The HedgeFund LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Volume 2, Number 16 April 23, 2009

Hedge Fund Manager Compensation

Addressing (and Resisting) Demands for Changes in Hedge Fund Manager Compensation

By Ira Kustin, *Akin Gump Strauss Hauer & Feld LLP*

While the unprecedented market events of 2008 and 2009 have resulted in pressure upon fund liquidity terms and governance provisions, market forces have resulted in requests from some investors for changes to the manner in which hedge fund managers are compensated for their services. The market turmoil of 2008 and 2009 resulted in unprecedented investor requests for withdrawals/redemptions from hedge funds. Few investment strategies seemed immune from the epidemic; even funds that were performing well faced withdrawal/redemption requests from investors hungry for liquidity from any possible source. Funds faced with cash shortages, portfolios with illiquid investments, assets with embedded value dependent on future events or longer-term liquidity options, or similar issues, have, over the past year or so, taken measures that were rarely used in the recent past. Some funds proposed changes to existing fund terms or exchange offers to stabilize those funds' capital and portfolios. Others utilized gating provisions or implemented full suspensions of withdrawals/redemptions and the calculation of the fund's net asset value in accordance with the fund's governing documents. While in the past, utilizing a gate or full suspension was seen as a death knell for the fund, funds utilizing these provisions are now in many instances viewed as positively positioned for a future recovery. Still, there are other funds that have simply elected, or were forced, to liquidate, either due to their investment strategy or for other reasons.

All of these events have brought the hedge fund industry some undesirable publicity and put it under the scrutiny of the government, the financial press and the general public. Hedge fund managers in the past typically never had to be concerned with, or address in the terms governing their funds, negative publicity of such intensity. Negative press, together with a common misunderstanding about the hedge fund industry among the press and general public, and even among legislators, has not helped matters for managers.

Regardless of the negative press, public perception of the hedge fund industry and its managers and the views of legislators and regulators (and new rules and restrictions imposed or proposed by them), the pool of assets available for investment in hedge funds or similar vehicles is likely to increase as the population of the U.S. continues to age. The percentage of people age 65 and older is projected by the U.S. Census Bureau to increase significantly over the next 20 years. Arguably, asset allocators such as corporate and state pension plans, fund of funds and high-net-worth individuals will, notwithstanding the general market scandals and tribulations of 2008 and 2009 so far, seek to invest with managers who can provide the most attractive returns on their capital. Hedge fund managers will likely continue to provide those attractive returns.

Assuming that market demand will ensure the continued existence of the hedge fund industry, it may be safe also to assume that, in light of recent fund restructurings, as well as the imposition of gates/suspensions, and the use of true or "synthetic" side pockets, some forceful investors will begin to

©2009 The Hedge Fund Law Report. All rights reserved.

The Hedge Fund LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation
www.hflawreport.com Volume 2, Number 16 April 23, 2009

seek certain concessions from fund managers. Over the past year or so, a small number of investors have indeed begun, in some cases very vocally and publicly, to criticize the incentive compensation structure for hedge fund managers that has developed to date.

Current Considerations for Fund Managers – Reasons for Resisting Change

Notwithstanding investor displeasure with management and incentive compensation (with regard to both the amount and manner of compensation), the cost of doing business for hedge fund managers appears poised to increase. The growing cost of regulatory compliance resulting from new rules or increased SEC scrutiny is a very real possibility for fund managers. Market perception and, at some point, legal requirements may compel fund managers to utilize third-party administrators to the extent they do not already. In fact, some larger fund managers that had developed administration expertise in-house have been forced by market perception or pressure from regulators to seek the imprimatur of a third-party administrator, notwithstanding the fact that these managers themselves are equipped to provide administration services to third parties. Furthermore, the cost of retaining existing talent and the valuable institutional knowledge they possess is a very real consideration for many fund managers seeking to unlock value embedded in longer-term investments. At least one large pension plan investor is demanding that managers demonstrate exactly how the manager will retain essential talent in the current market environment.

For hedge fund managers, the increased cost of doing business, in conjunction with increasingly vocal investors seeking to change the terms and conditions under which they invest, has resulted in a manager compensation market where certain terms are being adjusted, stretched and contorted in a process that is evolutionary. Discussed below are some common investor demands or proposals with respect to manager compensation and an overview of some possible evolutionary adjustments that could balance investor demands and the need for incentivized managers to be adequately compensated.

Investor Requests for Change

Some large institutional investors have recently become increasingly vocal in their requests for changes to fund terms. A number of significant pension investors have circulated letters or manifestos stating the terms upon which they will be willing to make investments. Some investors have made outright requests for reduced management fees. This is particularly true with respect to fees charged on interests in liquidating funds. Some investors have requested tiered management fee arrangements with fees tied to the size of each investor's capital, the length of an investor's lock-up period or some other objective term. Investors have begun to request incentive compensation provisions that pay a manager its performance fee or allocation at the end of a multi-year period, or demand that a portion of the incentive compensation earned with respect to any annual or other performance period be held in escrow, released over a period of time or subject to a private equity-style clawback. In certain exceptional cases, investors have requested that certain performance hurdles be cleared, or that the investor receive a preferred return, prior to the payment or allocation of any incentive compensation to the manager or general partner of the fund. Still other investors are demanding that their capital be managed in a separate managed account rather than a comingled fund, which gives the investor more control

©2009 The Hedge Fund Law Report. All rights reserved.

