Developments in Fee Structures

November 4, 2009
Developments Relating to Fees and Lock-ups
Current investor receptivity to longer lock-ups

- Correlation with underlying investment program
  - There is some investor receptivity to longer lockups dictated by the needs of the investment strategy, although short term strategies now dominate successful fund-raising.

- Reduced fees
  - There has been little investor appetite to give up liquidity to obtain reduced fees.
Performance Compensation associated with longer duration investments

- Investor demand for matching of performance fee cycle with redemption cycle
  - CalPERS, Utah and other institutional investors are increasingly insisting on deferral of performance compensation to coincide with investor liquidity

- Simple multi-year cycles
  - Typical arrangements defer accrual of entire performance fee until the end of the lockup period

- Rolling cycles with partial holdbacks
  - More elaborate arrangements may provide for partial payments, with the balance being subject to holdback/clawback based on subsequent performance (e.g., one-third payable at the end of each year over three-year cycles)

- Realization limitations
  - Some approaches include an overlay of a private equity style test of cumulative realized results, so that mark-to-market profits cannot give rise to full payout of performance compensation
Some traditional hedge fund managers have sought to adopt private equity fund structures to address the need for longer lockup while providing for a deferred payout to the manager. Even with relatively short investment periods, these structures continue to face severe marketing challenges in the current market.
Separate accounts

There has been considerable discussion regarding the appetite of institutional investors for separate accounts, in order to provide greater transparency, potentially more favorable liquidity and less exposure to impact of early liquidity needs of other investors. Few investors are in fact equipped to handle separate accounts. Some of the benefits of separate accounts, without some of the burdens, are being achieved through the creation of single investor funds.
Hurdles

There has been an increasing demand for hard and soft hurdles, possibly reflecting an erosion of the “absolute return” philosophy and an unwillingness to pay for beta. Hurdles may be based on a cost of money factor or on a benchmark index.
Gates, “Slow-pay,” “Synthetic Side Pockets” and other tools for managing imbalance in redemption demand

The widespread use of existing gating provisions and emergency measures (“synthetic side pockets”) during the crisis has not resulted in market consensus regarding the most appropriate tools. Individual investor gates have become more prevalent. The use of “slow-pay” terms seems to have declined.
Internal Revenue Code Section 457A and Multi-Year Performance Fees for Managers of Offshore Funds
IRS Circular 230 Notice Requirement. This communication is not given in the form of a covered opinion, within the meaning of Circular 230 issued by the United States Secretary of the Treasury. Thus, we are required to inform you that you cannot rely upon any tax advice contained in this communication for the purpose of avoiding United States federal tax penalties. In addition, any tax advice contained in this communication may not be used to promote, market or recommend a transaction to another party.
Changing Climate

■ Declining asset base (*Bloomberg*):
  - Peak Hedge Fund Assets as of Mid-2008: approx. $1.9 trillion
  - Hedge Fund Assets as of June 30, 2009: $1.43 trillion
  - *Delta: approximately $470 million*

■ Declining Manager Fees (*Bloomberg, citing Hedge Fund Research*):
  - 2007 FY: $55 Billion
  - 2008 FY: $25 Billion
  - Projected 2009 Fees: $45 Billion
Fundamental Premises

- Investment Manager performance based compensation in prior years was generally based on a single year’s investment performance.

- Investment Managers are now looking to appease investors by basing performance compensation on multi-year performance. Investors want the managers to share in the downside performance, if any.
## Example without Clawback

### Fee Based on Single Year Performance

<table>
<thead>
<tr>
<th>Performance Year</th>
<th>Starting NAV</th>
<th>Ending NAV</th>
<th>Fee (20% of App.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>$100M</td>
<td>$120M</td>
<td>$4M</td>
</tr>
<tr>
<td>2010</td>
<td>$116M</td>
<td>$100M</td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Total Fees Based on Single Years’ Perform. $4M</td>
</tr>
</tbody>
</table>

