

Paying Hedge Fund Managers with Fair Market Value (FMV) Options Increases Pension Returns and Enriches Managers

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Abstract: The current incentive compensation model of annual (or quarterly) crystallization (“annual banking”) is short-sighted and hurts both pensions and hedge fund managers. Pensions would realize significant increases in returns from their hedge fund investments if the fund paid the manager with fair market value (FMV) options. FMV options divide cumulative, pre-tax profits at the end of the life of the investment (or earlier if the parties agree). Based on historical averages of a sampling of ten “top 30” hedge funds, a 10-year investment using such a deferred profit sharing model could increase annualized returns by more than 2.0% and pension assets by more than \$1 billion for every \$1 billion invested. Pensions in the aggregate invest about \$300 billion in hedge funds, and could realize an incremental gain of more than \$300 billion of assets in 10 years simply by switching to FMV options. This incremental return is called “alignment alpha.”

Under a FMV option model, a typical manager could increase its after-tax, disposable wealth substantially assuming a 10 to 20 year accumulation horizon. Annual banking may maximize incentive compensation over the 5 to 8 year life of the average investment, but it fails to maximize managers’ long-term capital accumulation and sustainability. By accumulating on a pre-tax, tax-deferred basis over a period that spans investment lives, FMV options offer managers the opportunity to double their capital accumulation within 20 years.

Given the \$3 trillion funding deficit, pensions have an urgent need to capture alignment alpha. FMV options offer a risk free way to increase returns substantially. Managers should appreciate the advantages of accumulating capital on a pre-tax, tax-deferred basis over the long term that spans investments. They should also appreciate the advantages of attracting pension capital, which tends to be “sticky” and is likely to be “stickier” under a deferred profit sharing model. Nevertheless, managers are likely to be slow to initiate change to FMV options, given inertia and the infrastructure changes required. Pensions can accelerate conversion, however, by sponsoring fund infrastructures that provide incentive compensation in the form of FMV options.

Arrangements which call for annual (or, worse, quarterly) crystallization of performance fees greatly skew a manager’s incentives toward short-term gains at the expense of a long-term relationship – even when the manager claims to be (or truly is) a “long-term” investor.

These arrangements are particularly displeasing when a manager has realized tens of millions of dollars in performance fees and then suffers a sizeable loss, resulting in a minimal capital gain or a net capital loss for the investor – but a large profit for the manager – at the end of the so called “partnership.”

-- CalPERS Memo to Hedge Fund Industry (March, 2009)¹

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¹ “Memo to RMARS Managers,” at <http://www.calpers.ca.gov/eip-docs/investments/bus-opportunities/rmars/rmars-memo.pdf>; See also Press Release, “CalPERS Moves to Restructure Hedge Fund Relationships – Seeks Better Model for Alignment, Control, Fees and Transparency,” at <http://www.calpers.ca.gov/index.jsp?bc=about/press/pr-archive/pr-2009/mar/restructure-hedge-fund.xml> (Mar. 27, 2009) (“The present model provides for the possibility of a hedge fund manager realizing a 20 percent performance fee at the end of a bonanza year. If the fund suffers a significant decline the next year, the manager could still have a large net gain at the end of the two years, but the investor may break even or even lose money. . . . Performance fees should be

Introduction

The problem is well known.² The manager shares in profits, but not in losses. So instead of side-by-side, *pari passu* profit (and loss) sharing, it is “heads the manager wins, tails the investor loses.”

The bigger problem, however, is that annual (or quarterly) crystallization (“annual banking”) enables the manager to compound its compensation at the expense of the investor. The investor loses the profits it would have made on the profits the manager banked. A pension typically invests with a hedge fund for several years.³ Over time the loss of profit compounding becomes substantial.

The repeated complaint from investors is that “it is not the 20%, but the timing of the 20%.” Instead of paying the manager each year based on annual profits, the fund could pay the manager using fair market value (FMV) options. FMV options divide cumulative, pre-tax profits at the end of the life of the investment – i.e., deferred profit sharing. Investors and managers always receive their proportionate share of profits and losses. In addition, the manager can increase its after-tax capital accumulation by taking full advantage of compounding at a pre-tax, tax-deferred rate and the power of time.

