TFOA

Texas Family Office Association, LLC

SERVING THE SINGLE FAMILY OFFICE COMMUNITY SINCE 2007

Some Thoughts on Single Family Office Risk Management

Marc J. Sharpe

While most SFOs are founded to provide investment and concierge services for the family, perhaps the most important role of the SFO is to monitor and manage risk. With all investments and related activities managed by a single team, the SFO is in a better position than any individual family member, advisor, or external service provider to measure risk systematically and ensure SFO assets are protected. While a comprehensive risk-analysis discussion is beyond the scope of this whitepaper, a well-run SFO should be, at least, focused on the following risks a family may face:

➢ Reporting Risk

SFOs tend to manage many, complex private entities within a broad portfolio of private and public investments, all of which report their individual performance at different times and in different formats. As a result, generating timely, accurate and comprehensive investment performance reports is one of the most difficult challenges for most SFOs. When a family considers creating an SFO, it should plan to allocate a significant portion of the annual budget to consolidated investment performance reporting related expenses. At the very least, a consolidated P&L and balance sheet should be generated and available to the team responsible for managing and oversight of the family office. SFOs that under invest in developing their reporting capability often find themselves trying to make decisions with inaccurate, outdated information.

- **Accounting and Tax Reporting**

Most SFOs manage tax reporting and estimated payments for family members, who will have local, state, and federal tax filing obligations and may need to file in multiple jurisdictions. With complex holding structures, incorporating multiple pass through entities and grantor trusts, the task of com- plying with tax reporting obligations can become very difficult. The risk is significant: failure to file accurate tax reports and make timely payments can subject the client to audit, interest, and penalties. In addition to working with in-house and outside tax counsel, to ensure timely filing and payments, the SFO will need to stay ahead of tax law changes and new filing requirements.

- **Estate Planning**

Most SFOs play an important role in helping families put in place effective tax planning, and ensuring the plan is properly implemented. As with accounting and tax reporting, the prevalence of complex investment and wealth holding structures can lead to highly complex estate planning structures. The SFO will generally be responsible for coordinating with counsel on the development of estate- and gift-planning strategies and updating the plan as circumstances and assets change. SFO clients often include one or more multigenerational trusts created by prior generation family members, and the SFO is typically responsible for handling much of the administrative work for existing and new trusts, including maintaining accurate books and records, producing detailed accounts, and handling tax reporting and compliance. If the trustee of the trusts is a Private Trust Company (PTC), the SFO will typically manage administrative and investment functions for the PTC.

- **Investment Risk**

In addition to direct investments in equities, fixed income and other securities, SFOs typically invest a substantial portion of the family's wealth in mutual funds, hedge funds and private equity funds, in an effort to diversify the portfolio and boost alpha-related returns. Fund investments deserve careful due diligence before capital is committed and regular oversight reviews for as long as the investment is in place. Investing in funds can bring a variety of risks that need to be monitored by the SFO and its advisory team:

1. Funds may exhibit 'style creep' as managers venture into new markets to enhance returns.

2. Successful funds may become too large to function optimally in a given market, hurting returns.

3. Funds can be a way to diversify a SFO portfolio or provide expertise in a specific area of interest. However, this diversification benefit can backfire when multiple fund managers are investing in the same security or sector. It can be difficult to monitor such concentrations due to lack of transparency at the fund level.

4. Offshore funds may offer even less transparency than U.S. funds, and may create expensive tax reporting obligations.

5. Particularly in times of extreme market volatility, redemption limitations or 'gates' can impair the SFO's ability to generate liquidity.

6. The potential for fraud exists in any investment. Fund structures provide a level of opacity that makes them particularly susceptible. As a number of well know frauds have illustrated, regulatory oversight of funds is extremely limited.

- **Asset Protection and Reputation Management**

A major creditor claim - whether from a divorcing spouse, an injury occurring on family property, or con- sequences of a car accident - can be a significant threat to a wealthy family. How a given asset is titled, held, and insured can be critical to managing such threats successfully. The SFO generally will be responsible for managing asset protection strategies and for implementing multiple strategies (such as limited liability holding structures, insurance, indemnification agreements) where circumstances warrant a layered approach. SFOs for celebrities and prominent families should develop detailed risk-management plans that lay out procedures for family and staff to follow in the event of an incident or emergency.

Such plans are particularly important for families that travel abroad frequently or maintain a high public profile. With the rising use social networking sites by family members, many SFOs are also developing reputation-management protocols to reduce the risk of identity theft, kidnapping, extortion, or harassment of family members.

- **Background Checking & Monitoring**

One of the biggest risks to a wealthy family is a theft or other crime perpetrated by a member of the family's inner circle of staff, advisors, and service providers. Most SFOs undertake detailed background checks of potential hires, and many do extensive vetting of advisors and service providers as well. Appropriate monitoring of the SFOs staff and external advisors should be an ongoing activity, not simply a one-time event at the time of hire.

Marc J. Sharpe is the founder and Chairman of TFOA, an organization formed in 2007 to provide a forum for education and networking and to serve as a resource for single family office principals and professionals to share ideas and best practices, pool buying power, leverage talent and conduct due diligence. Mr. Sharpe is active in the community and has served on the Board of the Holocaust Museum Houston, the HBS Houston Angels, and on the Investment Committee for two Texas based foundations. Contact: Marc Sharpe