



Newsletter



The First Line of Defense:

Protecting Family Assets and Privacy in an Era of Increasing Regulatory Oversight

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“Diligence is the mother of good luck.” – Benjamin Franklin

by Lee Unterman, Esq.¹

The regulatory horizon is a darkening one for the single-family office (“SFO”). While most SFO’s have historically flown under the regulatory radar, in this post-Madoff era both legislative and investor driven changes regarding accountability and transparency are clearly in the air for all private funds and the individuals involved in the management, custody and/or oversight of their assets. On December 11, 2009, the House of Representatives approved “The Wall Street Reform and Consumer Protection Act” (H.R. 4173) which includes (at Title V) the “Private Fund Investment Advisers Registration Act of 2009” (“PFIARA”).² One of the primary purposes of PFIARA is to remove the exemptions from registration currently enjoyed by the advisers of private pools of capital, such as hedge funds, private equity funds and SFO’s which function as private investment funds, in order to give regulators and Congress access to hitherto unavailable data and other information pertaining to the operation of these private funds.

Unfortunately, there is little doubt that SFO’s are now squarely within regulatory target sights. In a statement released by the office of Rep. Paul E. Kanjorski (Chairman of the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises) on October 1, 2009, in connection with issuance of the discussion draft of PFIARA, it was boldly asserted that “[t]he

advisers to hedge funds, private equity fund firms, single-family offices, and other private pools of capital will have to obey some basic ground rules in order to continue to play in our capital markets.”³ For this and other similar reasons, SFO’s should anticipate that they may no longer enjoy the comfortable “anonymity” of their relatively “unregulated” status.

The New Regulatory Environment

Under the current version of PFIARA, private fund advisers who provide advice to “private funds” with assets under management of less than \$150,000,000 and venture capital fund advisers would be exempt from registration. So-called “mid-sized private funds” (not defined, but presumably with assets in excess of \$150,000,000) may be subject to some intermediate level of oversight based on “the size, governance and investment strategy of the fund” and the “level of systemic risk posed by such funds” as determined by the SEC. Apart from its registration requirements, PFIARA would impose some level of recordkeeping and reporting requirements on all private funds, similar to those currently required of registered investment advisers. In addition, private fund advisers may be compelled to release the identities of their clients and other sensitive information, regardless of whether an investigation or legal proceeding is pending. The SEC would also be permitted to share disclosure reports and other information obtained from private funds with the

¹ Lee Unterman is the managing partner of Kurzman Karelsen & Frank, LLP where he specializes in compliance and other regulatory issues as well as negotiation and strategic planning. Mr. Unterman has acted as general outside corporate counsel to, or special litigation counsel for, a number of small and large businesses with special emphasis on investment advisors and broker/dealers. In addition to his work as an attorney, Mr. Unterman has extensive experience in the securities industry, having started his career as on the trading floor of the NYSE and, most recently, having served as the COO and CCO of a three billion dollar dually-registered investment advisor and broker-dealer. Erin Loura and Marissa Winter, both associates at Kurzman Karelsen & Frank, LLP, assisted in the preparation of this article.

² H.R. 4173; 155 Cong. Rec. 185 (H144966). As of the date of this writing, this bill has been referred to the Senate Committee on Banking, Housing and Urban Affairs.

³ October 1, 2009 statement issued by Rep. Paul E. Kanjorski (D-PA), http://kanjorski.house.gov/index.php?option=com_content&task=view&id=1627.

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Federal Reserve and the Financial Services Oversight Council – on a confidential basis – for the assessment of “systemic risk.” Thus, an SFO’s ability to preserve its confidential information and financial data from government disclosure may be jeopardized.

It bears mention that an alternative bill which, in part, addresses the regulation of private funds is under consideration in the Senate. On November 10, 2009, Senator Christopher Dodd released a discussion draft entitled the “Restoring American Financial Stability Act of 2009”.⁴ Of particular note for SFO’s, the Dodd draft contains a provision which would specifically exclude family offices from the definition of an “investment adviser” in Section 202(a) of the Investment Adviser Act of 1940. As of the date of this writing, the Senate Banking Committee has not made any recommendations regarding this proposal and, moreover, it is certainly not clear which version of the proposed legislation will ultimately prevail.