Based on historical averages of a sampling of top hedge funds, a 10-year investment under a deferred profit sharing model would increase annualized returns by more than 2.0% and pension assets by more than \$1 billion on every \$1 billion invested. Multi-year investors always receive more from deferred profit sharing, whether the fund is up or down. The incremental return is “alignment alpha.”⁴

Under a FMV option model, a typical manager would increase its after-tax capital substantially over a 10 to 20 year horizon.⁵

Pensions’ need for alignment alpha has never been greater. The pension underfunding gap exceeds \$3 trillion and an increasing number of pensions face bankruptcy.⁶ The deferred profit sharing afforded by FMV options provides pensions with a risk-free way to increase returns substantially in up years and down years, and regardless of which managers they select. Pension trustees, directors and officers may have a fiduciary duty to take reasonable steps to secure alignment alpha.⁷ If pensions’ \$300 billion

based on long-term performance, and mechanisms such as delayed realizations and clawbacks can better align long-term interests of managers and investors.”)

² “Hedge Fund Report Card” ABSOLUTE RETURN-ALPHA (September 2009) p. 72 (“Alignment of interests is more important than alpha generation these days – according to investors in the industry’s top hedge funds.”); “The Hedge Fund of Tomorrow: Building an Enduring Firm,” CASEY QUIRK BANK OF NEW YORK MELLON THOUGHT LEADERSHIP SERIES, p. 11 (“Investors told us that they considered alignment a major challenge for the industry, on par with investment performance. Investors are seeking a restructuring of fees and terms that better align their long and short-term objectives with those of managers.”)

³ “The Era of the Investor: New Rules of Institutional Hedge Fund Investing,” SEI and GREENWICH ASSOCIATES (January 2010) (time horizon for institutional hedge fund investments: 94% 3 years or more, 52% 6 years or more and 31% 10 years or more).

⁴ See *Figure 2 infra*.

⁵ See *Figure 7 infra*.

⁶ “Public Pension Promises: How Big Are They and What Are They Worth,” Robert Novy-Marx and Joshua D. Rauh, *JOURNAL OF FINANCE*, Vol. 66, No. 4 (August 2011); “The Crisis in Public Sector Pension Plans: A Blueprint for Reform in New Jersey,” Eileen Norcross and Andrew Biggs, MERCATUS CENTER, GEORGE MASON UNIVERSITY, Working Paper 10-31 (June 2010) at <http://mercatus.org/sites/default/files/publication/WP1031-%20NJ%20Pensions.pdf>; “The Widening Gap: The Great Recession’s Impact on State Pension and Retiree Health Care Costs,” THE PEW CENTER ON THE STATES (April 2011); “Milliman 2011 Pension Funding Study,” John C. Ehrhardt and Paul C. Morgan, at <http://www.milliman.com/expertise/employee-benefits/products-tools/pension-funding-study/pdfs/2>; “The \$440 Billion Pension Gap,” *CFO JOURNAL*; “The \$2 Trillion Hole,” *BARRON’S* (March 15, 2010); “Hedge Funds Lure More Cash from Pensions as Gap Looms,” *BUSINESS WEEK* (February 25, 2010).

⁷ See “The Big Lie: Unfunded State Government Pension and Retiree Health Benefits, David E. Morse, *BENEFITS LAW JOURNAL*, Vol. 23, No. 3 (Autumn 2010) (“Even in these days of mega-bank and corporate bailouts, it’s hard for us mortals to get our heads around \$1,000,000,000,000. You could think of it this way: if you invested \$1 trillion at 6 percent interest, you’d earn almost \$7 million . . . an hour. Using a different yardstick, the \$1 trillion retiree benefit liability exceeds both total state borrowings (\$798 billion) and annual tax revenues (\$781 billion). States today are contributing an average of about \$1 to their pension plans for

investment in hedge funds were converted to deferred profit sharing, pensions' assets could be \$300 billion greater in 10 years.⁸

Despite the advantages for managers, securing alignment alpha in the near term will require pensions to commit to deferred profit sharing and develop fund infrastructure independently of the manager. Managers will convert to cumulative pre-tax, profit sharing, but manager-initiated change is likely to be slow given the changes required to fund infrastructure. There is precedent for investor-driven initiatives that separate infrastructure and operations from investment management. For example, several pensions have resorted to separately managed accounts.⁹ As soon as pensions begin supporting a FMV option infrastructure that is independent of the manager, alignment alpha should flow.

