Staffing the Family Office: Attracting and Retaining Talent

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Key Duties That Families Require of Family Office Executives

- Investment Strategy and Implementation
- Accounting, Reporting and Control
- Banking and Liquidity Planning
- Legal, Governance and Estate Planning
- Risk Management / Liability Management
- Education, Family Continuity; Mission Statements; Family Charters
- Integrated Financial Planning
- Tax Reporting
- Family Philanthropy

See Annex A for a more detailed description of the items listed above.

Need to Align Qualitative and Quantitative Functions Within the Family Office

- With increased sophistication of family office investment programs and operations, family offices are becoming more institutionalized and adopting best practices.
- While family offices are moving toward greater institutionalization and emphasis on quantitative functions (such as investment management and accounting), we are seeing an increased focus on qualitative roles (such as education, governance and family mission/values).
- It is important for family offices to align and balance those quantitative and qualitative functions to drive and reward behaviors by the family office team that further those goals.

Non-Financial Goals That Families Should Consider in Gauging Whether Their Family Office is Being Successfully Managed

- Developing/delivering a high-quality business plan and cash flow budget annually
- Developing/executing a sound investment program responsive to current conditions, supported by effective processes
- Developing/maintaining a strong investment team of employees, consultants and third party firms focused on managing the family's assets and supporting a positive and collaborative culture
- Developing a competent middle and back-office support team
- Managing the family's external financial, tax, and accounting advisors and legal counsel to avoid, limit, and manage liabilities, including tax exposure and litigation risks
- Working with the family to improve reporting systems, and reporting thoroughly and in a timely fashion to the family's board, family owners, and other internal constituencies
- Developing a family charter and family office policies (HR, compliance, office policies, etc.)
- Managing and funding expenses
- Working with counsel to comply with applicable rules and regulations and support a compliance culture
- Assisting and advising family members on their professional pursuits (inside and outside of the family office/business)
- Enhancing the family's reputation for competence and integrity among key employees and current and potential partners
- Maintaining confidentiality and protecting the privacy of the family
- Studying other family offices to identify useful innovations and "best practices"

Methods of Compensation Utilized by Families to Align Their Short and Long-Term Goals and Values With the Performance of Family Office Executives

- Compensation Tools Aligned With Short-Term Goals:
  - Base compensation
  - Attractive benefits package (less common in family offices)
  - Annual discretionary cash bonus
- Compensation Tools Aligned with Long-Term Goals:
  - Deferred Bonus/Incentive Compensation (often subject to time-based vesting)
  - Co-Investment Opportunities
  - Carried Interest (often subject to achieving after-tax hurdle rates of return)
  - Loans Programs
  - Phantom Equity
  - Equity in Portfolio Companies
  - Profits Interests
  - Supplemental Executive Retirement Plans (SERPs)
- We often see the payment of incentive compensation subject to achieving certain milestones, such as:
  - after-tax or after-inflation returns for the given year or a longer period;
  - assessment of liquidity and amount of risk taken to achieve the returns; and
  - assessment of returns generally available for similar liquidity and risk factors.

Recent Trends and Best Practices in the Marketplace for Compensation of Family Office Executives

- Larger family offices ($1 billion plus) with broader mandates, especially if active direct investment programs, paying higher compensation with more components
- While vast majority of family offices pay bonuses to the top executives (management and investment teams), discretionary bonuses still favored approach, but trend toward increased use of Long-Term Incentive (LTI) plans with objective performance milestones
- Written employment agreements more common now, but still not universally used (best practice is to document compensation arrangements and restrictive covenants)
- Co-investments and deferred bonus/incentive compensation are most prevalent Long-Term Incentives (LTIs)
- Phantom equity still more prevalent than direct equity in family-owned operating companies and the family office investment vehicles
- Increased use of vesting for phantom equity and direct equity participation to promote retention (3-5 years most common)
- Increased use of restrictive covenants:
  - Non-Disclosure Agreements to protect family financial/investment information, personal data and other confidential family information
  - Non-Solicitation restrictions on hiring of family office personnel
  - Non-Competes are less common due to nature of the family office's activities and lack of outside clients
- Increased use of industry data/surveys/consultants to better benchmark compensation structures and packages to ensure competitive with industry and adoption of best practice in order to attract and retain top talent

Structuring Family Office Co-Investment Vehicles to Permit Friends to Co-Invest in Deals Without Jeopardizing the Family Office Exclusion From Registration

See Annex B for Case Study.

