Converting a Private Investment Fund Business into a Family Office: Issues to Consider

March 2022

(I) Introduction

In recent years, there has been a significant increase in the number of private investment fund managers who have opted to convert their firms into family offices (typically of the single family variety, at least at first). Managers who have made this decision have found that the advantages of a family office structure far outweigh the disadvantages.

Among the most commonly cited **advantages** to conversion are:

- *A significant reduction in regulatory obligations* – Many private investment fund managers who opt to convert are registered as investment advisers with the SEC. By switching over to a family office, such managers are often able to rely on the family office exclusion from the definition of "investment adviser" under the Investment Advisers Act of 1940. Even managers who are not SEC-registered face a wide array of regulatory requirements. Becoming a family office eliminates many of these regulatory burdens, however, it does not eliminate obligations such as those relating to insider trading prohibitions and the anti-fraud provisions.

- *No pressure from outside investors* – Traditional private investment funds typically manage third party capital and have many outside investors who are often seeking extensive due diligence information and making other requests from the manager. In a family office there is a far smaller investor base to satisfy, consisting essentially of certain family members and key employees.

- *Reduced outside legal risk* – With decreased regulatory and investor interaction, exposure to actions and claims by such parties is greatly reduced.

- *Less media coverage* – Private investment fund managers are frequently subject to media coverage. Such coverage may impact their ability to trade and may also increase the potential for regulatory issues, which is much less likely to be the case for a family office.

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- *Lower costs* – Since a family office is typically not SEC-registered (as they rely on the family office exclusion) and often has fewer personnel, the costs to operate the business can be much lower than for a private investment fund manager.

- *Additional tax savings* – If properly structured, a family office can potentially allow for the deduction of certain expenses (like 3rd party manager fees) that were not previously deductible for a family's personal investing.

- *More time for other pursuits* – With the reduction in hours devoted to dealing with investors and regulators, family office managers are often able to spend more time on other matters of interest, including philanthropic, social and other activities.

- *Organization of family finances and related services* – A family office is often viewed as an excellent solution to better manage the investments of many family members and also provide them with relevant financial and other life services.

Among the most often mentioned **disadvantages** to conversion are:

- *All costs are now borne by the family* – While the overall costs of running a family office are generally much lower than those incurred in running a private investment fund business, the assets of the family office tend to be smaller and all the costs are paid out of the family's assets.

- *Less favorable trading terms and deal flow* – Family office managers may not necessarily receive the same level of counterparty treatment, nor may they have the same access to deal and research flow, as they did when they ran a larger private investment fund operation.

- *Track record may not be portable* – Should the family office manager decide to re-open a private investment fund business in the future, the "prop" track record generated by the family office may be discounted or ignored altogether from a due diligence standpoint by some investors, because the strategy and risk parameters may be different than when running third party capital.

- *Talent retention and recruitment challenges* – Since family offices typically have a smaller asset base, usually do not pay private investment fund level performance fees, and often do not permit investments by employees, it may be challenging to hold onto or attract top tier personnel.

(II) Moving Forward with the Conversion

Assuming the private investment fund manager has carefully weighed the foregoing and has decided to move ahead with the conversion, there are two somewhat parallel tracks that will need to be implemented:

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Track 1A: Winding Down the Private Investment Fund Business

There are numerous steps that will need to be taken when winding down a private investment fund business with the goal of converting it into a family office:

- *Providing notice to firm personnel* – This is a crucial step, since many of the firm personnel will be instrumental in assisting in the transition. As such, the manager needs to consider the following:
    a. who on the team to tell first,
    b. when to tell team members,
    c. which personnel will remain post-transition,
    d. how to compensate the remaining personnel, and
    e. how to assist any departing personnel.

- *Providing notice to the investors* – The manager should seek to time the investor notice to ensure limited adverse exposure to the portfolio, in case word gets out and other investment firms seek to trade against the manager's positions. As a result, the manager may wish to sell some of the more sensitive positions before providing notice.

- *Providing notice to board members (if any)* – Any board of directors will need to be advised promptly to protect the interests of investors.

- *Providing notice to counterparties* – Winding down private investment fund assets may trigger provisions in certain counterparty documents. In addition, if the manager will want to maintain counterparty relationships after the conversion, early dialogue with trading partners is strongly recommended.

- *Conferring with counsel, accountants/auditors and the administrator* – These various service providers will need to be consulted on issues such as audit requirements, valuation issues, and regulatory and compliance obligations.

- *Determining and paying off all liabilities* – If the private investment fund has any creditors, they will need to be paid off prior to liquidation.

