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Family Offices

How to Convert a Private Fund Manager Into a Family Office

By Robin L. Barton, *Hedge Fund Law Report*

Managing a private fund requires a lot of time and money. It also opens the manager up to the scrutiny of the SEC and investors, both of which can be quite demanding. Even if the fund's strategy is profitable, the intense pressure and competition may be enough to drive a manager from the business – and possibly into the creation of a family office instead.

The Hedge Fund Law Report recently spoke to Daniel Bresler, partner at Seward & Kissel, about the issues to consider when converting a private fund manager into a family office. This article presents the discussion on family offices in the current environment; the pros and cons of converting a private fund manager into a family office; other factors to consider; the conversion process; and the role of regulators in that process. It also includes two checklists based on the firm's white paper on this topic: one checklist on the winding-down process and another on the process of setting up the family office. Managers can download and use these checklists to guide the conversion process.

For additional commentary from Bresler, see our two-part series on SEC examination and enforcement priorities: "Cybersecurity, Business Continuity and Conflicts of Interest" (Jul. 22. 2021); and "ESG, New Marketing Rule and Other Potential Focuses" (Jul. 29, 2021).

Family Offices in the Current Environment

HFLR: How common is it for a manager – whether it's a hedge fund or a private equity (PE) manager – to convert into a family office?

Bresler: Generally speaking, it is rare, but when you're talking about the end of life of a manager, it's much more common. When management firms are considering winding down in some version, which happens to most firms at some point, then family office conversions end up being a significant percentage of those firms.

HFLR: The firm's white paper on converting to a family office notes that there has been an increase in conversions to family offices in the last few years. Why?

Bresler: There are a few reasons, one being that with a family office, there's a lot less regulation to comply with on an overall and day-to-day basis, which also can reduce costs. The regulatory environment has been consistently growing with an increased focus on private funds. The more regulation there is, the more that pushes managers to consider converting to a family office.

Sometimes, another big driver of converting to a family office can be investor demands for liquidity and transparency in a volatile market. For example, if a fund is struggling with either returns overall or returns relative to some index and it has to have to have discussions with and maintain investors, the manager may make the determination to convert to a family office instead. So, when you combine the growing amount of regulation with high index performance and/or market volatility, that could cause private fund managers to decide to switch to family offices.

[See "Family Offices, Endowments and Foundations Drive Interest in Hedge Funds, According to New Study" (Mar. 17, 2022); and "Why and How Do Family Offices and Foundations Invest in Hedge Funds?" (Jan. 3, 2013).]

HFLR: With the collapse of family office Archegos, and SEC Chair Gary Gensler's comments about that, might we see more regulation of family offices in the near future that could undercut one of the motivations for converting to a family office?

Bresler: Yes, absolutely. For this purpose, you can bucket regulations into two categories:

1. those that family offices are exempt or have some exclusion from; and
2. those that have applied to family offices historically and will going forward.

In the first category, you have requirements such as being a registered investment adviser – which is a big one and comes with things such as custody requirements, specific code of ethics rules and routine SEC exams – and family offices are exempt from that registration. Family offices also get some relief from other obligations, such as Form 13F filings, for example, for which family offices often qualify for confidential treatment.

Then, there's a whole host of other obligations that family offices are subject to, such as 13G and 13D reporting. There's also the new proposal for reporting large swaps exposure that came out of Archegos. Those regulations would apply to every market participant – whether a registered adviser, family office or something else.

[See "SEC Proposes New Rules for Security-Based Swaps" (Feb. 17, 2022).]

The more regulation of family offices that there is, however, means that converting to a family office doesn't exclude you from as many regulatory obligations, which pushes against the motivation to become a family office. What Archegos shows – and what Gensler is certainly highlighting – is that family offices are still large market participants, and the new swap proposal is targeting all large market participants. The SEC saw that there is this gap that you can build large swap positions with multiple counterparties without anyone really knowing what's going on. And, by the way, that could have happened with a registered adviser, also; it wasn't specific to being a family office. It just so happened that Archegos, a family office, was doing it.

But, yes, those types of regulations are definitely going to continue. I won't be surprised at all when the next one is proposed. I don't know what it's going to be, but I know there will be continued proposed regulation that impacts family offices.