### Fee Based on Multi-Year Performance

<table>
<thead>
<tr>
<th>Performance Year</th>
<th>Starting NAV</th>
<th>Ending NAV</th>
<th>Fee (20% of App.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>$100M</td>
<td>$120M</td>
<td>N/A</td>
</tr>
<tr>
<td>2010</td>
<td>$120M</td>
<td>$100M</td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Total Fees Based on Multi-Year Performance $0</td>
</tr>
</tbody>
</table>
Investor Demand for Fee Structure Changes

- Larry Powell, Utah Retirement Systems has called for:
  - (A) Tiered Management Fee Structure
  - (B) Tiered Performance Fee Structure
  - (C) Hurdle Rates of T Bills plus Management Fee
  - (D) Multi-year performance fee; portion of year’s fee heldback

- CalPERS is demanding better terms from funds in which it invests, including:
  - (A) fee structure focused on long-term, rather than short-term performance
  - (B) clawbacks for poor performance
  - (C) “separately managed accounts” or similar customized vehicles
  - (D) greater disclosure and transparency regarding investments
  - CalPERS suggested that it “will no longer invest [with] managers” that adhere to industry standards with no regard for individual situations.

- PAMCO has sought to withdraw from certain funds and alternatively invest using managed accounts

- To date, hedge funds have been reluctant to change fee structures without some commitment of investors to a longer lock-up and other consequences
IRC Sections 457A and 409A

**Code Section 457A**
- Internal Revenue Code Section 457A eliminates the ability of certain tax indifferent parties, i.e., offshore funds in “tax haven” jurisdictions, to sponsor deferred compensation arrangements.
- Amounts that are not subject to a “substantial risk of forfeiture” must be paid to the service provider no later than the last day of the year following the year in which the amounts are vested (i.e., the manager can separate voluntarily and receive the deferred amounts).
- Consequences of impermissible deferral would be immediate taxation in year of vesting to the extent amount determinable. If undeterminable, then upon determination of such amounts, *additional* 20% taxation.

**Code Section 409A**
- Internal Revenue Code Section 409A requires recipients of deferred compensation to elect a time and form of payment of such deferred compensation in a manner that complies with Section 409A and Final Treasury Regulations thereunder.
- Payment timing can include a date(s) certain or a separation of service of the manager from the fund (among other timings).
- Failure to elect timing and form properly or prohibited acceleration of payment of deferred compensation would result in *additional* 20% tax, immediate taxation upon failure, and heightened interest assessment.
Applicability of Section 457A

Section 457A applies to “nonqualified deferred compensation plans” of “nonqualified entities”

“Nonqualified Entity” means:

- (A) any foreign corporation unless substantially all of its income is (i) effectively connected with a US trade or business, or (ii) subject to a comprehensive foreign income tax
- (B) any partnership unless substantially all of its income is allocated to persons other than (i) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and (ii) tax-exempt organizations
End of 2008

- At the end of 2008, Investment Managers had the opportunity under transition relief provided for under Internal Revenue Code Section 409A to finalize/rearrange payment dates of deferred compensation that was scheduled to be paid in years after 2008.

- In addition, under grandfather rules of Section 457A, such rescheduled payment dates were revised to fall within the year end 2017 deadline of Section 457A. That is, amounts that were deferred for years prior to 2009 can continue to be deferred so long as they are paid prior to the end of 2017.

- A plan (and back to back elections) can be amended before December 31, 2011 with respect to compensation earned for services performed prior to January 1, 2009, to change the time and form of payment to satisfy the 2017 457A deadline. Such an amendment should not violate Section 409A’s subsequent deferral rules.

- 457A’s 2017 deadline significantly restricts managers’ use of the redeferral rules of Section 409A (i.e., the “one and five” year rule).

- Section 457A’s prohibition on deferred amounts under a plan of a “nonqualified entity” begins with respect to calendar years beginning on and after January 1, 2009.
2009 and Beyond...

