office will need specialist advice on whether it is carrying on its activities by 'way of business' and whether any 'regulated activities' in relation to 'specified investments' are being carried out – and, if that is the case, whether any exemptions apply.

Section 21 FSMA provides that an unauthorised person may not communicate

a financial promotion in the UK, in the course of business, unless either its contents are approved for the purposes of section 21 by an authorised person or it is subject to an exemption under the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005. The family office will need advice if it is engaged in making 'financial promotions', i.e. an invitation or inducement to engage in 'investment activity' as defined in section 21(8) FSMA. This may occur if they decided to promote investment opportunities.

Family offices with activities in the UK may benefit from becoming FSA authorised in a number of often unanticipated ways:

- it widens the investment opportunities available as they become categorised as a 'professional investor' and investment banks will be able to offer them institutional offerings simply, albeit no longer with retail protection;
- when investing abroad, most jurisdictions will be happy to accept the FSA authorisation number and do not seek to look behind the ownership structure unless it is a fiscal enquiry;
- complying with FSA rules and the FSA handbook ensures a rigour to investment management and risk management processes and forces provision for capital adequacy; and
- if plans include eventually becoming a multi-family office it is essential to consider authorisation at an early stage before the culture and processes of the family office are set.

The process of applying for FSA authorisation requires the family office to consider strategy, risk management, contingency planning, capital adequacy, rules relating to anti-money laundering, insider dealing, market abuse, the Bribery Act, data protection, conflicts, reporting, roles and responsibilities.

An application pack for the entity and the persons required to carry out approved functions will need to be completed. The process of approval for a correctly completed application may take up to six months but the FSA seeks to adhere to a voluntary performance standard to process 75% correctly completed applications within 12 weeks. Once authorised there are on-going compliance and reporting responsibilities.

A lawyer is required who understands the application of FSMA and its associated regulatory orders, the FSA General Principles and regulatory processes and the relevant FSA handbooks for prudential requirements and conduct of business.

During 2013, there will be a separation of prudential regulation from conduct regulation, both currently carried out by the FSA, moving the Prudential Regulation Authority and the Financial Conduct Authority. This will necessitate changes to the current rules and approach.

Other areas of UK law

In addition, family offices require assistance with a range of UK legal issues:

- Family law for pre-nuptial agreements, divorce and custody issues
- Immigration law for movement of family members
- Tax advice and estate planning
- Corporate, commercial and funds law for the acquisition and sale of businesses and the creation of private fund structures and/or investor protection review
- Reputation management, privacy and defamation
- Dispute resolution, litigation and international arbitration
- Commercial and residential property
- Criminal (occasional!)

International law and regulation

The cross-border nature of the vast majority of family offices also requires awareness of foreign law and regulatory issues. Family members may move across jurisdictions and many asset protection and private fund structures cross jurisdictions.

The key principles of foreign law to consider include:

- the application of financial services regulation;
- 'forced heirship' provisions affecting wills;
- laws applicable to situs of assets;
- whether the integrity of a trust or entity will be upheld;
- rules relating to fiduciary duties;
- asset tracing; and
- enforcement of injunctions and judgements.

EU regulation

The Alternative Investment Fund Management Directive (AIFMD) came into force in July 2011 and must be transposed by all Member States by 22 July 2013. Many of the provisions at Level 1 of the directive require clarification and a significant amount of detail is to be defined at Level 2 through subordinate measures. Provisions need to be reviewed on an ongoing basis.

The stated objective of the European Commission is to create a comprehensive and effective pan-European regulatory and supervisory framework for alternative investment fund managers following the 2008 financial crisis. The Commission wants to enable Member States to provide effective macro prudential oversight of the sector and to take co-ordinated action as necessary to ensure the proper functioning of financial markets and to help overcome gaps and inconsistencies between national regulatory frameworks.

Managers of alternative investment funds who are established in the EU – other than UCITS (EU authorised investment funds) – will require authorisation.

Managers outside the EU can still market funds within the EU pursuant to individual country private placement regimes. After 2015, third country regulators of those non-EU managers will need to put in place co-operation arrangements with EU regulators to monitor systemic risk.

There is a recital in the AIFMD which explicitly excludes 'family office vehicles which invest the private wealth of investors *without* raising external capital' from the definition of alternative investment manager caught by the directive. However, multi-family office clients or single family office clients who co-invest may inadvertently be caught if they do not fall into the de minimis exemption – where a manager must manage alternative investment funds with a cumulative value of less than EUR 100m, or EUR 500m if the alternative investment funds are unleveraged and subject to a minimum five-year lock-in period.

US regulation

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is the US response to the 2008 financial crisis and affects the regulation of financial activity and financial conduct by domestic and international participants in US financial markets.

Previously, many family offices relied upon a generous exemption within the Investment Advisers Act to avoid

registration with the Securities and Exchange Commission (SEC). This exemption was repealed in 2011 and new rules provide for a family office exception with a very tight definition of 'family office' for offices which do not hold themselves out to the public as investment advisers, advise only family clients and are wholly owned by 'family clients' and exclusively controlled by family members or family entities.

Multi-family offices providing investment advice for remuneration who do not fit within that exception now need to fit themselves within a narrow 'foreign private adviser' exemption by meeting all of the following criteria:

- no place of business in the US;
- in total, has fewer than 15 advisory clients and investors in the US in private funds advised by the investment adviser;
- has less than $25m in assets under management attributable to clients in the US and investors in the US in private funds advised by the investment adviser (or such higher number as advised by the SEC); and
- does not hold itself generally out to the public in the US as an investment adviser or advises a business development company or an SEC registered investment company.

Holistic approach

Family offices require highly tailored solutions to meet their personal, business, financial and philanthropic goals and a holistic approach is required. The range of professional support required varies over the lifecycle of the office and the cross-border nature of activities creates a series of legal and regulatory challenges that affect family offices in an ever-changing political, economic, regulatory and fiscal environment. ■

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