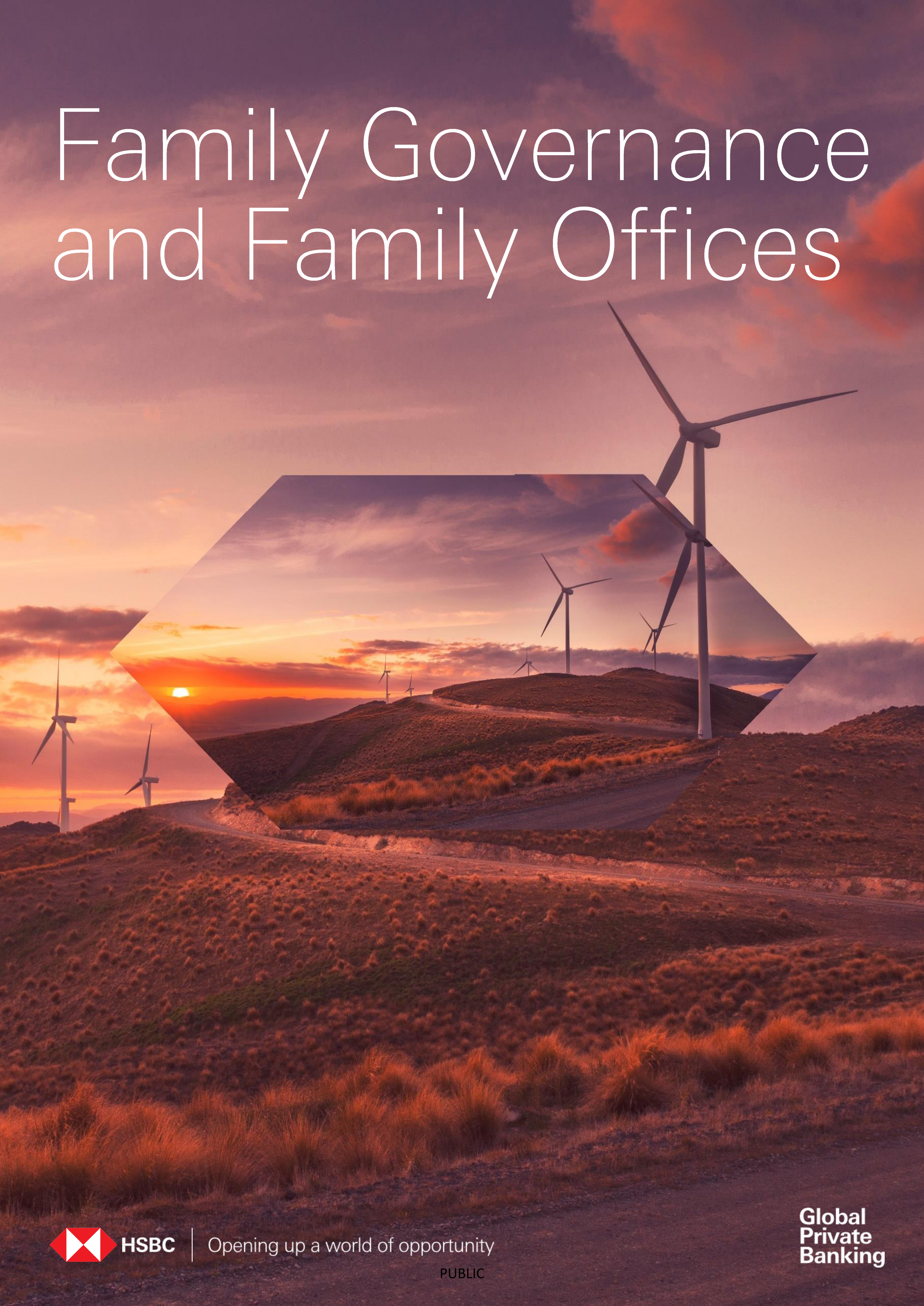
Family Governance and Family Offices



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With a recent family wealth report[1] stating that only 1 in 10 ultra-high-net-worth families have a formalised governing body, it's no surprise that family governance continues to be a significant source of interest for the very wealthy.