Alternatives for complying with Section 457A

- Establish Allocation using Fund Partnership Structure
- Subject Manager to Clawback of Fees Paid
- 457A Substantial Risk of Forfeiture; i.e., amounts are always subject to time based vesting requirement. Performance based vesting criteria not sufficient to establish 457A SRF
- 457A Short Term Deferral Rule; i.e., amounts will be paid no later than the last day of calendar year following year in which amounts vest
- Issue Fund Options/Stock Settled SARs
Establish Allocation using Fund Partnership Structure

■ Establish Fund as a Partnership
  ● If Fund is structured as partnership, and manager receives interest in Fund’s profits as allocation (rather than fee), can provide for multi-year performance period

■ Advantages
  ● Can have multi-year performance period
  ● Can provide for post-termination performance payments
  ● Can provide for payments following voluntary termination
  ● Aligns investors and manager (see tax distributions)
  ● Could afford capital gains treatment
  ● 409A and 457A should not be applicable, thus more flexibility

■ Disadvantages
  ● No tax deferral given partnership tax regime
  ● Amounts are taxed when allocated rather than distributed (and allocations are generally made annually)
  ● Would generally require preferred tax distributions to manager, which could be difficult for investors to digest
  ● Clawback of distributed amounts is difficult if performance ultimately not met
  ● Target of Carry Legislation, which could jeopardize favorable character of gain
Clawback of Fees Paid

- Fees paid annually although subject to full clawback, or clawback of after tax amounts
- Consider whether clawback is on “gross” amount paid or amount “net” of taxes. “Claim of right” inefficiencies

Attributes to Consider
- No Tax Deferral
- Tax Inefficiencies if have to repay (risk IRS does not respect claim of right)
- Presence of contingent liability results in “strings” on after tax amounts paid
- Difficulty of enforcement—have to run after the guy with the money...
457A Substantial Risk of Forfeiture

**Advantages**
- Allows deferral of taxation
- Allows for multi-year performance period
- Provides retentive effect and continuity of investment management
- Aligns investors and manager

**Disadvantages**
- Under 457A a substantial risk of forfeiture cannot be based on performance, but rather must be based solely on time vesting
- Income must be included within the 409A payment period and the 457A short term deferral period following end of performance period.
- Amounts are subject to forfeiture
- Substantial risk of forfeiture can be called into question if the fund is a self-sponsored (i.e., manager sponsored) fund. [Continued on Next Slide]
Self-Sponsored (i.e. Manager Sponsored) Fund

- Whether a substantial risk of forfeiture exists is based on the facts and circumstances

- In the hedge fund/investment manager setting, a significant risk exists that a self-created forfeiture provisions will be disregarded by the IRS

- This is especially true if the manager is the sponsor of the fund and its fees were never subject to forfeiture
457A Short Term Deferral

- Vested performance fee would have to be paid no later than the last day of the calendar year following the year of vesting
  - Example: Typical 2/20 structure with performance only vesting (i.e., no time vesting element): Multi-year performance fee vests at beginning of 2009 performance period. Fee would need to be paid in 2010 calendar year

### Advantages
- Can use performance based vesting criteria
- Can provide for post-termination performance payments
- Can provide for payments following voluntary termination
- Can use multi-year performance period
- Can provide clawback feature for post termination payments
- Aligns investors and manager

### Disadvantages
- Performance period is only able to be two years *at a maximum*
- Amounts that vest based solely on performance would be deemed “vested” from grant, and would have to be paid in 457A short term deferral period.
- Have to structure so as to comply with Section 409A rules (and amounts would be subject to 409A vs. exempt from 409A)
- Payment and determination of year two performance must be made on the last day of year, thereby causing extreme administrative difficulty
Hybrid Short Term Deferral Approach

- Hybrid means: performance and time based vesting
- For example, 2009-2010 Performance Period. Must be employed on January 1, 2010. Can pay in 2011
  - Less administrative difficulty in making payments
  - More flexibility in timing of payments
  - Limited ability to pay payments following termination
  - Easier to be exempt from 409A if paid in early 2011 year (by March 15th)
  - Ability to clawback amounts prior to payment
Issue Fund Options/Stock Settled SARs