The Hedge Fund Law Report
The definitive source of actionable intelligence on hedge fund law and regulation
www.hflawreport.com Volume 2, Number 16 April 23, 2009

over liquidity but presents complications for the manager, including the task of allocating investments across their existing funds and those managed accounts.

Exactly how successful large institutional investors will be in altering the compensation landscape for hedge fund managers remains to be seen. Some managers with strong performance, notwithstanding the recent market turmoil, or managers with strength in a particular niche market may be able to fend off requests for lower management fees and altered incentive compensation. Other managers who are able to demonstrate a particular need to retain existing talent in order to efficiently manage a complex portfolio of assets may also be able to resist demands for compensation changes. But certain other managers will need to look for creative ways to balance investor demands against the desire to make their ventures sufficiently profitable for themselves and their employees. Given market pressures, there are a variety of options available for fund managers to consider.

Separation of "New" and "Old" Funds

Some managers with funds that have suspended redemptions or are in liquidation have been able to propose a "clean break" from toxic assets or doomed investment strategies in an existing fund and "roll over" investors into a new fund (in some cases, depending on the performance of the older fund, with a reset high watermark or loss carry forward for the benefit of the manager). This strategy will provide the manager and its employees with incentives to focus on the more attractive investment strategy. Manager compensation can be adjusted in accordance with the particular characteristics of the older fund and the prospects for the new fund.

Adjustments to Management Fees

At least one pension plan investor has reiterated the position that management fee provisions should be crafted to permit a manager to operate and maintain its business rather than be a source of outsized profits. Therefore, it may make sense in certain cases to divide a fund's portfolio between varying classes of assets based on the complexity of the management required with respect to those assets. The management fee and performance compensation could then be tailored to the characteristics of the assets involved and provide the manager with sufficient capital to manage its business and retain essential talent. This and other adjustments to the traditional management fee structure might avoid a wholesale reduction in management fees across the board.

Adjustments to Incentive Compensation

Striking this balance between investor demands and manager desires, incentive compensation schemes for certain funds may also increase in complexity. Staged payouts of incentive compensation may be substituted for the now common annual or semi-annual fee or allocation. In the staged payout model, a certain percentage of the performance compensation with respect to any year is payable immediately, while the balance is held back for payment or allocation over a number of years. The release of this held-back balance is also sometimes contingent on meeting future performance benchmarks. Another variation on this theme, often supported by investors with a long-term investment horizon, involves extending the period over which performance is measured (e.g., performance allocation is measured as a percentage of net gain over a period of three years rather than one). In this regard, managers, however, could demand from investors longer lock-up terms or other

©2009 The Hedge Fund Law Report. All rights reserved.

The HedgeFund LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation
www.hflawreport.com Volume 2, Number 16 April 23, 2009

structural adjustments which align with longer incentive compensation measurement and payout periods.

Complications Arising from Possible Adjustments

While these scenarios, and other similar ones, may provide new manager incentives and align with the wishes of investors, each added layer of structural complexity raises a new set of questions for hedge fund managers to consider. Multi-year incentive compensation look back, holdback, hurdle and clawback provisions all raise significant tax issues for U.S. managers that need to be understood. There may also be considerable tax or regulatory issues in other jurisdictions that should be studied with local counsel prior to their implementation. Resulting fund documents all should be carefully drafted not only to address tax complications, but also to achieve sufficient clarity regarding creative compensation structures so that the intent of the manager and investors is unambiguous. And fund managers must understand the flexibility and restrictions in their funds' current governing documents, as well as any side letters granted to investors, before implementing changes to a fund's terms or compensation structure. Any creative solutions that change the terms of management fees and incentive compensation may also have personal tax and estate planning implications for a fund manager's partners, members or employees. Finally, of course, changes in U.S. and foreign tax laws and related legislation, as well as the uncertainty that will exist until any rule changes are implemented, may compromise the benefits of even the most carefully designed compensation structure.

While wholesale changes to the methods by which hedge fund managers are compensated are unlikely to occur simultaneously or immediately across the industry, compensation structures will likely evolve with the entire alternative asset management industry. Rather than being an impediment to fund success, these new structures may actually help assure their viability from the perspective of both hedge fund managers and asset allocators with funds ready to invest.

Ira Kustin is a Partner at Akin Gump Strauss Hauer & Feld LLP. Mr. Kustin's practice focuses primarily on advising sponsors of hedge funds and private equity funds regarding the formation, documentation and investments of both domestic and offshore investment vehicles, as well as advising registered and unregistered investment advisers in connection with their ongoing operations and regulatory compliance matters. Mr. Kustin also advises clients regarding investments in private funds and their related management entities.

©2009 The Hedge Fund Law Report. All rights reserved.