The continued growth of global wealth and allied growth in the number of family offices around the world means an increasing number of wealthy families will be grappling with the issue of governance and family offices.

So why isn't there more governance in Family Offices?

- **A preference for trust-based governance (or a lack of motivation for more formal governance)**

  Many family offices start out with a governance framework that is underpinned by a long-term trusted relationship that, often, will stem from a preceding and successful business enterprise relationship. It's why we see many UBOs appointing a close and trusted person from the family business as the family office director. High levels of trust can trump the need for the right skillset, particularly in the early days.

  This form of governance can endure for many years. It's felt that there's often no need for layers of formal governance as the governance model is strongly based on trust and an implicit understanding between a very small group of key people.

  But over time, as the family, the wealth and the family office develop, whether through growth or succession, that core, trusted relationship is likely to be stretched, and this is before even considering the "what if" scenario where that trusted adviser is out of action and the entire operations come to a halt. At this stage, the natural governance model will need to change.

  Unless, of course, that trust is broken beforehand - which will lead to a breakdown, not only in the governance framework, but often in relation to the management of the wealth or the family. The fracture will need to be addressed and a new governance model put in place. That can be difficult where it's built on a history of broken trust. Planning to update and refresh trust-based governance in good time and times makes sense.

- **Lack of agreement on what needs to be governed and where the boundaries are**

  Recent and well-publicised failures in family offices have seen calls for greater regulatory oversight and scrutiny. But they have also shown that there is room for improvement within family offices and the way they organise and run themselves, especially since the recent operational curveball thrown by the new practices of remote and hybrid working in a post COVID world posing numerous reputational, cyber and other administrative risks to name a few.

  That much of the focus has fallen on issues that come under a geopolitical spotlight – tax avoidance, wealth inequality, effects on markets and systemic risk – is not mis-directed, but it doesn't focus explicitly on the state of governance inside family offices. Focus from external sources is likely to continue to grow, but family offices, as they become more complex and increasingly institutional, need to ensure they stay in touch with, if not one-step ahead of, the state of governance and control of risk required for the level they're at. It raises the question of who, within the family office governance structure, is responsible for setting the governance standards and frameworks

[1] Julius Baer Family Barometer 2021

and, just as importantly, as they do so, are they free from conflicting interests. High levels of transparency within the family and family office doesn't conflict with the need for confidentiality from the outside world.

- **Lack of an accepted governance code for family offices**

  In recent years we have seen the broadening of corporate governance codes, going beyond being just applicable to quoted companies, and even those have been enhanced. We have seen the development of corporate governance codes for unlisted companies[2] and for family businesses[3]. Yet we have seen nothing like this for family offices.

  Principle 9 of the ecoDa Guidance and Principles (below) is really helpful in this regard, and seems just as applicable to governance in family offices – one just has to replace the phrases 'Family-controlled companies' with 'Family-controlled wealth' in the first sentence and 'corporate governance' in the last sentence with 'family office governance'

  "Principle 9: Family-controlled companies should establish family governance mechanisms that promote co-ordination and mutual understanding amongst family members, as well as organise the relationship between family governance and corporate governance.

  Many jurisdictions across the world are starting to legislate and promote clear and alluring family office rules to attract the wealthy onto their shores in a quest for improving local economies and speeding up recoveries. Whilst not game-changing at this stage, these initiatives show the imperative of having a robust framework that is transparent and easy to assess. This is particularly helpful at times where cross-border mobility of the upcoming generations and their need for speed and flexibility are key.

- **Inherent structural issues and complexity**

  The primary stakeholders, owners, service recipients and beneficiaries are family members. There may even be family members working in the family office. It's all about the family. There's not really much accountability to external stakeholders at all. Family offices are by their nature private and interested in maintaining that privacy.

  Consequently, family offices, for the most part, tend to be inwardly focused. Excessive amounts of formal governance, particularly where that involves external persons or parties, might seem to run counter to the founders' entrepreneurial spirit, family primacy and privacy drivers.