Capturing Profit Compounding

Annual banking hurts investors. The investor loses its share of the profits it would have made on the manager's share ("profit compounding loss"). The better the performance of the fund, the greater the investor's loss will be. Conversely, deferred profit sharing avoids the profit compounding loss and enables the investor to capture profit compounding gains.

The annual banking of 20% of the profits hurts the investor's accumulation in the same way that annual taxation of profits erodes growth. Assets grow at 80% (1-20%) of the gross performance (after management fees). For example, a 15% gross rate equals a 12% annualized net return.

With deferred profit sharing, all the assets remain invested and compound pre-tax, tax-deferred at the pre-incentive fee rate of return of the fund. The 20% charge is applied at the end. As a result, the annualized net return is higher than under annual banking. Moreover, the longer the investment life, the higher the annualized net return.¹⁰ See *Figure 1* below:

every \$10 in taxes they take in. To reach just full pension funding, those contributions would need to grow by 75 percent for ten years, while pension investments somehow earned 8 percent annually. Right now, unfunded state pension promises in the United States average an extraordinary \$166,500 per participant.”); “California’s Canary in the Coal Mine: Public Pension Underfunding,” James P. Baker, *BENEFITS LAW JOURNAL*, Vol. 23, No. 3 (Autumn 2010).

⁸ At the end of calendar year 2010, aggregate state and local government retirement system assets totaled \$2.93 trillion, a 35 percent increase from their quarterly low point during the market collapse.

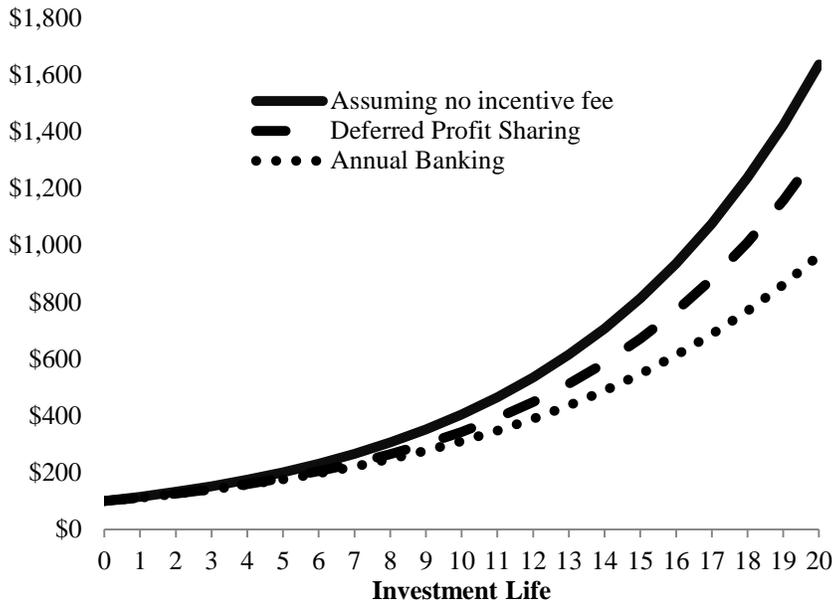
<http://www.nasra.org/resources/NASRANCTR1104.pdf>. December’s \$8 billion increase in market value brings the Milliman 100 PFI asset value to \$1.220 trillion, up from \$1.212 trillion at the end of November 2011, an investment gain of 0.8% for the month. <http://www.milliman.com/expertise/employee-benefits/products-tools/pension-funding-index/>. Public pension plans: Mean allocation of this group of investors to hedge funds has been steadily growing over the past few years and currently stands at 6.8%. The mean target allocation for pension funds is 7.7%. Private pension plans: Mean allocation has dropped back slightly in the past year to 8.2% (down from 8.6% in 2010), it has generally been growing in recent years. However, the current mean target allocation amongst private sector pension funds is 9%.

http://www.preqin.com/docs/samples/The_2012_Hedge_Fund_Investor_Review_Sample_Pages.pdf?rnd=1. Total hedge fund investments by pension plans = \$299 billion (6.8% * \$2.93 trillion) + (8.2% * \$1.22 trillion).