As has been well publicized, the SEC has recently approved the adoption of amendments to Rule 206(4)-2 of the Investment Advisers Act of 1940 which relates to the custody of client assets. The revised rule targets investment advisers that have “custody” of client assets in an effort to prevent those assets from being lost, misused, misappropriated or subject to the advisers’ own financial reverses. The new rule defines custody as “holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them”⁵ and is designed “to strengthen controls over the custody of client assets by registered investment advisers and to encourage the use of independent custodians.”⁶ Among its

requirements, the new rule requires that registered investment advisors with custody of client funds must use a “qualified custodian” to maintain these assets and deliver account statements to clients on a quarterly basis. Registered investment advisers that also act as qualified custodians with respect to client assets, or that have a related person act as such, are subject to additional requirements, including an annual assessment of custody controls conducted by an independent public accountant registered with, and subject to regular inspection by, the PCAOB. While these regulations will not affect SFO’s unless they or their advisers must be registered with the SEC, they further portend increased government oversight of private funds.

The SFO Manager/Adviser

Clearly, the SFO CEO/CIO/manager (collectively referred to as the “SFO Manager” for the purposes of this article) will be situated at the frontlines of any new regulation(s) which affect private funds. Many SFO Managers typically outsource investment and other advisory functions to third party providers, such as registered investment advisors, accountants and legal counsel. Still other SFO Managers elect to outsource more traditional “in-house” services such as tax-planning, compliance, accounting, bill paying and cash-flow management. All SFO Managers, however, remain privy to confidential and sensitive family information (both financial and personal) and many even retain some control over the family’s assets. Regardless of which investment and advisory functions and/or services have been delegated to others, an SFO Manager occupies a position of confidence and trust with respect to the family it serves.

⁴ See, http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=943242e1-ca66-411c-89e2-8954eb3fc085.

⁵ Revised § 275.206(4)-2(d)(2).

⁶ Securities and Exchange Commission, Release No. IA-2968 “Custody of Funds or Securities of Clients by Investment Advisers - Final Rule,” <http://www.sec.gov/rules/final/ia-2176.htm>

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Although simplistic, it must always be remembered that an SFO Manager (regardless of whether he or she is a paid employee or family member) is a legal fiduciary. Accordingly, he or she must discharge his or her duties in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances. This includes the duty to exercise reasonable due diligence in the performance of his or her responsibilities, including the selection and oversight of third party providers. Many have made note of the fact that increased due diligence entails increased financial outlays – monies which many SFO’s may be hesitant to spend in the wake of recent market upheavals which depleted their investment portfolios. As recent cases and the new and proposed legislation discussed above demonstrates, this decision may seem penny wise but could ultimately prove pound foolish for the families behind the SFO and the Managers who serve them.

While few, if any, decisions have been reported in cases brought against SFO Managers for investment decisions that ultimately resulted in funds being placed with Madoff, liability and accountability are clearly snaking their way back up the investment chain -from Madoff to hedge funds and the hedge fund managers that placed money with the Madoff and, now two degrees of separation away, to the individual investment advisers that used their discretionary authority to invest client assets in the hedge funds that placed the money with the Madoff firm.

Many of the lawsuits filed against hedge fund managers and others generated by the Madoff⁷ debacle seek to impose financial losses and liability on the intermediaries who, in one way, shape or form, connected investors to the Madoff firm. Most of these lawsuits are predicated on basic failures of due diligence – in particular, the failure to recognize

so-called “red flags” (e.g. Madoff’s unusually good and consistent investment returns, his failure to provide any meaningful information as to his investment process and his use of a small, no-name outside accounting firm), the failure to make reasonable inquiry prior to electing to invest and the failure to reasonably assess the risks associated with such investment prior to committing client funds. Although none of the named defendants made the ultimate investment decisions themselves, disgruntled investors are now seeking to hold them accountable for the disastrous financial aftermath of Madoff’s conduct. Here is yet another wake-up call to SFO’s and the SFO Managers who serve to “connect” family assets to outside investment firms and service providers. Given the inevitable effort to extend the chain of liability up the ladder to all involved in the investment decision-making process, the importance of due diligence – in particular, the necessity for reasonable (and documented) investigation of outside professionals prior to outsourcing investment and/or advisory functions as well as the continuous (and documented) monitoring of those selected – cannot be overstated.