HFLR: Given the current state of the economy and the world in general, is now a particularly good or bad time to convert to a family office?

Bresler: The current uncertainty is something that, depending on your investment strategy, could push you to convert now. Certainly a manager with a global macro strategy can find value in the uncertainty going on in the world today. But, a manager with a more fundamental approach may decide that it wants to operate with even fewer restrictions by not having to adhere to investor requests and liquidity demands, which you can do when you're a family office because your only investors are your family, giving you a lot more latitude.

The Pros and Cons of Converting to a Family Office

HFLR: The firm's white paper does a good job of going through this, but walk us through the pros and cons of converting to a family office.

Bresler: In my mind – and maybe I have a different lens because I'm a lawyer – the biggest pro is that you significantly reduce your regulatory burden, meaning you avoid the expense and the time that goes into compliance. If you look at a lot of big advisory firms, they will have a full staff dedicated to compliance, and that costs a lot of money. If you deregister and become a family office, then that staff can shrink significantly. So, you have a lot of cost savings.

[See our three-part series "Developments in Family Office Regulation": Part One (Oct. 1, 2010); Part Two (Oct. 29, 2010); and Part Three (Jul. 8, 2011).]

Converting to a family office also takes away a lot of headaches because now you have less regulator involvement and less investor involvement. So, it simplifies everything a bit.

One point the memo didn't go into a lot of detail on is that converting usually allows you to be more nimble. A regular private fund will have an investment mandate – an investment strategy with disclosure outlining all the risks. If you want to expand that strategy outside of the current investment mandate, then you have to go back to the investors. When you are a family office, that process becomes a lot easier because it's your own family's capital, so you don't have to worry about third-party investors. It allows managers to move a lot more flexibly in different markets.

There can also be some tax structuring benefits for a family office that are harder to do as a registered adviser.

[See "Investments by Family Offices in Hedge Funds through Variable Insurance Policies: Tax-Advantaged Structures, Diversification and Investor Control Rules and Restructuring Strategies (Part One of Two)" (Apr. 1, 2011).]

HFLR: What are the downsides?

Bresler: There are probably two big downsides. One is you can't take third-party capital – and that's where the fees come in. So, you lose all or a significant part of your revenue by not charging fees to third parties.

The other concern that is less obvious upfront is that it can be harder for family offices to attract and retain top talent, particularly on the investment side, because there aren't those potentially really large fee sources that employees can participate in. So, family offices may struggle to come up with different compensation structures to get the best analysts and portfolio managers in the door.

Other Factors to Consider

HFLR: In addition to weighing those various pros and cons, are there other factors that a manager should think about before converting to a family office, such as the family dynamics?

Bresler: Yes. There are a lot of different forms a family office can take, and certainly, family dynamics is a big factor to consider – especially when evaluating who will participate in the family office. There are a lot of family offices that are really only one person – a matriarch or patriarch, a spouse and some kids or trusts for kids – and that's the extent of who participates. There are others that are a lot broader and include many other people that are still within the family. So, they take different forms.

Another factor is that, when you run a family office, it can free up a lot of time to do something else. Running an investment management firm is more than a full-time job; running a family office doesn't need to be. People have other goals. Often, people at that stage are going to be involved in different charitable ventures or have other aspirations in their lives. This is a good way for them to be able to still have some control over their family's wealth and still be involved in the investment universe but be able to pursue those other goals, too.

HFLR: Are the decision-making process and the conversion process different in any way for a hedge fund manager versus a PE sponsor? If so, how do they differ?

Bresler: The big difference is timing. With a hedge fund, you can redeem investors. A hedge fund will have liquidity in some way – maybe monthly, maybe quarterly with a lockup or a gate – but there is an opportunity for investors to redeem or for the manager to mandatorily redeem investors. A hedge fund is striking a net asset value on a regular basis, so there's a mark that you can use to redeem investors. Therefore, you can wind down a hedge fund whenever you want, within reason.

