

# (R)evolution of the Family Office

By Patricia M. Soldano

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The wealth management industry has experienced a tremendous change in the last couple of decades. This shift has occurred primarily for three reasons: 1) the information age has leveled the proverbial playing field, 2) new wealth creators have amassed great fortunes in the last decade and seek an alternative to mainstream financial advice and wealth management services, and 3) the collapse on Wall Street in 2008 forced families and investors to look at the alignment of their provider to their goals and objectives. These forces have led to changes in family offices in particular, and wealth management in general. The following essay provides an overview of the family office solution.

## BACKGROUND OF FAMILY OFFICES

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It is estimated that family offices were started over 100 years ago by families of wealth who wanted to centralize the management of the families' financial affairs, while building a purchasing power base greater than individual family members could achieve on their own. There are estimated to be from 2,500 to 3,500 family offices in the U.S. (Shapiro; 2002; Avery, 2004) and an estimated 4,000 plus family offices worldwide (Hauser, 2001). Each family member benefits from a consolidated group of professionals in the family office: investment and financial managers, estate planners, tax accountants, philanthropic administrators, and compliance personnel all dedicated to, and knowledgeable about, each family's unique situation.

The formation of a family office typically occurs under one of three conditions:

1. The liquid assets of the family grow to such a size that professional management is required for the investable assets of the family, and such management cannot be provided by the family business professionals. This might be because they do not have the expertise to manage these assets or, if they do, it cannot be done effectively without the business suffering.
2. The family's business is sold, creating liquidity that again needs to be managed by the appropriate professionals.

3. The family has attempted to manage their personal financial affairs, but the business has suffered due to the time they have spent doing so, or they realize that they are not equipped to manage the level and complexity of their own assets.

## **THE SINGLE FAMILY OFFICE (SFO) VS. THE MULTI-FAMILY OFFICE (MFO)**

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A single family office (SFO) is an office that manages the financial affairs of one family, and a multi-family office (MFO) manages the financial affairs of more than one family, generally not related to each other. A family may decide to form an SFO if they have enough assets to support the professional staff needed and they wish to have the exclusivity of their own office. It is estimated by many that an SFO must have assets in excess of \$400 million to support the professional personnel that are needed to manage the assets. An MFO that manages the financial affairs of more than one family has a much smaller asset requirement per client, but the total of all assets of the MFO should be sufficient to make economic sense for both the MFO and the clients. There are various levels of minimum asset requirements per client for MFOs that range from \$1 million to \$100 million in assets.

It is important to note that a family office is an operating business, with all the requirements for commitment and capability that goes into any operating business. So the family must assess the family resource pool to make sure there is either the talent to manage the business or the willingness to find a manager and provide oversight. Once that determination has been made, the family must be involved in developing an operating plan and a plan for generational transitions.

Another consideration is the long-term viability of a single family office. Frequently, SFOs are initially formed to handle a small number of family members with a relatively simple asset base. However, as the family grows, there are more family members to serve and often diminished assets due to the payment of estate tax and generations of spending. “Generational mathematics,” or the erosion of principal as assets are transferred to more and more beneficiaries, is a natural consequence of an expanding family tree. The management of a family office is also affected by constantly changing business practices and laws governing the financial industry.

In addition, the family office executive, who is often a trusted advisor of the family, may struggle to keep abreast of all of the demands of each generation. A trusted advisor is not only critical to the management of the family's assets, but often functions as an intermediary in family conflicts, While this role as family counselor can take priority at times, the family office executive must be careful to maintain objectivity and remember that it is the collective family objective that is his priority, not the needs of each individual.

For all of these reasons, a family that begins with an SFO may decide to move into an MFO as the family matures.

MFO's vary in size and the services they provide, but mostly they differ in how they are compensated for services.. A competent MFO should provide the same sense of exclusivity that an SFO provides for the family, even though other families are served by the MFO. It should be a high-touch, personalized, customized service.

