Hedge Fund Employee Compensation

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A Practice Note addressing hedge fund employee compensation, including the sources of income that hedge fund managers receive from investors, the investment professionals who receive compensation based on these income streams, and the various approaches that hedge fund managers take when compensating their employees and incentivizing particular behaviors.

Hedge fund managers (or firms) do not deal in tangible products and generally do not own tangible assets. They instead generate revenue from:

- Fees their investors pay for asset management, based on a percentage of assets under management.
- Incentive compensation based on investment performance.

The employees who help to generate these revenue streams, that is, the portfolio managers, analysts, traders, marketers and investor relations personnel, and the operations personnel who support the revenue generators, are a hedge fund manager's most valuable assets.

Hedge fund compensation is usually tied in some way to the employees' contributions to the bottom line. The compensation philosophy adopted by a hedge fund manager typically reflects the culture of the firm. At one end of the spectrum, the firm's employees may be siloed with their team and compensated based on team performance. At the other end of the spectrum, employees may be compensated based on the performance of the firm as a whole. Hybrid approaches abound. Common goals for all hedge fund managers, however, include:

- Incentivizing profit generation.
- Investor acceptance.
- Legal and regulatory compliance (for example, compliance with the Investment Advisers Act of 1940, the Commodity Exchange Act, and data protection laws and regulations).
- Engagement and long-term retention of valuable employees.

The compensation philosophy adopted by a hedge fund manager should be structured with these goals in mind.

SOURCES OF INCOME

Hedge fund managers have two sources of income from investors:

- Management fees, which are a percentage of assets under management (traditionally 2 percent, but more commonly today, 1.5 percent). Management fees are typically paid monthly or quarterly and are paid to the management company (or investment manager). Management fees are paid without regard to the fund's performance and are generally used to pay the management company's fixed expenses (such as office space and employee salaries).
- Incentive compensation, which is based on a percentage of the fund's profits generated through investment activities each year (traditionally 20 percent, usually subject to a high water mark and sometimes subject to a hurdle). Incentive compensation is generally earned annually. Depending on legal, business, and tax considerations, including the structure of the fund, incentive compensation may be:
  - allocated to the general partner of the fund (this is referred to as "incentive allocation"); or
  - paid to the management company (this is referred to as an "incentive fee").

ROLE OF THE MANAGEMENT COMPANY AND THE GENERAL PARTNER

The firm is typically comprised of the management company (the investment manager) and the general partner.

The management company:

- Employs the employees.
- Leases office space.

- Pays the expenses of operating the business.
- Is responsible for day to day investment activities.
- Earns the management fee and any incentive fees.

The general partner:

- Is responsible for operating the fund.
- Receives any incentive allocations.

INVESTMENT PROFESSIONALS

Investment professionals who receive compensation from the management company and the general partner generally fall into three categories:

- Employees of the management company who receive a base salary and may also be entitled to receive discretionary and/or formulaic bonuses from the management company, subject to wage tax withholding.
- Employees of the management company who are admitted to the general partner (typically, a limited liability company) and, therefore, are allocated profits (in the form of a profits interest) from the general partner in addition to wages from the management company. Individuals who are admitted to the general partner are typically admitted solely for the purpose of receiving their profit allocations and do not have any governance or voting rights in the general partner.
- Individuals who are admitted as limited partners of the management company and, therefore, receive a draw or guaranteed payment from the management company and a share of net fees. These individuals typically include a firm's founders and, in some situations, other senior firm personnel. They are also admitted as non-managing members of the general partner and, therefore, receive profit allocations from the general partner. Individuals who are admitted to the management company and the general partner may or may not have governance rights.

