

Are your ducks in a row?

Steps Family Offices may consider making to institutionalize practices

The recent regulatory reform bill—the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”)—was established to promote the financial stability of the United States by improving accountability and transparency in the financial system. Even though the Dodd-Frank Act includes an exception from the definition of “investment adviser” under the Investment Adviser’s Act of 1940 for “family offices,” the bill has prompted many family office executives to review their business practices. This may be a good opportunity for you to reflect on operational and procedural improvements you may consider making to enable your office to act in a more disciplined manner.

Please note that the term “family office” is in the process of being defined by the SEC; the Dodd-Frank Act indicates that the SEC should do so consistent with previous exemptive orders for family offices. This is something that should continue to be monitored closely.

Fidelity Family Office Services’ clients whose offices are registered investment advisors (RIAs) with the SEC have indicated that the infrastructure they were required to implement as an RIA forced them to act institutionally—ultimately benefiting their family members. Angus West of Cabot-Wellington, LLC,¹ a registered family office, believes there are many benefits to institutionalizing his practices. “RIA ‘institutional’ practices do come with substantial costs, but the benefit of those practices may outweigh the costs, depending on the family situation,” says West. He adds, “Bearing those costs up front might be analogous to buying insurance against future hazards.”

Following are some examples of steps the SEC requires of RIAs that may assist in the process of institutionalizing a nonregistered office:

Business plans and client agreements. As part of Form ADV and in client agreements, RIAs have to articulate a clear business strategy and a list of the services to be offered. Although many offices may feel they have an understanding with family members of what is expected of them, a review in writing of these assumptions can help solidify expectations. In addition, a well-defined strategy can make it easier for the family office to evaluate performance at year-end.

Here are some key questions to consider:

- Has the office created an overarching mission statement?
- Is there an investment policy statement for each client?
- Have all services to be delivered been clearly defined?
- What work will be done in house, get outsourced, or a combination of the two—and what are the roles of the respective parties?

Written documentation on the investment strategy and a list of services provided helps to define the work involved for the family office staff and the resources needed to accomplish that work. It also helps executives and family members prioritize services when additional service requests are made.

Another key part of the client agreement is the fees or expenses to be charged for the services rendered. What are the fees and how will they be charged to family members?

Policies and procedures. RIAs are required to adopt and implement certain written compliance policies and procedures and to review them annually. These procedures are to be reasonably designed to prevent violations from occurring, identify any gaps, and correct any violations promptly.

In developing these policies, you should first identify conflicts and other compliance factors that may create risk exposure for your office and your family members. Then you can design procedures that help address those risks.

The SEC expects that an advisor's policies and procedures, at a minimum, should address issues such as:

- Portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the advisor, and regulatory restrictions
- Trading practices, including best-execution obligations, the use of client brokerage to obtain research and other services (soft dollar arrangements), and allocating aggregated trades among clients
- The accuracy of disclosures made to investors, clients, and regulators, including account statements
- Safeguarding of client assets from inappropriate use by any personnel
- The accurate creation and maintenance of required records such as employee trading activity

- The process for valuing client holdings and assessing fees based on those valuations
- Safeguards for the privacy protection of client records and information
- Business continuity plans

Code of ethics. The Investment Advisers Act of 1940 requires RIAs to adopt and implement a code of ethics that sets forth a standard of business conduct that the advisor demands of all its supervised persons. At a minimum, the advisor's code of ethics should include the following provisions:

- Require the reporting and reviewing of personal securities transactions and holdings periodically
- Require supervised persons to report any violations of your code of ethics promptly
- Require that each of the supervised persons receive a copy of the code of ethics and any amendments
- Require that each of the supervised persons provide a written acknowledgment of receipt of the code of ethics

Background checks on employees. While many family office employees have been employed for years by the family and have gained a great deal of trust, family offices may want to consider conducting background checks on employees who have access to client assets. Background checks may help uncover any bankruptcy filings, lawsuits, convictions, and other potential findings the family office principals may want to review further. It is another measure to help instill confidence in the family members that there has been appropriate due diligence in the family office.

External audit. A typical RIA may be examined by the SEC every three to five years, depending on the risk profile of the RIA. In order to assist with preparing for these exams, some firms may consider an external audit of their office. Although family offices that are not RIAs may not need to prepare for an SEC exam, it may be a good practice to have a third-party firm review business policies and practices. It is a good way for family office principals to obtain objective guidance on how to improve policies, or confirm existing practices.

Amid the regulatory uncertainty over the past several months, David Guin from Withers Bergman² outlined another smart practice for offices to take in a recent update for Fidelity clients. Although not required by the SEC, Guin recommended taking an inventory of all entities and individuals in the family office structure. He advised that such an audit would serve multiple purposes.

“First, because most family office structures grow organically over the years in reaction to specific situations, it is good practice to undertake a holistic review on a periodic basis. This will help to insure that the overall structure is effective and efficient, from estate planning, tax, and operational perspectives, in serving the family’s goals,” said Guin.

“Second, understanding who is participating in the structure and the role of each individual and entity could prove critical in determining whether the family office will satisfy the definition eventually adopted by the SEC.”

Guin also advised that family offices consider formally documenting responsibilities so that they are not subject to future characterization by regulators in a manner adverse to the family office.

Conclusion. The SEC rules require much more from RIAs than what is outlined here. This paper is intended to provide some thoughts for consideration. The regulatory landscape continues to change, reminding us of how important it is to examine our businesses and the controls and procedures that are in place. Whether SEC registration is required or not in the future, now is the time to reflect on your business practices. As always, each family office’s situation will vary and legal and compliance professionals should be consulted in order to assess your needs.

For more information, please contact your relationship manager, call **866.273.2130**, or visit **Familyoffice.fidelity.com**.



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¹Angus West was interviewed and agreed to be quoted for this article on September 8, 2010. Cabot-Wellington, LLC, is an independent organization and is not affiliated with Fidelity Investments.

²David Guin was interviewed and agreed to be quoted for this article on August 23, 2010. Withers Bergman is an independent organization and is not affiliated with Fidelity Investments.

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