  Yet the formation, ownership and management of legal entities and asset owning structures, and the use and appointment of third parties require decision-making, which in turn requires governance. This should require appropriate levels of expertise, the definition of clear boundaries, objectivity and impartiality, alignment of interests, checks and balances, and the management or removal of conflicts of interest.

The perception that the safeguards of good governance bring rigidity needs to be challenged – it doesn't need to get in the way of flexibility and agility and indeed, it rarely does. The bottom line is that survival takes planning and planning takes time and careful consideration.

That is not to say a complex framework is required at all times - as the saying goes - if you have seen one family office, you have seen one family office. Approaching the issue of governance based on trust is one way forward, more formal governance mechanisms, with greater clarity of arrangements, documented safeguards, clear paths for recourse and resolution of disputes is another. It would seem that both can work, but its perhaps more obvious how the latter does than the former.

[2] E.g. ecoDa Corporate Governance and Guidance and Principles for Unlisted Companies in Europe, 2010
[3] E.g. The Governance Code for Family Businesses, Kommission Governance Kodex fur Familienunternehmen, 3rd edition. May 2015

What should be considered to create effective governance in a Family Office?

- **Purpose**

The driving force (or need) for a family office should lie in the purpose the family has defined for its wealth, which is predicated on the family wishing to stay together in the management of its wealth. This usually starts out as the wish of the family wealth founder(s), yet as families grow, very often the forces within the family seem to want more recognition of the individual family member wishes and desires. The larger the family, the greater the possible range of these.

Besides the purpose of the family's wealth, it's important that the family office itself has a clearly defined purpose. This will help protect the family, it's wealth and the staff in the family office.

Achieving such purpose surely requires a constant focus on three elements:

- Continuity – in recognising that the family has the objective of long-term management of its affairs and wealth together, planning for successful continuity in all critical roles and relationships should be a first order issue.
- Return – protecting and growing the family's wealth is at the heart of the rationale for a family office. Focus on managing for the achievement of the desired level of return within the agreed appetite for risk will be paramount.
- Resilience – with the concentration of very high levels of wealth, sensitive information, key person vulnerability, and increasing complexity, the framework for and controls around the management of a wide range of risks will be critical.

More often than not, family wealth declines because whilst the original founder(s) had a strong purpose for the wealth, this has not been updated and adapted to take into account the wishes of the current generations and stakeholders. Having a well-defined process around reviewing one's shared purpose when a significant trigger event occurs (such as marriage, divorce, death, etc.) is critical for longevity.

- **People**

"Good governance is not just about observing rules. It is about personal behaviour".[4] We can't forget that governance, however it is constructed, is a system that relies on people, and that the ways in which people behave are not pre-ordained.

Most of the focus on people in family offices seems to be about the structures they inhabit, and the recruitment and appointment processes. Perhaps more important is to look at the structure of the family office in terms of all of the roles and relationships to understand how people's personal behaviour might influence the governance culture and dynamics. Key issues include:

- Powers of appointment, dismissal and renewal – well-structured processes for hiring and firing key individuals are a positive for governance in the same way that over-concentration of these things in the hands of one individual can be the source of harmful patronage. This is particularly important where family members are

[4] "Why strong board rooms are vital for companies – now more than ever". Sir John Tusa. September 23rd, 2020 https://inews.co.uk

employees, to ensure transparency across the board, and is of heightened importance in the context of facilitating a smooth succession to the next generations.