⁹ “Managed Accounts on the Upswing” PREQUIN RESEARCH REPORT (February 2010) at http://www.preqin.com/docs/reports/Results_of_Preqin_Survey_into_Managed_Accounts.pdf (“16% of all institutional investors surveyed have a current allocation to managed accounts. A further 23% of institutional investors are considering a maiden allocation to a managed account structure over the course of 2010.”); “Institutional Investors Leap on Managed Accounts Bandwagon,” Lynn Strongin Dodds, *FINANCIAL NEWS* (June 7, 2010) at <http://www.efinancialnews.com/story/2010-06-07/investors-leap-on-bandwagon>.

¹⁰ Under annual banking, the asset accumulation is calculated as follows: $FV = C[1 + r(1 - IFR)]^n$, where FV = future value, C = contribution, r = return before incentive fee, IFR = incentive fee rate and n = number of years. Under deferred profit sharing, the formula is as follows: $FV = C[1 + r]^n - \{[C(1 + r)^n - C]IFR\}$.

Figure 1. Profit Compounding Gain under Deferred Profit Sharing Model



The magnitude of alignment alpha depends primarily on the magnitude of returns and the investment duration. Figure 2 below shows how much alignment alpha an investor could expect from equal investments lasting 10 years with the following ten managers.¹¹

Figure 2. Magnitude of Alignment Alpha (\$s in 000,000s)

Fund	\$100 Million Invested for 10 Years					
	Annual Banking		Deferred Profit Sharing		Alignment Alpha	
	Annualized Return	Cumulative Profit	Annualized Return	Cumulative Profit	Annualized Return	Cumulative Profit
Paulson & Co.	26.2%	\$875	29.8%	\$1,230	3.6%	\$354
Pershing Square Capital Management	25.0%	\$801	28.4%	\$1,113	3.4%	\$312
Viking Global Investors	17.3%	\$375	19.3%	\$470	2.1%	\$96
York Capital Management	17.3%	\$384	19.4%	\$483	2.1%	\$99
Canyon Capital Advisors	14.5%	\$280	16.1%	\$344	1.6%	\$65
King Street Capital Management	14.4%	\$278	16.1%	\$338	1.6%	\$59
Elliott Management	14.4%	\$276	16.0%	\$334	1.6%	\$59
Brevan Howard Asset Management	13.6%	\$252	15.6%	\$324	2.0%	\$72
Greenlight Capital	10.4%	\$159	11.3%	\$188	0.9%	\$29
D.E. Shaw Group	9.8%	\$144	11.4%	\$187	1.6%	\$42
Average	16.3%	\$382	18.3%	\$501	2.1%	\$119