- Issue fair market value options or stock settled SARs in FUND
  - Exercise/Strike price will be equal to fair market value of Fund share on grant date based on grant date NAV
  - Investment Manager will benefit if NAV increases over time after grant date
  - Spread on options/SARs realized upon discretionary exercise; thus, potential for significant deferral and ability to control timing of taxation
  - Spread taxed as ordinary income upon exercise
  - Compounding potential is significant
  - Investors have clawback on performance compensation because option/SAR spread would be reduced based on poor performance
  - Grants can be made periodically, including upon: implementation of the program, at the end of each performance period, when new investor money is obtained
  - Lockup non-exercise period for options/SARs can coincide with investor lockup periods, and/or can require post-exercise holding period
  - Generally options must be exercised upon withdrawal of related investments
Issue Fund Options/Stock Settled SARs

**Conditions and Concerns**

- Service relationship of awardee must be established directly with fund
- Must be “common stock” options/SARs—can’t have certain non-liquidation preferences
- Exercise/Strike price must be at or in excess of FMV of common stock
- Puts or calls on the options/SARs must be no greater than FMV
- Repurchase obligation cannot be mandatory (other than ROFR)
- Must be stock settled, although no clear guidance on how long stock must be held post-exercise
- Discrepancies regarding use of equity under 457A in Treasury Notice and Statute (457A)
- Noncorporate entities may only issue options (not SARs) under Notice. Thus, cashless exercise for noncorporate entities may not be permissible (i.e., cashless exercise akin to a SAR). Further guidance needed.
- Options on PFIC raises tax issues: (A) Options over PFICs are treated as PFIC stock, but only for purposes of anti-deferral rules of IRC 1291; (B) a purging election would be required after exercise to prevent IRC 1291 from applying to the disposition of the stock; (C) a QEF election would typically be made after exercise
- Administratively difficult once number of grants becomes significant
- Highly unusual, at present
Issue Fund Options/Stock Settled SARs

- Post-Exercise Holding Period: should help to prevent recharacterization that awards are cash settled
- Coinciding lock up periods (i.e., prohibition on exercise) among investors and manager will align all interests
- Option Term must be determined: generally, any longer than 20 years could be abusive
- Liquidity concerns: how much of each exercisable grant can be exercised in any one year?
- What to do when new investors invest? New grants could be made
- Who will bear administrative expenses?
- Policy Point: By its terms, could be more favorable to investment manager than pre-457A plans. Was Treasury’s notice intended to apply to passive investment vehicles versus only operating company options?
- We understand that the program is being adopted in the industry and several of our clients have been approached by Optcapital on behalf of institutional fund investors. Further analysis is necessary before we can endorse this program
STUART E. LEBLANG, Partner
sleblang@akingump.com

New York T (1) 212.872.1017
F (1) 212.872.1002

Practice Areas:
Tax
Investment Funds
Distressed Real Estate Asset Services
Corporate Finance and Securities

Stuart E. Leblang is the co-head of Akin Gump's tax practice. Mr. Leblang also serves on the firmwide management committee.

Mr. Leblang’s practice includes planning and negotiation of domestic and international business transactions, corporate and financial tax counseling, and representation of clients on tax legislative and policy issues before the U.S. Congress, the U.S. Department of Treasury and other federal agencies. He also focuses on various investment fund related matters.

Prior to joining Akin Gump, Mr. Leblang was the associate international tax counsel at the U.S. Department of Treasury. During his tenure there, he was involved in legislative and regulatory developments in the international arena. He initiated and developed a number of international provisions contained in the Taxpayer Relief Act of 1997, including those relating to foreign tax credits, passive foreign investment companies and the taxation of foreign investors. He also played a central role in the creation and development of the international tax provisions contained in President Clinton's 1998 Budget Proposal and in a number of international regulatory projects. Mr. Leblang has spoken extensively on issues relating to international tax policy.

In addition to his legislative activities at the Treasury, Mr. Leblang was responsible for initiating and implementing a number of tax regulatory projects, including those relating to foreign tax credits, hybrid entities, passive foreign investment companies and cross-border derivative transactions. He also was integrally involved in other completed and ongoing regulatory projects, including projects relating to the subpart F consequences of hybrid entity structures, the sourcing of losses on sales of personal property, the treatment of step-down preferred stock transactions, the taxation of FASITs, corporate tax shelter registration requirements and interest expense allocations. Mr. Leblang also participated in a number of negotiations with current and prospective U.S. tax treaty partners.