INCENTIVE-BASED PAYMENTS FOR INVESTMENT PROFESSIONALS

There are multiple ways for a hedge fund manager to compensate its investment professionals over and above base salary or draw. Common examples are:

- Paying discretionary bonuses from management fees, bonuses calculated based on the firm's profits, and bonuses from compensation pools funded by management fees that are allocated to pool participants in a discretionary or formulaic manner.
- Paying a percentage of the profits the individual or a team, or both, generate after deduction of direct expenses and overhead.
- Allocating a fixed or discretionary percentage of the incentive compensation earned by the general partner and the management company on an annual basis.
- Setting aside a certain percentage of the firm's annual incentive compensation to a pool for senior investment professionals and allocating a fixed or discretionary share of the pool to pool participants.

These various approaches are not without their drawbacks. Linking an individual's compensation solely to the individual's performance can lead to a mentality where employees (and partners) are concerned solely with their own performance and not the performance of the firm as a whole. While compensating individuals based on the firm's overall performance can lead to a greater sense of investment in the firm's overall performance, it may also cause top performers to leave if they feel their individual compensation is being adversely affected by poor performance in other areas of the firm.

Compensation methodologies are more complicated when the firm engages in both hedge and private equity-type investing. While hedge funds offer their investors liquidity and often seek quick returns from investment in liquid assets, private equity funds lock their investors up for the duration of the fund's life and, therefore, contemplate a longer time horizon and generally make illiquid investments in private companies, often through leveraged buyouts of financially distressed companies. These different approaches are reflected in the compensation practices of the funds.

Hedge funds compensate the management company and general partner on a fixed schedule (generally annually for incentive compensation), whereas private equity investments generate carry only when the investments are sold, which may be years down the road, or when dividends, interest, or similar periodic items are produced. An employee who is accustomed to receiving a bonus annually based on investment performance during the year may expect to be paid with respect to private equity-type investments before any profits have been realized.

BONUS COMPENSATION

Bonus compensation is an important component of most hedge fund professionals' compensation. Bonus compensation to an employee is taxed at ordinary income rates and is subject to wage withholding. The employer reports the employee's bonus compensation on a Form W-2. A bonus also needs to be structured to comply with or be exempt from Section 409A of the Internal Revenue Code of 1986, as amended (Code), which creates complex rules for nonqualified deferred compensation arrangements (26 U.S.C. § 409A). The tax penalties for noncompliance with Section 409A are severe and include:

- Current taxation if vested (even if amounts have not been paid).
- A 20 percent penalty tax.
- A premium interest charge.

Section 409A's rules can be avoided by structuring bonuses to fit within one of Section 409A's exceptions. One of the most important exceptions from Section 409A is the exception for "short-term deferrals," that is, payments that must be made within a short time period after they are no longer subject to a substantial risk of forfeiture. In the calendar year context, this short-term deferral exception applies to compensation that is both payable and actually paid no later than March 15 of the year following the year in which the employee's right to the compensation is no longer subject to a substantial risk of forfeiture. The short-term deferral exception is often relied on as it eliminates concerns about bonuses that are always paid shortly after the close of the year or end of the applicable performance period. For more information about Section 409A, see Practice Note, Section 409A: Deferred Compensation Tax Rules: Overview (6-501-2009).

PROFITS INTERESTS

The general partner may divide up slices of the incentive allocation that it receives from the fund and allocate them to its members, who are also employees or partners of the management company. These "slices" are generally structured as profits interests. A profits interest entitles the holder to a share of partnership profits (that is, future appreciation or income of the partnership). If properly structured, the grant of a profits interest is not taxable to the recipient at the time of grant or vesting. The recipient of the profits interest is instead taxed on his or her share of the incentive allocation generally at the same time that the fund's investors are taxed (typically, the year when the fund realizes income and gains) and the tax character of the income (which may be capital gain in some cases) is passed through to the employee, provided that, under new Code Section 1061, long-term capital gain treatment generally is limited to gains from the sale of assets held over three years (26 U.S.C. § 1061). The individual's profit allocations are reported on a Schedule K-1.