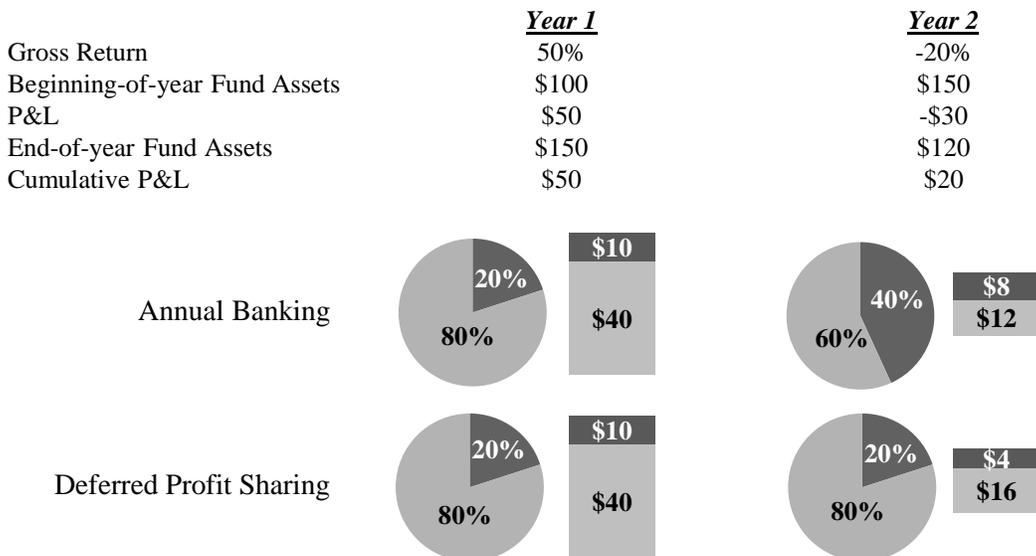
¹¹ We ran the comparison one thousand times and calculated the average increase in returns. For return and volatility data, see “Memorandum to the State Investment Council by the New Jersey Division of Investment,” at <http://www.nj.gov/treasury/doinvest/pdf/Third%20Point%20&%20Pershing%20Square.pdf>, [http://www.nj.gov/treasury/doinvest/pdf/Agenda%20Item%207a%20Canyon%20Balanced%20Fund%20\(Cayman\).pdf](http://www.nj.gov/treasury/doinvest/pdf/Agenda%20Item%207a%20Canyon%20Balanced%20Fund%20(Cayman).pdf), http://www.nj.gov/treasury/doinvest/pdf/10-10_KingStreet.pdf, <http://www.nj.gov/treasury/doinvest/pdf/ElliottAssociates.pdf>, <http://www.nj.gov/treasury/doinvest/pdf/BrevanHowardMasterFund.pdf>, <http://www.nj.gov/treasury/doinvest/pdf/HF-AcceptedJan07.pdf>; “Merrill Lynch Investment Solutions: UCITS Fund Platform,” at www.fundspeople.com/rs_archivos/201104280155094116.pdf. The returns and volatility for Pershing, York, Canyon, King Street, Elliott and Brevan Howard are inception through 2011. The returns and volatility for Paulson, Viking, Greenlight and D.E. Shaw are 2005-2009.

The Inherent Claw Back

Under the current annual banking model, managers receive their share of new growth each year. But when there is a subsequent decline, the investor bears all the loss. The manager retains its previously banked compensation, unaffected by the investor’s loss.

Figure 3 below illustrates how deferred profit sharing ensures that profits and losses are shared proportionately.

Figure 3. Alignment Alpha in Down Years (\$s in 000,000s)



With deferred profit sharing, the division of profits is tentative until redemption, at which time the profits are divided 80/20. Consequently, there is an inherent claw back mechanism that ensures that the manager participates in losses. The incremental return is alignment alpha.

Nature of Alignment Alpha

The size of alignment alpha is a function of many factors. Initially, it is dependent on a positive annual return. Without at least one growth year, the investor’s returns from the annual banking fund and the deferred profit sharing fund will be the same.

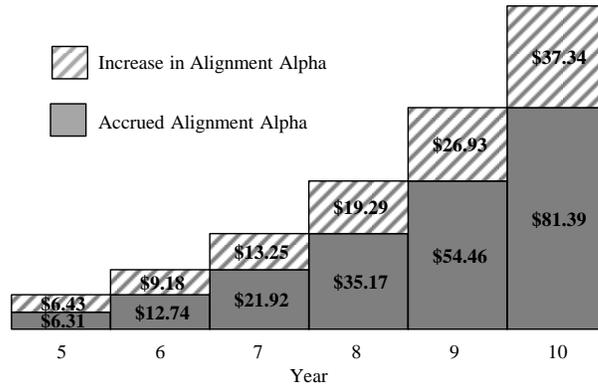
Alignment alpha grows exponentially. As the investment in a fund ages, the increase in alignment alpha is greater than the year before. Figures 4 and 5 below shows the relationship between investment duration and alignment alpha, based on the return and volatility data of the ten funds in Figure 2.¹²

Figure 4. Alignment Alpha and Investment Duration

Investment Duration	5	6	7	8	9	10
Annualized Return Increase	1.17%	1.38%	1.57%	1.75%	1.91%	2.06%
Cumulative Return Increase	12.74%	21.92%	35.17%	54.46%	81.39%	118.73%
Change in Cumulative Return Increase		9.18%	13.25%	19.29%	26.93%	37.34%

¹² See footnote 11 *supra*.