Bar Admissions
New Jersey
New York

Education
J.D. Columbia University School of Law, 1990
B.A. Cornell University, 1987
Prior to working at the Treasury, Mr. Leblang was an associate in Akin Gump's New York office and at another international law firm, in its New York and London offices.

Mr. Leblang earned his B.A. from Cornell University in 1987 and his J.D. in 1990 from Columbia Law School where he was a James Kent Scholar and a Harlan Fiske Stone Scholar, as well as a coordinator of the Columbia Moot Court Program. Mr. Leblang is a member of the New York and New Jersey state bars.
Trends and Opportunities in Hedge and Private Equity Fund Investing

Alexander V. Moomjy
Managing Principal
Park Hill Group LLC

Mr. Moomjy, Managing Principal, is the head of Park Hill's hedge fund origination and project management team. Mr. Moomjy joined Park Hill Group with over 17 years of experience in the alternative asset and investment space. Prior to Park Hill, Mr. Moomjy held Managing Director positions at Credit Suisse First Boston and Merrill Lynch, raising capital for hedge funds, placing secondary interests in private equity limited partnerships and raising private equity capital for corporate clients. Previously, Mr. Moomjy was a Director at the Treasurer's Office of General Motors, where he was Director of Corporate Finance and Investments. He received an M.B.A. from the Wharton School at the University of Pennsylvania and a B.S. in Chemical Engineering from the University of Pennsylvania.

Park Hill Group LLC, subsidiary of The Blackstone Group, is a leading global alternative asset placement agent. Since inception, the firm has served as a placement agent to funds that raised in total in excess of $77.1 billion of commitments for its private equity and hedge fund clients. Park Hill’s mission is to represent “best of breed” general partners and managers in connection with the raising of private equity funds, hedge funds and other alternative investment products. Park Hill advises on all aspects of the fundraising process, including competitive positioning and market assessment, marketing materials and related documentation, and partnership terms and conditions most prevalent in the current environment. Additionally, Park Hill provides top-tier global distribution capabilities through its senior relationships across the limited partner arena. Park Hill looks to continually service limited partner alternative investment needs through its proprietary research capabilities.
Bruce E. Simonetti is engaged in the practice of executive compensation and employee benefits law including ERISA, federal taxation and securities law.

Mr. Simonetti has experience negotiating employee benefits aspects of major corporate transactions, including mergers and acquisitions, spin-offs and initial public offerings. In addition, he has negotiated executive compensation arrangements, including employment and severance agreements and equity-based compensation plans. Mr. Simonetti has advised various financial institutions with respect to marketing investment products to employee benefit plan investors. He has also advised clients regarding the application of ERISA's prohibited transaction and fiduciary responsibility rules.

Mr. Simonetti received his B.A. magna cum laude in 1991 from Boston College and his J.D. summa cum laude in 1994 from American University, where he was a member of the American University Law Review. He received his LL.M. in taxation in 1995 from New York University, where he was a graduate student editor of the Tax Law Review. Mr. Simonetti is a member of the New York State Bar.
Stephen M. Vine leads the firm’s investment funds practice group and was one of the founding partners of the New York office. He also serves on the firmwide management committee.

Mr. Vine’s practice focuses exclusively on private investment funds and their managers. For the past 25 years, he has advised some of the largest and most prominent private investment funds and fund managers in connection with their fund formation and capital raising activities. These funds have involved a diverse range of investment disciplines including global macro, distressed investments, private equity, domestic and foreign real estate, arbitrage, financial services and country funds. In addition to the creation of private investment funds, Mr. Vine's practice includes advice on the planning and execution of investment and financing transactions, as well as on the formation and operation of investment management firms and related service companies, including broker-dealers. He also assists fund managers in registration and regulatory compliance.

Mr. Vine earned his A.B. magna cum laude in 1974 and his J.D. cum laude in 1977 from Harvard University, where he was elected to Phi Beta Kappa. He is a member of the New York Bar.

Mr. Vine is listed in The Best Lawyers in America (2006) and in every edition of Chambers USA: America's Leading Lawyers for Business.