Memorandum

April 13, 2009

Changes Coming to Fund Compensation Structures?

By Jahangier Sharifi and Kenneth E. Werner

"Recent changes and proposed changes in the tax laws and this past year's market events may cause both investors and fund managers to reconsider the optimal way to structure compensation for management."

Three factors have been important in structuring investment fund compensation in the past: deferral of taxes on offshore fee income, favorable tax treatment of carried interest, and the prevailing view that compensating a fund manager primarily based on the performance of the fund was the best way to align the interests of the manager and the investors. Recent changes and proposed changes in the tax laws and this past year's market events may cause both investors and fund managers to reconsider the optimal way to structure compensation for management.

First, until last year, fees received from offshore funds could be deferred for tax purposes. The ability to do this was eliminated, effective for services performed after December 31, 2008, by the Tax Extenders and AMT Relief Act of 2008.

Second, currently, to the extent a fund manager receives a carried interest as an allocation of income from an entity taxed as a partnership, the character of that income passes through to the manager, making this a very attractive form of compensation for managers of funds that generate substantial long-term capital gains. However, President Obama and certain members of Congress have proposed to eliminate this tax treatment of carried interest income, and instead to tax any such allocation as ordinary income. On April 3, 2009, Rep. Sander Levin reintroduced legislation to effect this change.

Third, the prevailing view has been that compensating a fund manager primarily based on the performance of the fund was the best way to align the interests of the manager and the investors. The manager would do well if, and only if, the fund did well. That thought led to fund managers receiving carried interests of typically 20% - and higher percentages in certain instances - of the profits of a fund, with annual management fees of 1% to 2% of the assets of the fund. As a result, in years prior to 2008, the lion's share of the compensation of successful fund managers was attributable to their carry. (Without a hurdle, a "2 and 20" compensation structure will cause the carried interest compensation to exceed the management fee when the fund achieves a return of over 10%.)

While basing a substantial portion of the compensation of a fund manager on the profitability of the fund creates incentives for managers to maximize fund returns, it is possible that fund managers may face the prospect of investors actively seeking to negotiate a reduced rate for this incentive compensation. We would like to suggest

that this development may not be wholly negative from the point of view of fund managers, so long as they use this as an opportunity to negotiate a trade-off in the form of higher management fees.

Since most fund performance fee arrangements provide for a “high water mark” (i.e., a carried interest will only be earned once the fund makes up for prior losses), funds which suffered substantial losses in 2008 are now faced with the possibility of not receiving any carried interest in the near term. This may lead to serious problems with retaining key employees, who may find it more profitable to leave for new funds, allowing them to reset the base for their performance compensation.

In light of the above, it may make sense for fund managers and investors to consider restructuring fund compensation arrangements to provide for a higher management fee and a reduced performance fee. If the tax differences between management fees and performance fees are eliminated, this will reduce the difference to the fund manager of receiving compensation in one form or the other (although there still may be tax differences for the investors in these forms of compensation, which should be considered, depending on the legislation that is eventually adopted). Although such a change might be viewed as somewhat blunting a fund manager’s incentive to maximize fund value, on balance it may more appropriately align the interests of managers and investors in promoting stable fund management seeking long-term returns for the fund, without taking on an inappropriate level of risk.

Under arrangements in which the preponderance of fund manager compensation is expected to come from performance fees, fund investors may be satisfied if their funds relatively outperform in uncertain or declining markets, but fund managers may not feel adequately compensated with the performance fees generated by such relative outperformance (which in 2008 resulted in no carried interest payments for many hedge funds that provided far superior performance to nearly all other asset classes). Having greater certainty of annual revenues will permit fund managers to commit long-term to investment strategies and retain experienced investment professionals during a period of uncertain profits. Fund investors may be open to a higher management fee, particularly if all or portion of that fee is offset against any performance fee that is eventually earned. If legislation is passed to make the tax character of the management fee and the performance fee the same, then such set-off arrangements should be less objectionable to fund managers.

Another consideration that may cause fund managers and investors to restructure fund compensation arrangements is the possible change in the inflation environment. In the past 25 years, the period during which the private investment fund business largely developed, the United States has experienced only moderate inflation. In a higher-inflation environment, which many suggest may occur in the years following the current recession, fund investors may seek to structure the carried interest so that it would only be paid on profits that exceed a hurdle rate; investors may not agree to pay carried interest on profits that do not exceed the risk-free rate of return. Fund managers may be willing to concede this point if they are compensated by a higher management fee, providing them with a more certain revenue stream to fund their operations.

The “2 and 20” compensation model has held sway for a number of years and may well prove resilient notwithstanding the events of the recent past. However, if the tax advantages of carried interest payments are legislated away, in an uncertain and potentially high-inflation economic environment, both fund managers and fund investors may agree on compensation structures that are significantly different than the current market standard.

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QUESTIONS

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