- Skillsets – the benchmark for the capability levels of family office staff should be the equivalent in firms providing outsourced services to family offices. The right levels of capability need to be in place in the short, medium and long-term. A key ingredient for successful recruitment is around appreciating the different dimensions a family-linked office requires as opposed to a non-family investment business and factor it into the assessment and selection of staff – for instance a chief investment officer from a large and reputable financial titan may not necessarily be the right match for a small family office focused on sustainability and wealth preservation.
- Responsibility and accountability – clear lines of sight in terms of responsibility and accountability assist in supporting transparent decision-making as well as enabling effective review of the results of actions taken. Having a clear understanding of where and in whom the oversight function lies is also important. The family office needs to have and to maintain sufficient independence from unwarranted influence if it is to protect the long-term interests of the family.
- Single point of failure people – this issue is often looked into in terms of business continuity, where the criticality of skills, knowledge and even relationships is assessed in terms of the value or risk to the business. In small, high value, high complexity teams like family offices, it should also be looked at in terms of financial exposure and the opportunity to create additional operational risk. Given that critical single point of failure people may also be some of the most trusted, the control environment around them should be fully assessed. Key management risk should be assessed and contingency plans put in place.
- Time and interest, as well as expertise – it's common to hire people with deep expertise into critical governance roles such as non-executive directors, co-trustees, sub-committee members, chairs etc. Usually they will be appointed on a part-time basis (so many days per month for example), and often they will have several such roles. How then to ensure that they make sufficient time available with the appropriate level of enquiry and interest. Equally important is to understand their personal interest in a role, and whether this might conflict with the organisational interests.
- Reward – in reward strategies we often hear about the importance of the alignment of interests. Important, clearly, in ensuring that people are commonly aligned with the achievement of certain goals and objectives, but there is risk that you end up with the equivalent of group-think in terms of reward, where, in effect, everyone is rewarded to achieve the same outcome, and no-one has the incentive to question or challenge. Once again, clarity around family remuneration where both family and non-family members are employed is paramount to avoid challenging perceptions.
- Diversity of people and perspectives is a really good counterbalance in many situations, particularly so, perhaps, in small, highly trusted, goal-aligned teams. Since most family offices tend to operate lean teams, having diversity of thought and a mix of backgrounds is a key component.
- Conflicting interests – these can come about for a variety of reasons including power, position(s), access to resources (including information and relationships), reward, policies, undue or inappropriate pressure, competing goals, or even (as the point above suggests) due to different values and attitudes. It's really important to understand where individuals are in positions where they are subject to conflicting or competing interests. Some of these are inherent, some of them only arise situationally. The source of them matters not, having clear processes and standards for their identification, declaration and handling clearly does.

Process

When we refer to 'process' we mean the structures; the policies and procedures; the decision-making authorities; and the reporting and communication processes through which the governance model is operated by the people. Process should look not only at the family office as an operational entity, and its relationship with the family but also with the external environment.

We’ve highlighted a number of areas below that one expects to see in the governance ‘process’:

- Longer term objectives and annual plans: with clearly articulated accountability and responsibility for their delivery
- Structures: clear terms of reference; delegated authorities and limits; meeting cycles; reporting and communication; composition strategies and outlines; role descriptions; terms of office; appointment criteria; and performance monitoring
- Risk management approach and control framework: including a responsibility culture; staffing of risk functions; roles and responsibilities; risk and exposure limits and metrics; checks and balances, and enforcement; and measurement and reporting
- Performance assessment and reward strategy
- Code of conduct; separation of duties; and management of conflicts of interest
- Governance review programme and mechanism

Having clearly drafted policies and terms built within legal documentation can be transformational as the family office evolves and grows alongside the family it serves. Clarity provides comfort and comfort encourages alignment and motivation, especially with non-family members that are in effect serving the family.

Conclusion

Family offices are becoming increasingly complex, in a world where the level of external oversight and regulation of them will only increase. This places pressure on trust-based governance approaches and is increasing the need for more formal governance, especially with the succeeding generations coming into the wealth with a new outlook and perspective. Whilst not getting in the way of the required level of agility, such governance needs to be based on sound principles and practice, and be implemented objectively in a timely manner. Fundamentally, building a family office should be seen as building a business and therefore, similar frameworks should be considered for its good functioning and prosperity.

◆ **Potential Actions for Family Offices:**

- Review the existing Family Office set up and governance mechanism for purpose, people and process
- Conduct a risk and control assessment for the Family Office
- Run stress testing and scenario analysis for the Family Office

Russell Prior leads the Family Office Advisory and Family Governance practice for HSBC Private Banking across EMEA. He is author of Family Governance and Surplus Wealth: Sustaining Family Fortunes published in June 2021.

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