ANNEX A

Investment Strategy and Implementation

- Prepare periodic market updates (markets, trends, risks and opportunities)
- Develop and implement an Investment Policy Statement and review/update periodically
- Develop, agree and implement an Asset Allocation Strategy
- Work with external advisors to research and select external fund managers to implement the agreed Asset Allocation Strategy, monitor manager performance and adjust or replace managers as appropriate
- Source, review, negotiate and invest in illiquid opportunities in real estate, private equity, venture, credit, special situations, etc. **Accounting, Reporting and Control**
- Prepare and maintain an inventory of all assets and entities
- Oversee and maintain ownership structures for entities and assets and new investments
- Oversee collection and reporting of financial and accounting information for the assets and new investments
- Coordinate work of external accounting and property management advisors **Banking and Liquidity Planning**
- Maintain banking relationships; supervise and report on bank accounts and oversee all banking transactions

Legal, Governance and Estate Planning

- Review, develop and implement restructuring and central control of the family's asset structures; optimize legal, accounting, tax and other risks
- Facilitate and coordinate estate planning programs for the family and successors; facilitate wealth transfer(s)
- Develop and implement legal structures (with assistance from external advisors)
- Develop and implement shareholder agreements among beneficial owners.
- Coordinate and manage work of external advisors and corporate service providers **Risk Management/Liability Management**
- Perform general and focused risk management
- Organize and manage periodic evaluation of liabilities and risks

Education, Family Continuity; Mission Statements; Family Charters

- Identify and help access various informational and educational opportunities for the family and other individuals to further professional and personal growth (both within and outside of the family office/business)
- Share information on best practices relating to family planning, communication, dispute avoidance/resolution, wealth management, spending and philanthropy

Integrated Financial Planning

- Help the family develop a strategic plan, and annual cash flow budget
- Design systems to monitor major assets and liabilities, businesses, portfolio investments, personal liquid resources and cash flows
- Work with external advisors to develop and implement tax and income planning **Tax Reporting**
- Oversee preparation/filing of tax returns in relevant jurisdictions **Family Philanthropy**
- Develop and help implement philanthropy programs, including forming a family foundation

ANNEX B

Case Study: Single Family Office Co-Investment Partnership

Background: Day Pitney is currently working with a single family office client now who has made a fairly significant direct investment in cryptocurrency/digital assets and wants to have two close friends that are knowledgeable about the crypto space (and who brought the investment to the family), but are not "family clients" (i.e., neither family nor key employees), participate in the investment along with the family. The client wanted to ensure that doing so did not violate the family office rule that requires that the family office only advise "family clients."

"Family Office Rule" Analysis: In this particular situation, the family office was neither recommending this investment to the non-family client investors nor charging them any fees (in part because they brought the deal to the family but also due to a long and close relationship). Since the family office was not charging any fees (including no promote or profit split) and was not recommending the investment to the non-family clients, having them participate along with the family together in a single investment vehicle should not be deemed to violate the family office rule.

Investment Structure: We structured a Delaware LLC and had separate classes of units for the family members, key employees and the non-family clients. The family gave the non-family clients a "profits interest" in the LLC in recognition of the value provided by bringing the investment opportunity to the family. The profits interest is tax-efficient for the recipient and was subject to a vesting period. The profits interest was in addition to the capital interests issued to all members, including the nonfamily clients for each member's respective cash capital contributions. Governance of the investment vehicle was ultimately controlled by the family office.

Loans to Key Employees: The family office provided a loan to two key members that matched the amount of cash put up by the key employees (CIO and COO) to boost the amount of their investment. The loans were at 3% interest (interest and principal to be deferred until maturity) and were secured by half of the equity purchased in the LLC (i.e., the amount of the interest purchased with the loan proceeds). The loan balance was required to be paid down with any distributions from the LLC.

Tracking Partnership: We also are working with the client to establish a tracking partnership to create flexibility for family clients and key employees to co-invest together in a single investment vehicle. A tracking partnership allows the partnership to separate its assets into classes or pools, enabling partners to participate in each asset class to varying degrees. For example, a tracking partnership may hold securities (Class A), commodities (Class B), and alternative investments (Class C). Some partners may want heavy exposure to Class C, while others are more risk averse. A tracking partnership allows each partner to have a fixed partnership "percentage interest" while holding varying percentages of each asset class. The partnership is treated as a single entity from both a state law and a federal tax perspective. The tracking partnership allows families to then decide how they want to allow key employees and/or family members to participate in some or all of the investments made by the tracking partnership and to vary the sharing ratios of each depending on a variety of factors (e.g., origination, finding co-investors, lenders and exit partners).