Internal controls and operational considerations for family offices

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Introduction

Family offices are effectively wealth management firms that serve high-net-worth individuals or their families ('**Family Groups**'). While multi-family offices ('**MFOs**') are third party platforms that are set up to manage the assets of many different Family Groups, single family offices ('**SFOs**') are set up by one Family Group solely to manage the assets of that Family Group. As such, SFO entities will often be wholly (or at least largely) owned by the Family Group which they serve, whereas MFOs may be wholly independent from their Family Group clients.

As far as the Securities and Futures Commission of Hong Kong ('**SFC**') is concerned, SFOs should not need any regulated activity licence (including a Type 9 (Asset Management) licence) as they are not 'carrying on' any business of asset management in performing their roles and functions for the Family Group (since it is the Family Group effectively managing its own moneys). MFOs, however, will need to be licensed for regulated activity (namely Type 9 (Asset Management)) since they are carrying on a business of asset management for third parties - see our article summarising the licensing and regulatory considerations here.

Regardless of whether they are regulated or not, SFOs and MFOs are responsible, ultimately, for managing significant amounts of assets and wealth. It would be crucial, therefore, for them to have robust internal controls and operational processes in place to ensure they carry out their functions effectively and efficiently, and in a professional manner. This is particularly important given the complex and often diverse nature of family office investments, which may include allocations to private equity, real estate, hedge funds, and other alternative asset classes.

In this final instalment of our three-part series on the family office regime, we set out some considerations that would be relevant to both MFOs and SFOs in terms of their internal compliance, governance, and operating processes/designs.

Internal controls and operational considerations for family offices

Typically, the relationship between the family-owned investment holding vehicle ('**FIHV**') and the SFO / MFO (the '**Family Office**') will be governed by the investment management agreement ('**IMA**'). The IMA should set out the following terms:

- investment strategy and objectives
- scope of discretionary power
- limitation of liabilities
- conflict of interest
- investment restrictions
- duties of the family office
- fee structure
- termination

If the Family Office is to be an SFC regulated entity, please also consider requirements (including as to disclosure) under the Fund Manager Code of Conduct (‘**FMCC**’).

Family Offices should ensure that investment made or trading activities carried out on behalf of the FIHV are in accordance with the investment strategy, objectives and investment restrictions, whether in terms of asset class, geographical spread or risk profile, as set out in the IMA. Therefore, Family Offices should have in place effective and properly-implemented procedures and controls as follows:

1. Due diligence processes

Thorough due diligence should be conducted to assess and evaluate the merits of a potential investment. In particular, for private equity investment, there should be (i) initial due diligence prior to investing and (ii) on-going due diligence to be conducted on an annual basis. The exercise should cover areas such as:

- operational feasibility and resilience – to consider the effectiveness of the overall operation;
- legal, risk and compliance – to ensure policies and procedures in place are compliant with the relevant rules and mitigate risks of non-compliance; and
- financial and tax considerations – to monitor the performance of the investment and determine whether and when to exit or continue to hold an investment.

2. Risk management

It is crucial to have robust risk management policies and procedures in place to identify, assess, manage, monitor, and possibly mitigate risks, such as market risk, credit risk, liquidity and operational risks associated with investments, operations and compliance issues. Family Offices should monitor the investment portfolio regularly to ensure that investments made do not deviate from the FIHV’s objectives. A dedicated investment team (if any) should report to the Family Office regularly on portfolio performance and risk metrics, and review and adjust the portfolio’s asset allocation and risk exposure accordingly.

3. Valuation

In order to monitor the overall performance of the investments made and determine the return of investments, Family Offices should establish valuation policies and procedures, which set out the valuation methodologies of the assets, the frequency of valuations and dealing frequency of the FIHV. Such valuation policies should be reviewed on a periodic basis to ensure their continued appropriateness and effective implementation.

Where a Family Office arranges the appointment of a third party to perform valuation services, it should exercise reasonable care in the selection of the third party and should ensure that the third party’s activities are periodically reviewed.

4. Anti-money laundering

Family Offices should have policies and procedures in place to comply with the relevant anti-money laundering (‘**AML**’) and know-your-customer (‘**KYC**’) rules, including customer risk assessment; report of suspicious transactions; provision of training to staff; record keeping; and ongoing monitoring of accounts.

While it is possible to delegate its AML function to a third party, the family office should monitor its activities regularly as outsourcing controls.

5. Recordkeeping and reporting

Maintaining accurate and complete records of all transactions, financial statements and investments is a fundamental part of a Family Office’s operation. This is particularly important for tax purposes. Moreover, as mentioned in our first article of this series, accepting third-party money may disentitle the Family Office from being able to rely on the intra-group exemption (which may lead to more complex regulatory considerations and issues). Therefore, any abnormalities in the book should be reported to Family Group clients and other stakeholders such that appropriate remediation can be taken in a timely manner accordingly.

6. Compliance

Generally, Family Offices should have a compliance framework and monitoring programme to govern their operations and a more cautious approach should be taken by those being regulated by the SFC, which should deal with the issues below and include disclosures required under the FMCC:

- conflicts of Interests
- handling of client money/assets
- gift and entertainment monitoring
- professional investor assessment

- disclosure of Interests, Substantial Shareholding Reporting, Short Position Reporting
- fit and proper assessment
- staff members' personal account dealing
- breach/compliant handling

7. Succession planning

Effective succession planning Family Offices can help to ensure the sustainability of a Family Group's wealth and assets and minimise the risk of having disputes over management and ownership of the Family Office.

Family Offices should establish a governance structure that outlines the roles and responsibilities of family members in the management and oversight of the Family Group's wealth and assets. This may include the establishment of a family council or board of directors to oversee the Family Office's operations and succession planning process. It should also develop contingency plans to ensure continuity of operations in the event of unexpected events such as the death of incapacity of key family members.

By following the above best practices, Family Offices can ensure the long-term success of their clients' wealth management strategies, while also maintaining trust and confidence of their clients and stakeholders.

Conclusion

As the family office tax concession regime introduced by the Hong Kong SAR Government is intended to attract and support the establishment of Family Offices in Hong Kong, it is important that those set up in Hong Kong not only comply with the relevant laws and regulations of Hong Kong, but also adopt best practices distilled from Hong Kong's long-established asset and wealth management industry. This will ensure a vibrant and healthy ecosystem that is also best placed to compete with other financial centres on the world stage.

PwC Risk Assurance team, together with Tiang & Partners, will be able to assist you in reviewing your existing internal controls, performing a gap analysis against the SFC requirements (if applicable) as well as providing suggestions to remediate any non-compliance, to ensure the above goals are achieved in the most cost and time efficient manner.

Let’s talk

For a deeper discussion of how this impacts your business, please contact us.

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