- *Determining the timing of portfolio liquidation and what is to be liquidated or distributed in-kind* – Timing of portfolio sales could impact NAV and will need to be managed carefully. In addition, if the manager feels that certain positions should not be sold due to tax, liquidity and/or strong investment outlook considerations, it must decide whether to (1) offer all investors the option to receive some or all of the relevant positions via an in-kind distribution, (2) keep the pro rata share of those positions just for the family members (which could raise conflicts of interest concerns) and cash out all outside investors, (3) buy out all outside investors' interests in the positions at market prices (which would be a principal transaction requiring investor consent), or (4) take some other approach.

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- *Filing certificates of dissolution/disqualification* – Once the above steps have been taken, an assessment will need to be made as to which entities are intended to survive post-conversion. Those entities that will not have a family office purpose will need to be dissolved/disqualified from the relevant states.

Track 1B: Setting Up the Family Office

While the wind-down of the private investment fund business is progressing, the manager will also need to start thinking about the steps relevant to establishing the family office itself:

- *Determining the scope of the family office* – The decision that will inform all others is what form will the family office take, as this will impact most other actions. For example, if the manager is planning to invest just his/her own family's capital and provide no other services, the issues presented are far less challenging than if there will be multiple families involved (which raises SEC and other issues). In addition, the manager will need to determine whether there are services beyond investment management being contemplated. Complicating matters even further is if the private investment fund manager wants to maintain the private investment fund structure (even if just for a short time frame), while also running the family office -- this presents significant conflicts of interest and compliance issues that will need to be addressed.

- *What will the family office's entity structure be* – If the manager wants to keep it very simple, it may opt for just one entity (perhaps an LLC) for both the investment activity and to manage the business. However, for liability and other reasons, a manager may want to consider an approach whereby it establishes a management company and a separate investment vehicle. Depending on whether any investment management compensation is contemplated for the family office's manager, in order to avoid tax concerns associated with the non-deductibility of such payments, consideration should be given to the establishment of a C corporation and the implementation of a profits interest. Finally, after assessing all of the foregoing, the manager may also wish to explore whether any of the original private investment fund entities (such as the fund itself) may be repurposed for tax or simply cost saving reasons.

- *Who will manage the family office* – Bringing one's family into the mix may present numerous delicate challenges as far as management oversight is concerned. Oftentimes, to alleviate these issues, an independent board will be established. Moreover, since many family offices are multi-generational, effective succession and contingency planning will be crucial in the process.

- *Hiring and incentivizing the right personnel* – As discussed above, the family office may wish to retain the services of some of the private investment fund manager's employees. The family office will need to come up with a creative compensation solution to overcome the fact that private investment fund managers are perceived to provide more lucrative compensation packages.

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- *How will costs be handled* – Family office budgets will likely be far different than private investment fund manager operating costs. Attention will need to be paid to the costs expected to be incurred, whether there are outsourcing and other solutions available to reduce expenses, and whether additional income streams can be created to offset the expense burden.

(III) Conclusion

Family offices are a great next step for many private investment fund managers. However, to best maximize success, extensive consideration of the many issues presented and careful planning will be required.

If you have any questions regarding the matters covered in this memo, please contact any of the partners and counsel listed below or your primary attorney in Seward & Kissel's Investment Management Group.

Daniel Bresler
bresler@sewkis.com
(212) 574-1203

Debra Franzese
franzese@sewkis.com
(212) 574-1353

Robert M. Kurucza
kurucza@sewkis.com
(202) 661-7195

Nicholas R. Miller
millern@sewkis.com
(212) 574-1359

Paul M. Miller
millerp@sewkis.com
(202) 737-8833

Joseph M. Morrissey
morrissey@sewkis.com
(212) 574-1245

David R. Mulle
mulle@sewkis.com
(212) 574-1452

Steven B. Nadel
nadel@sewkis.com
(212) 574-1231

Kevin Neubauer
neubauer@sewkis.com
(212) 574-1355

Patricia A. Poglinco
poglinco@sewkis.com
(212) 574-1247

Christopher Riccardi
riccardi@sewkis.com
(212) 574-1535

Robert B. Van Grover
vangrover@sewkis.com
(212) 574-1205

Alexandra Alberstadt
alberstadt@sewkis.com
(212) 574-1217

Jay Baroody
baroody@sewkis.com
(212) 574-1347

Lancelot A. King
king@sewkis.com
(202) 661-7196

David Tang
tang@sewkis.com
(212) 574-1260

Valentino Vasi
vasi@sewkis.com
(212) 574-1281

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