When structuring compensation arrangements, the hedge fund manager must keep in mind that an individual who receives a profits interest immediately becomes a partner in the entity granting the interest for tax purposes. In addition, an individual cannot be both a partner and employee of the same entity. For more information on profits interests, see Practice Notes, Profits Interests (3-422-4189) and Partnership Equity Compensation (1-525-2704). For information on the issues associated with treating an individual as both a partner and an employee in the same entity, see Practice Note, Dual Status: Treating Partners as Employees (9-583-9305).

Section 409A has historically not applied to a service provider's profits interest in the general partner or the management company. It would, however, apply to a guaranteed payment arrangement (such as a fixed salary or bonus equivalent that is not based on partnership profits). For more information on the taxation of profits interests and other partnership equity compensation, see Practice Note, Partnership Equity Compensation (1-525-2704).

INTEREST IN A SALE OF THE BUSINESS

Very senior investment professionals may also be entitled to a percentage of profits on a sale of all or a portion of the firm. An interest on sale is usually reserved for the firm's founders; however, in the past decade it has become more common to give other senior personnel, including new hires, slices of equity. Sale participation is generally structured as a profits interest in the entities that comprise the firm, meaning that the participant would not earn anything if the management company and the general partner were immediately sold for their value on the grant date. The participant, however, would participate in the future growth of the firm and may even be allowed to "catch up" out of future appreciation to be placed in the position the participant would have been in had the participant been granted the profits interest at the time the firm commenced operations.

For example, if the existing partners of a management company granted a new partner a 20 percent interest in partnership profits at a time when the entity had a $100 million valuation and offered that partner a full catch-up in subsequent increases in the entity's value, the partner would be allocated the next $25 million of sale proceeds in excess of $100 million ($25 million = 20 percent of $125 million). On the other hand, if the management company were sold for $110 million, the new partner generally would only be allocated $10 million of sale proceeds (and $0 if the sale were for $100 million or less).

DEFERRAL OR REINVESTMENT OF BONUS COMPENSATION

Most hedge fund managers operate offshore funds through which certain investors invest. Before 2009, many management companies using the cash method of tax accounting elected to:

- Defer all or a portion of their incentive fees (and sometimes management fees) earned from the offshore funds they managed.
- Establish "back to back" arrangements whereby the fund established a deferral arrangement with its management company that paralleled the deferral arrangement between the management company and its employees.

This type of deferral arrangement:

- Prevented the management company from being subject to current taxation on deferred employee bonuses.
- Allowed the deferred fees to be paid out from the fund to the management company when a corresponding payment was due to the employee (for example, on an employee's separation from service).
- Was required to comply with Section 409A but was permissible if structured properly.

With the introduction of Code Section 457A ("Section 457A"), effective beginning with the 2009 tax year, a management company became unable to defer its compensation from these offshore funds for a period extending beyond 12 months unless the management company was willing to forfeit the compensation should it decide to cease providing substantial services to the fund (a proposition that most management companies have rejected). For more information on Section 457A, see Practice Note, Code Section 457A: Overview (5-534-6273).

Revenue Ruling 2014-18 exempts from Section 457A nonqualified stock options and stock-settled stock appreciation rights (SARs) on a fund's shares if they qualify for favorable treatment as "stock rights" under Section 409A. For information on the rules regarding stock rights under Section 409A, see Practice Note, Section 409A: Deferred Compensation Tax Rules: Overview: Equity Arrangements (6-501-2009). However, few management companies have used this arrangement to date for various reasons, including:

- The inherent clawback feature that would need to be built into the arrangement (old deferrals generally were indexed to the performance of the fund but would not dwindle to zero absent a complete loss of all fund assets).
- The requirement of having to exercise into the fund's shares and the complexity involved with either:
  - creating new funds with this compensation structure; or
  - restructuring the compensation structure within the existing funds.

For more information on Revenue Ruling 2014-18, see Article, Expert Q&A on Section 457A of the Code and the Impact of Revenue Ruling 2014-18 (9-572-1626).