## **THE FAMILY OFFICE DIFFERENCE**

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How does a family office differ from financial planners, investment managers, stockbrokers, bankers, and accountants to families of wealth? The primary difference is that a family office provides unconflicted, objective advice and serves the family as its most trusted family advisor. Truly objective family offices sell no products to their clients except that of the service or advice as a family office. They collect no fees from any person or organization except the clients of the family office. The family office is not paid a broker fee for insurance placement, securities purchases, real estate purchases, custody, commissions, or transactions fees, unlike that of brokerage houses, investment management firms, investment banking firms, private banks, and product-compensated financial planners. The real difference between a family office and many of the organizations that provide products to the family office industry is that the family office has a *serve* culture and the others have a *sell* culture. In the *sell* culture, the client does not pay a fee for the service; the client pays a fee for the product. A family office should have an open architecture, meaning that it is capable of providing its clients a diverse group of investment opportunities in an unconflicted manner. This universe of products meets their client's needs and is not limited to the products of one firm, even if that firm has the

best and brightest. One of the most important values of a family office is the objective advice that it provides to its clients in all areas needed by the family. It is important to point out that the family office cannot have a *sell* culture and be compensated by product sales if it is to provide the objective advice that the family is retaining them to supply. The family office should be unconflicted and unbiased in the recommendations that it makes to family members. Its only goal should be to provide the best advice and service to the family; it should not collect a fee from anyone or any organization except the family member. Otherwise, the advice is not objective.

## VALUE OF A FAMILY OFFICE

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In a time when families and investors have paused to reflect on the best solution to perpetuate and sustain wealth for future generations, a shift is occurring in the industry away from traditional institutions, financial brokers, and money managers. The full service family office not only plans, but also executes and manages all of the financial affairs of a family over generations. The typical full service family office will provide the following services:

- investment management, which includes asset allocation and investment policy development, in addition to performance reporting and monitoring
- bill paying
- cash flow management and accounting for investment and personal assets
- tax projections and advice with tax return preparation
- philanthropic management, including the grant making process and all necessary filings
- estate planning, execution of the plan, and trust administration
- regular organized and facilitated family meetings
- insurance placement and management
- personal services as needed by the family.

Some family offices offer all of the services, but will allow a family to pick and choose the services that it wishes to receive and pay for, cafeteria style. This has been done effectively by some family offices, but it can erode the

coordination of all the diverse financial aspects of the family assets, which is one of the most important values of a family office. By choosing just certain services, the family can run the risk that coordination does not occur and a professional will not attend to important elements of the family's financial affairs. A full service family office manages all of the financial affairs of the family functions, much like that of a primary care physician who monitors a patient's physical well being and manages all of the specialists. Without the primary care physician, a person is required to manage his or her own specialists without the medical knowledge to do so. When a full service family office manages and coordinates all of the financial affairs of the family, it is less likely that something will slip between the cracks.

Since the family office manages the entire investment process, the family office professionals have a better appreciation for what assets should be included in the family estate plan, and what should be used for charitable giving. Since all disbursements and receipts are paid and received by the family office, the family office can efficiently and effectively budget family cash flow, execute tax planning, and prepare tax returns. Insurance can be placed and managed more effectively because the family office is constantly aware of what needs to be insured and the level of protection the family requires. If legal or other professional assistance is needed in a transaction, the family office's knowledge of each family member's complete financial situation serves to prepare them to ask for the right assistance and monitor the process. In addition, the family members need only interact with the family office representative, and not a multitude of professionals.

In many cases, family offices will also assist family members with the purchase of homes or businesses, manage and be involved in lawsuits, assist in the operations of the family business, and mentor the next generation with advice on career, education, and pre-marriage contracts.

