

## **Protecting the Family Office by Using Managed Accounts**

By Michael G. Tannenbaum <sup>1</sup>

Family offices are unique in the investment world. By definition they are composed of numerous family members, often multiple generations, each with its own investment horizon and criterion. Those issues need to be addressed carefully and require unique and informed solutions. On the other hand, because of the need to diversify investments among various strategies and managers, they are akin to multi-manager platforms or funds of funds. Unlike a typical investment product where risks can be disclosed and accepted by informed investors, in the family office setting, the risk often needs to be avoided, not just disclosed.

This article speaks to a central principle that is common to all levels of the family: protection of its assets. This necessitates a complete understanding of the intricacies of the various investments, ability to monitor the same and the ability to act quickly should the need arise. This principle has become even more evident during the recent economic crisis coupled with the subsequent well publicized scandals. Losses have occurred in part because of a failure on the part of some family offices to understand concepts and practices that are well known to true institutional investors – concepts such as privity, hypothecation, title, custodianship and anti fraud rules, to say nothing of the failure to recognize and comprehend the rights and obligations of the limited partners (often the family office, as investor) under fund arrangements and commingled accounts.

### **Commingled Investments versus Managed Accounts**

Managed accounts, as the name suggests, are accounts in which only the investor (in this case the family office) has an interest, as opposed to an arrangement in which other investors’

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capital are pooled and commingled. The investible assets are placed with a broker, and a special limited power of investment over the account is given to the investment manager. On the other hand, the typical hedge fund or private equity fund is a commingled account in which there are numerous investors, usually unknown to each other. Let's examine some of the benefits of the managed account approach.

## **Title**

First and foremost is the notion that title to the investible assets is owned at all times by the family office. In a commingled arrangement, that direct privity is broken – the investor invests in the fund (in the limited partnership interest, limited liability company interest, or shares in an offshore product, for example) and not directly in the assets. Those are owned by the vehicle usually in common with all of the other investors. This break in the chain of title leads to a lack of control over the assets which in times of stress and financial panic often means an inability of the family to get its hands on the assets and protect its economic interests, a situation we have seen play out (unfortunately with some frequency) in the last twenty-four months.

## **Transparency**

Often an investment in a fund is coupled with the investment manager's desire to keep its investment strategy and methodology secret for real (or imagined) proprietary reasons. At the end of each reporting period, a statement of account is usually sent to the investors showing the net asset value as a composite.<sup>2</sup> Rarely does the statement set out the underlying investments; certainly positions that are short sales. A managed account on the other hand eliminates that because the account is directly owned by the investors who in turn receive statements from the broker showing each and every trade, thereby providing complete transparency. This may be a mixed blessing to some because having received the information and data flow, a burden falls on the recipient to process the same. In the event of a dispute, it would be difficult if not impossible for the investor to claim that they were unaware of the trades.

Also, the tax impact of the account is more predictable when managed accounts are used because gains and losses can be controlled better in that format than in the case of commingled pools.

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<sup>2</sup> New custody rules were adopted by the SEC, effective March 12, 2010, that insure that statements are to be sent by the custodian instead of by the investment manager.

## **Fees**

Usually the fee arrangement with the investment manager is a negotiated item, negotiation being the key word. Much depends on the investor's leverage usually relating to the size of the SPV, the identity of the investor and the size of the investment manager's portfolio as well as their eagerness for assets to manage. After all, the adage "the one with the gold rules" is a relevant one, certainly when it comes to fees. As a result, in the managed account context, fee negotiation proceeds in a more natural manner than in the hedge fund setting where the fees are set out (and perhaps fixed) in the offering documentation.

## **Protection from Other Investors**

Our experience during the past two years has shown that not all investors act rationally – certainly not for the same reasons. Some may simply panic out of an investment. Others may need the cash from one investment as a result of losses sustained in an entirely separate investment. In a commingled account, each investor is, to some degree, at the mercy of the others. For example, during times of economic stress, a fund that employs an illiquid investment strategy suddenly faced with a lack of a rational market, the best strategy may be to do nothing so as to allow the market place to reassert itself towards fair valuation. Even so, there may be some investors who demand redemption, forcing an untimely sale of assets. In a fund that has both liquid and non-liquid investments, the early redeemer often ends up with the more liquid portion of the fund and the non-redeemers are "left holding the bag" so to speak, with the more problematic illiquid portion. A managed account eliminates this issue entirely and each investor can act unimpeded by the needs of others.

## **Special Attributes**

Each managed account can have its own parameters – the amount of leverage that may be employed (if any), whether or not certain investments can be made (consider, say, the socially conscientious investors), fees as mentioned above, lock ups, needs under ERISA if pension investment is employed, even things like governing law or the venue in the event of a dispute, perhaps arbitration clauses, and so on. Termination of the agreement is certainly an important issue to deal with virtually eliminating the concept of "lock ups" or "gates" which are prevalent in many hedge funds. The investment management agreement can deal with each of these items, the point being that a great deal of customization can be achieved in a managed account arrangement.

## **Manager Push Back**

In negotiating the managed account agreement, it is important to be realistic about the impact not only to the investor but also to the manager.

Investors need to process the data mentioned above. There are expenses associated with running one's own account, similar in fact to the expense of running a hedge fund. It is important for the family office to have a qualified infrastructure in place thereby relieving some of this burden.

From the manager's standpoint, there is the question of efficiently managing what may be dozens or hundreds of accounts, thereby foregoing the efficiency of having a single pool and allowing the auditors to allocate the profit and losses in accordance with accounting standards and the limited partnerships agreement. Related to this is the practical reality to maintain a minimum account size. This will vary from manager to manager to be sure, but it is unlikely that a manager would agree to a managed account without a significant commitment (for that manager at least) from the family office.

Moreover, if each account has a different set of parameters, there is a higher chance of error – doing a trade that is not allowed, or employing leverage when there should have been none. And if the investor has the authority over the account, and can perhaps even direct or veto a trade, this can harm the investment manager's performance record under the SEC rules.

## **Conclusion**

There is no doubt that the current economic environment can be quite difficult to navigate especially in the family office context where there is more at stake than mere investment returns. Protection for successor generations is a big factor and using managed accounts to position the family's wealth is often a beneficial device. We can assist in structuring such arrangements.

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