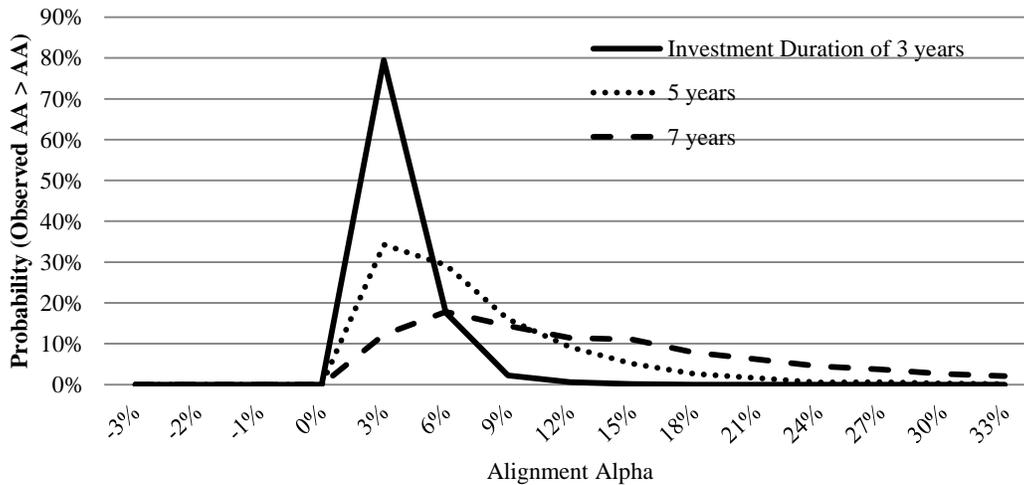
Figure 5. Alignment Alpha in Dollars for Every \$100 Invested



The dispersion of alignment alpha for any investment duration exhibits a long, fat right tail with no probability of negative outcomes and a high probability of positive to extremely positive outcomes. As the duration increases, the right tail becomes longer and fatter. Basically, deferred profit sharing provides a risk-free option to realize increased returns within a wide range. As the investment ages, expected alignment alpha increases exponentially. As a result, investors' incentive to stay invested grows with each passing year.

Figure 6 below compares the dispersion of alignment alpha for a 3-year, 5-year and 7-year investment life.¹³

Figure 6. Dispersion of Alignment Alpha



¹³ We assigned a probability distribution for hedge fund returns, including an expected return (11.45%) and standard deviation (11.49%) consistent with the Hennessee Hedge Fund Index[®]. Probability distribution of expected alignment alpha is generated by running the model one thousand times. The average and median alignment alpha increase as the investment duration increases. The average increases at a greater rate than the median, because the probability distribution of expected alignment alpha exhibits long right fat tail and as the investment duration increases the right tail gets longer and fatter. Long fat right tail implies high probability of extremely positive alignment alpha. As the investment duration increases the right tail gets longer and fatter.

Note how much the curve flattens and the right tail widens as the investment duration increases by only 2 years. For example, with a 5-year duration there is a 32% probability of receiving alignment alpha of 6% or greater. By extending the duration 2 more years, that probability increases to 62%.

In short, deferred profit sharing provides pensions with a risk-free option to increase returns in up years and down years, and regardless of the manager. As the investment duration increases, the probable increase in alignment alpha grows exponentially.