A PE fund, a venture capital fund or other closed-end fund has a much longer and more definitive life cycle. Usually, a PE manager has to wait until the assets that the fund invested in work themselves out and are otherwise disposed of before it can convert to a family office. So, instead of maybe six months, it can take years to close down a PE fund. It's a very similar process, but it can expand the timeline significantly if you have closed end vehicles with illiquid assets.

The Conversion Process

HFLR: Once you've made the decision to convert and then need to start the processes that the white paper outlines, who should be leading those processes? Is it the legal department? Compliance? Some other department or a combination of departments?

Bresler: It's really a combination. There are a lot of people involved. Certainly, the legal team should be heavily involved. Compliance should be involved in the deregistration process. You will want the finance team, the chief financial officer and the bigger team, if there is one, to know what's going on. Operations would certainly be involved, as some of the entities will morph. Often, it will be someone in the legal side who is overseeing everything and quarterbacking the process, but there are a lot of hands that will need to be involved in some stage.

HFLR: Are there any key third parties that should be involved in this process as well, such as fund administrators, auditors, etc.?

Bresler: Yes, definitely. As a fund either winds down or converts into a family office vehicle, the administrator will need to be involved in paying out third-party investors. The administrator may stay on to work with the family office or may not be needed, depending on the complexity of the family office.

It's similar with the auditor. An auditor will always be there, auditing the fund until all the third-party investors are gone or the fund is liquidated.

Those are really the key service providers, but everyone will need to know what's going on, including your counterparties, prime broker, etc. There's going to be a shift in your business, a shift in assets under management and potentially a shift in investment mandate. There will be a lot of people that need to know that the process is going on but may not be as involved day to day in it.

HFLR: You mentioned timing. Even though there's more flexibility in terms of timing on the hedge fund side, are there still timing issues for a hedge fund manager to consider? Is there a better time of the year, for example, such as after the annual audit is done, to start this process?

Bresler: I don't think there's necessarily a good or bad time to start thinking about it. The process takes some time. The old adage, "Measure twice, cut once," applies here. Everyone is well-served by putting a lot of thought upfront into what the end product should look like and the steps to get there. Just the thought process and the planning can take a little while, and then the implementation will have a variety of steps within it. So, I wouldn't say there's a bad time to convert or that it needs to necessarily be keyed to audit season or tax returns because the process will end up going through a cycle of most of that anyway.

HFLR: The white paper talks about two different tracks: the winding down of the private fund and the setting up of the family office. Should those tracks happen sequentially – *i.e.*, do you do one then the other? Are they happening simultaneously with some degree of overlap?

Bresler: There's definitely overlap. The two tracks, for the most part, run simultaneously. They're all part of the bigger transition of converting to a family office but certainly have their unique components.

HFLR: What are the key steps in winding down the private fund?

Bresler: In the simplest version, you come up with a plan internally for liquidating all the assets that are necessary to pay out third-party investors. You notify investors of what's going to happen with a letter that typically informs them of your plan to convert, outlines the timing of the conversion – including when you intend to pay out their capital – and thanks them for their support. Once the dates outlined in the letter hit, the money is paid out, and then you're essentially done.

If the fund itself is going to wind down, then there are additional steps depending on where the fund is formed. In Delaware, it's fairly easy. If it's an offshore fund, such as in the Cayman Islands, it's not complicated, but there's a little bit more that you have to do on the filing side.

The operational side of a wind down is not that difficult. The biggest consideration is the assets. If it's a public equity fund, for example, you can usually sell out of the positions pretty quickly. You may have some restricted securities or some other circumstances in which you can't sell immediately, but you usually are able to sell those assets relatively quickly versus a fund that has side pockets, private investments that are hard to value or some credit instruments or other assets that don't have a market. That can stretch out the time period because those positions are harder to sell at the right value.

HFLR: What are some of the other key steps in that part of the process?

Bresler: When winding down the fund, one of the keys is really just communication with investors to tell them what's going to happen and when they're going to get their money back. They still get all their full reporting through that date.

The more intellectual piece of it is restructuring the management company and related entities. There's a lot of tax structuring that goes into a family office because it's a very different business than running a fee-generating management company, so there will often be restructuring of entities.

Personnel may also change significantly. You probably don't need investor relations staff, for example, or at least not the same number because your investors are now just your family.