## **OWNERSHIP STRUCTURE**

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The legal structure of the family office can differ based on the needs and objectives of the family and the goals established for the family office. As an operating and/or investment entity, some SFOs use one or more limited partnerships or limited liability companies. The family members hold a limited partnership interest or an LLC membership, with a corporate entity acting as the general partner or managing member. This entity provides

liability protection for the family members, as does an S corporation. In determining the right structure for the family, it is important to consider if there is a need for distributions, and if so, the methods of distributions from the entity. If all the family members are owners, either as partners in an LLC or shareholders in an S corp, the law requires that all family members take the same amount of distribution at the same time. This may often create a problem if family members do not want equal distributions.

In an LLC membership structure, the family members are clients of the family office, which will manage their assets separately, possibly in a separate investment structure, for a fee reflecting the amount of assets and services to be provided.

The legal structure of an MFO is not subject to the same concern regarding unequal fees or distributions to family members. An MFO is often not owned by a family member (although it may be if it began as an SFO that later accepted non-family member clients). In either case, the legal entity may be a C corporation, an S corporation, an LLC, or a limited partnership. The choice is not restricted because of a need to provide for equal family member distributions or fees. The selection of entity type depends upon the needs and preferences of the non-family member professionals that own and operate the MFO.

## **FEES AND CHARGES**

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Family offices charge for their services in a variety of ways, but most bill a fee based on assets under advisement (AUA) or assets under management (AUM). AUAs are those assets that the family office may be monitoring or tracking, but not directly managing. For example, non-liquid assets such as closely held securities, or non-investment related assets such as an art collection, may fall under this category.

AUMs are those assets that are directly managed by the advisor and are most often liquid investments. Family offices typically apply a different fee to those liquid investment assets. Some firms bill on a retainer basis, or a combination retainer plus AUM basis, to allow themselves to be paid for the management of non-investment assets. Less commonly, some firms bill on an hourly basis. The all-inclusive fee charged for managing the family's financial affairs is usually about one to two percent of assets. However the fee depends largely on the level of

assets under management, the size of the family, the complexity of the assets, the services provided, the type and frequency of reporting and communication, and many other factors.

Single family offices and multi-family offices generally have different fee structures as the SFO will charge a fee to the family based on all of the costs to serve that one family, which usually results in a break even. It could be more or less than the fee they would pay if they were part of an MFO. In addition, in the SFO, the allocation of that fee to each family member may or may not be based on the level or cost of the service to each family member. In some cases, family members may unequally share the cost, with the older generation paying a larger percentage of the fee. An MFO will bill each family member based on the cost of the service that he or she requires. And the challenge of the MFO is to account for and understand the cost of the service for each family member, and still be competitive in the marketplace. Some family offices do so by recording its time so it has a better understanding of the costs associated with a particular task or client. If a family office provides a range of services, allowing each family member to choose what services he or she wants and does not want. There will probably be a charge for each of the services requested. As an example, the family wants bill paying, for which they pay a fee, and they want investment management for which they pay another fee, but they do not want tax or accounting work, so that service is not calculated in the fee structure. But ultimately, the fee paid to the family office must cover the cost of that service to enable the family office to sustain itself.

In addition, a family should be mindful of the tax deductibility of family office fees, as well as trust and investment expenses. Many times these fees are subject to two percent of the adjusted gross income (AGI) floor.

## **FAMILY OFFICE REGULATION**

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If an SFO or MFO is going to accept non-family members as clients, there may be a need to register with the SEC. The federal government and many states require that family offices register as investment advisors. Such registration is triggered if “investment advisory services” are provided. Investment advisory services would include not only selection or recommendation of security purchases and sales, but also selection of investment managers, reports on investment performance, asset allocation

recommendations, and similar services. In addition, if the family office has possession of client funds or securities, its financial statements must be audited. Possession includes having signature authority on a client account in order to pay the client's bills, no matter how much money is maintained in that account. Consequently, most MFOs will need audited financial statements. Registration as an investment advisor involves additional costs, systems, and controls.