With the loss of the traditional offshore fund deferred fee arrangements, the alternatives for deferring unvested employee compensation have become more limited. Post-Section 457A, this has generally been accomplished through either:

- A pre-tax deferral of a portion of an employee's bonus, which forces the management company's partners to pay tax on the amount it is not currently expensing.
- A post-tax mandatory reinvestment of a portion of the bonus in the fund(s) managed by the firm, which when properly structured gives the management company's partners a current deduction but is currently taxable to the employee. Tax distributions of unvested amounts are often provided for on a going-forward basis.

The amount deferred or reinvested, adjusted for phantom or actual gains and losses, is then paid or distributed to the employee in accordance with a vesting schedule and is subject to forfeiture conditions.

There are two different vesting options firms can use:

- **Cliff vesting**. The full amount deferred or reinvested vests on a single date in the future (for example, two years after deferral or reinvestment). If the employee leaves the firm at any time before the single vesting date, the employee forfeits the entire deferred or reinvested amount.
- **Graded vesting**. The amount deferred or reinvested vests over time (for example, 25 percent on December 31 of each calendar year over a four-year period). Amounts typically are paid as they vest and unvested amounts are forfeited, unless a qualifying termination occurs (for example, the employee's death or termination without cause).

FORFEITURE

Depending on program design, deferred compensation programs can incentivize certain behaviors a firm wishes to encourage, including:

- Retention.
- Post-termination non-competition.
- Post-termination non-solicitation.

For example, to incentivize non-competition, employees may be permitted to vest after resigning, but forfeit their deferred compensation if they compete with the firm. Deferred compensation programs can also serve to align the employees' economic interest with the firm's interest, because the ultimate value of the deferred compensation is typically tied to the performance of the fund(s).

PAYMENTS ON TERMINATION

While most employees and partners of hedge fund managers are "at will" and are not entitled to compensation on termination of employment, some firms choose to provide severance payments for "good leavers" and others agree to the payment obligation and conditions up front. Payment is usually contingent on the employee executing a release of claims and complying with continuing obligations to the firm after termination. These obligations may include restrictive covenants regarding:

- Non-competition.
- Non-solicitation of investors.
- Non-solicitation of employees.
- Non-disparagement.
- Non-disclosure of confidential, proprietary, or trade secret information.

SUNSET DISTRIBUTIONS

High-level, long-time partners of the management company (or members of the general partner) are sometimes entitled to "sunset distributions" in the event the partner leaves the firm. The sunset typically provides the partner with a declining percentage of the firm's incentive compensation and/or management fees for several years (typically three to five years) after the partner leaves the firm. The partner may also be entitled to receive a declining percentage of net sale proceeds if the firm is sold.

A sunset arrangement is generally much more tax efficient for remaining partners, as the departed individual still participates in the management company or general partner as a partner or member and pays tax on the allocated items. A buy-out, on the other hand, would cause the remaining members/partners to be taxed on the amounts being paid out without an ability to currently deduct the buyout payments.

To be eligible for a sunset, the partner must meet certain vesting criteria and must be a "good leaver." A common vesting hurdle is five-year cliff vesting, with the partner not being entitled to any distribution regarding a sunset if the partner leaves before having been at the firm for five years.

FORFEITURE FOR COMPETITION

In the event a partner leaves voluntarily, a firm may also consider making the sunset contingent on the partner not competing with the firm or engaging in other conduct that could damage the firm (such as soliciting investors or employees). This type of provision is not a restrictive covenant, in that it does not restrict a partner from engaging in competitive behavior. It instead provides that a partner who chooses to engage in competitive behavior forfeits his or her sunset distributions.

The tools and structures described above demonstrate that compensation in hedge funds is not just about the amount of dollars paid every year. Thoughtful hedge fund managers adopt a compensation philosophy that reflects their goals and structure their compensation programs to help achieve those goals.

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