HFLR: Can you expect to get some pushback from unhappy investors? Do they have any recourse?

Bresler: Investors don't have a lot of recourse. In this, as with many other areas, investor happiness is usually driven by returns. If returns have been good and the manager just decides that it's time to switch to a family office, there's probably less investor push back. If returns have been bad and investors have lost money, they may not be thrilled to know that they've invested capital, lost some of it and won't have an opportunity to recoup those losses. But, there's not a lot they can do about it.

HFLR: To be clear, you don't necessarily have to burn the house down and start from scratch, so to speak. You will often be able to repurpose and restructure the existing entities that you have in the private fund for use in the family office, right?

Bresler: Absolutely, and there are a lot of advantages to that, too. The existing entities already hold positions that you may not want to realize for tax purposes or transactional cost purposes. Those entities already have trading accounts set up, and if you have a more complex trading strategy, you could have dozens of counterparties. You don't want to have to redo all that work.

HFLR: In terms of setting up the family office, what are the key steps in that part of the process?

Bresler: The biggest step is the planning because it's not that difficult to move, redomicile or change the form of your entity, but you want to make sure that you're changing it for the right reasons and that the final structure achieves your goals. Most of the work goes into the planning stage and figuring out what the right structure will be. Then the legal changes aren't too difficult.

Operationally, it takes some thought internally to figure out the right team to continue with the family office. Most family offices tend to keep on some of the private fund staff, at least initially. There aren't necessarily too many new hires, but there certainly could be, especially if you're thinking of bringing on someone on the tax or operational side when that used to be outsourced and now you're bringing that function in-house for the family office.

HFLR: This is obviously not a fast process, correct? You don't make the decision, and two months later, boom, you're now a family office. What's a rough estimate of the timeline on the hedge fund side and on the PE side?

Bresler: On the hedge fund side, the short end is probably around six months. You certainly could rush to do it more quickly if needed, but there's usually not as much time pressure. PE fund managers can see multiples of that because it takes a lot longer to unwind their assets and get realized proceeds for investors.

HFLR: What are the main costs associated with the process?

Bresler: There are expenses with restructuring the fund, although those are relatively minimal. There are a fair amount of expenses in the structuring of the family office itself and of the management company. Legal expenses can end up being a fair amount.

Then your costs going forward are going to be very different. The makeup of what you do internally versus what you outsource is often different for a registered adviser versus a family office. So, there are different expenses and obviously very different revenue streams because you're not bringing in fees anymore from third parties. That changes the financials significantly.

HFLR: What would be your biggest piece of advice for a private fund manager contemplating going down this road?

Bresler: The biggest thing to think about is the big picture economics. Look at what your projected revenue is and consider whether you're willing to forgo that for the benefits of running a family office. That can obviously be a very big number that you have to give up. So, unless you're comfortable with that, then it's not really worth thinking about the whole structure.

[See our three-part series on going private: "Factors to Consider When Closing a Hedge Fund to Outside Investors" (Jan. 21, 2016); "Operational Considerations When Closing a Hedge Fund to Outside Investors" (Jan. 28, 2016); and "Mechanical Considerations When Closing a Hedge Fund to Outside Investors" (Feb. 4, 2016).]

The Role of Regulators

HFLR: What role, if any, does the SEC, the CFTC or any other regulator play in the process? Are you required to notify them, or are there certain regulatory filings that you're going to need to make as part of this process?

Bresler: Regulators play a minimal role, I would say. Most managers that convert to a family office are registered advisers, and they need to deregister. So, there is a deregistration filing that is made to the SEC. If the manager is trading commodity interests and is registered as either a commodity pool operator or commodity trading advisor, then there's similarly a deregistration filing with the CFTC. The family office exemption then kicks in. It's a self-executing exemption for both the SEC and CFTC, so the regulator's role is limited to that deregistration.

The one piece that is a little bit different with family offices is that, if they trade Section 13(f) securities and have to make quarterly Form 13F filings, family offices usually can get confidential treatment of their positions. That requires sending a request to the SEC that explicitly states that you are a family office and sets out facts to warrant confidential treatment. That's probably the first time that people end up affirmatively telling the SEC, "We are a family office."