## CHOICES

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In considering a family office, there are many issues to think about. Below are bulleted a number of key considerations:

- Does the family have sufficient assets to warrant a single family office? If the family has sufficient assets to form a family office, they should understand that it is a business, just like any other business, and it will take time and resources to operate. Some single family offices have closed their offices and joined multi-family offices because of this very issue.
- What services should be provided to the family? Should the office be a full service family office, serving all of the needs of the family, should it offer only investment management to the family, or should the office allow family members to pick and choose what services they want to utilize? The family should not forget the value of the full service family office and the coordination of all of the various functions that many family offices perform when making that choice.
- What type of culture does the family want the family office to have? The family needs to consider the culture of the organization that they are going to join or the family office they are going to form. Does the family want objectivity in the management of their assets and a complete open architecture to all of the products available in the market place, or is being captive to one firm's platform of products acceptable?
- How will the family pay for services? Is it preferable to pay through product sales or pay a fee based on all of the services to be performed? If the family sets up their own office, how will each family member be charged; and if they pay a fee to a multi-family office, are the assets of each family member capable of paying for their own services or will the other family members assist in paying the total family cost? In setting up a single-family office, the family should think about the long-term

objective of the family office. If the family office is going to be designed to operate for many generations, a governance structure should be developed, especially if the family is going to participate in the operation. This governance structure should include the requirements of whom and how family members can be part of the operations of the family office. If the size of the family office matters, guidelines should spell this out.

- What are the varying reporting needs of family members? The family should consider the type of reporting family members may desire and how often they would like to receive reports. Is it necessary to have customized reporting, or are the standard reports produced by a specific firm acceptable? Will reports be updated daily and made available online, or communicated in person at family meetings, or some combination of both?
- Does geography make a difference? Some families like to have their family office close by so they can visit on a regular basis, while others believe that with email, phones, and the Internet, it is not necessary to have an office in their backyard. There are many considerations that families should think about before they form or join a family office; these are just some of them.

## CONCLUSION

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While there are many issues for a family to consider when deciding to form or join a family office, the most important are the objectives and the wishes of the family. Family members should work together closely to make sure the model they choose is the correct mode with the right services for themselves and future generations. The development of a family governance structure with the participation of the family members would help insure that the family office continues to serve the family needs.

## REFERENCES CITED

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Hauser, B. (1999, November). Working effectively with wealthy families. *Trusts & Estates*, 138(12), 24-32.

Shapiro, H. (2002, December). Family matters. *Worth Magazine*, 109-114.

## Additional Resources:

Family Office Exchange (FOX) [www.foxexchange.com](http://www.foxexchange.com)

Family Wealth Alliance (FWA) [www.fwalliance.com](http://www.fwalliance.com)

Institute for Private Investors (IPI) [www.memberlink.com](http://www.memberlink.com)

## AUTHOR BIO

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Patricia M. Soldano has spent over 25 years managing family offices, and established family offices for the Brown Family of California, the Plimpton Family of New Jersey, and the Field Family of Illinois. She developed Cymric Family Office Services into a multi-family office in 1996 and in January 2009 Cymric Family Office Services became part of GenSpring making Pat Soldano President and Chairman of GenSpring Southern California.

In addition, Pat is President of Policy and Taxation Group an organization that educates on the destructive effects of the estate tax to families and their businesses. As a registered lobbyist she has advocated for the reform of the estate tax by lobbying legislators and executive branch officials for the past 17 years, spending one week a month in Washington DC. “Death by a Thousand Cuts,” a book written by Yale professors Ian Shapiro and Michael Graetz, chronicles her work and that of others over this time period.

Pat received her MBA from Claremont Graduate School, and her BA in Business Administration from California State University, Fullerton. She is a member of the Women’s Philanthropy Fund of Orange County, a member of the Board of Directors of Alzheimer’s Association of Orange County, as well as its Policy Committee Chairman. She is also a member of The Paul Merage School of Business Advisory Board and a member of the Center for Investment and Wealth Management.

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