Steps to Consider

SFO’s that are registered investment advisors are obviously subject to the revised custody rule. For those SFO’s that are not registered investment advisers and, for the moment, have dodged this particular regulatory bullet, SEC Release No. IA-2968 is nonetheless instructive. The Release offers guidance with respect to policies and procedures that SFO’s should consider adopting or, if they have similar policies in place, revisit. For example, the SEC recommends that advisers with custody of client assets:

- Conduct background and credit checks on employees who will have access or could acquire access to client assets;
- Require the authorization of more than one

⁷ *S\ et al. 2009 CV 3614 (S.D.N.Y. complaint filed April 8, 2009); Rothschild v. Rye Select Broad Market XL Fund, et al., 2009 CV 08571 (S.D.N.Y. complaint filed October 8, 2009).*

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employee before the movement of assets within and withdrawals or transfers from a client’s account;

- Where the adviser serves as a qualified custodian for client assets, segregate the duties of advisory personnel from custodial personnel to make it difficult for any one person to misuse client assets without being detected;
- Require that any problems be brought to the immediate attention of management;
- Develop policies regarding the ability of individual employees to acquire custody of client assets (e.g. becoming trustees or obtaining powers of attorney); and
- Develop procedures to periodically test the effectiveness of the firm’s controls over the safekeeping of client assets.

Many of these procedures can be tailored and adapted to fit the particular risks and business models of individual SFO’s in order to create and implement a formal set of checks and balances to protect the family’s assets as well as individual SFO Managers from personal liability due to insufficient due diligence. For example, an SFO considering a perspective money manager can inquire whether the adviser has adopted the above-described rules or can impose these rules or similar guidelines on “third party providers.” In addition, SFO Managers should consider adopting a series of due diligence questions to be asked of every third-party provider as well as a document review checklist to make certain that appropriate underlying documentation has been requested and received.

SFO’s should also review their existing procedures for the collection, retention and confidentiality of family records and information in order to circumscribe the scope of any mandated disclosures in the future. Each SFO should also revisit and challenge the privacy policies of the outside investment advisers who serve them to insure confidential information

will not be inadvertently disclosed in the event of a government inquiry. Where the SFO functions as more than an investment vehicle, the family should further consider instituting a so-called Chinese wall or forming a separate entity to segregate its more “personal” services (such as tax and estate planning) from its actual investment activities. However, the SEC has made it clear that control of the family checkbook will amount to “custody” under the new rules.

Further, regulatory changes in the private fund sector are inevitable. It is impossible to predict the extent to which SFO’s will be subject to this widening net of regulatory oversight and no SFO should assume that they will be able to wholly insulate themselves from its reach. While it is probably premature (and perhaps counterproductive) for SFO’s to take such steps as moving the SFO offshore or changing the corporate structure to avoid regulatory scrutiny, taking steps now to protect confidential family information and adopting reasonable due diligence systems and procedures will become each SFO’s frontline of defense when and if they are compelled to do so in the future through legislation and regulation. As Benjamin Franklin once aptly observed, “Diligence is the mother of good luck.”

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FOA Newsletter Guest Columnist

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We urge everyone to always perform their own due diligence.



About Family Office Association

The Family Office Association (FOA) is a global membership organization exclusive to single family offices (SFO) and families of wealth. In a world of uneven information, families of wealth need to come together in a confidential setting to share ideas and compare notes. The Family Office Association seeks to provide the combination of privacy and openness where relationships of trust can grow. FOA also provides programs, roundtables, significant summits, research and a secure place online for the exchange of experience and thoughtful advice from such peers and families who may be journeying on the same path. FOA seeks out the best experts and notables in the family office industry to educate our members. FOA establishes the place where families can truly raise social capital.

Family Office Association is the trusted and respected source that families of wealth can turn to for independent resources, education and guidance. For these families, FOA is the advocate for establishing and sustaining a single family office (SFO). With an SFO, these families create their own private company of dedicated professionals exclusively devoted to their investment, legacy and personal needs. An SFO enables a family to customize their own solutions mindful of their values and goals. FOA provides the foundation, insights and encouragement for families to engage with the long-term preservation and conservation of their wealth and family stories.

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