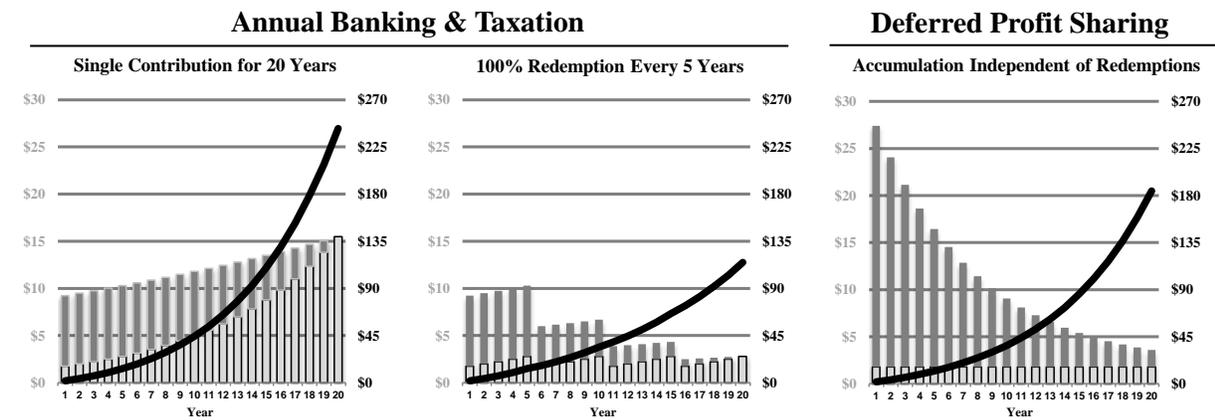
The Manager Advantage

The advantage of annual banking is that the manager’s incentive compensation with respect to a single contribution compounds. The manager receives not only 20% of the profits on the contribution, but 20% of the profits on the previous profits. When a contribution is redeemed and replaced with a new contribution, however, the manager’s compounding starts over. Thus, the shorter the investment (the higher the redemption rate), the less the manager earns.

The disadvantage of annual banking is that the manager must accumulate on an after-tax, taxable basis. The manager pays taxes each year on the banked compensation and on the growth of such banked compensation. The rate of return is reduced by the annual tax erosion.

The manager’s time horizon, however, is longer than a single investor’s investment duration. It spans many investors. Under deferred profit sharing, a manager compounds its share pre-tax, tax-deferred across investments over the long term. The benefits from tax deferral far outstrip the benefits of compounding over the life of an investment. Moreover, the accumulation is independent of redemptions. See *Figure 7* below.¹⁴

Figure 7. Manager’s Advantage from Deferred Profit Sharing



- Banked or, in case of Deferred Profit Sharing, Accrued Share of Profits
- After-Tax Growth of Share over Remaining 20-Year Period
- After-Tax Accumulation

¹⁴ Assumes \$100 contribution, 15% gross return, 20% incentive compensation rate, no management fees, and manager tax rate of 40% on incentive compensation from annual banking and from deferred profit sharing. It is also assumed that new contributions replace redeemed contributions so that there is \$100 of contributions at all times.

Figure 8 below compares a manager's after-tax compensation under a 20% redemption rate and a 25% redemption rate. It assumes \$100 million of contributions at all times and a 40% manager tax rate.¹⁵

Figure 8. Comparison of Manager's After-Tax Compensation from \$100 Million of Contributions (\$s in 000,000s)

Redemption Rate	Accumulation Period	Annual Banking	Deferred Profit Sharing	Manager's Incremental Wealth Accumulation from Deferred Profit Sharing	
				(\$s)	(%)
20%	10 years	\$56.5	\$64.7	\$8.2	14.6%
	15 years	\$127.6	\$189.3	\$61.7	48.3%
	20 years	\$261.2	\$528.3	\$267.0	102.2%
25%	10 years	\$53.8	\$64.8	\$11.1	20.5%
	15 years	\$120.8	\$190.1	\$69.2	57.3%
	20 years	\$246.8	\$531.3	\$284.4	115.2%

Pre-tax, tax-deferred profit sharing enables the manager to harness the power of accumulating over a long period, and do so at a higher rate of return (the pre-tax performance of the fund rather than the after-tax). Annual banking may maximize the manager's compensation from a single investment, but it fails to maximize across investments over the long term. Annual taxation erodes the manager's accumulation, as do redemptions.

Deferred Profit Sharing through FMV Options

The threshold issue is whether the pension and manager can share cumulative profits at the end of a multi-year period without the manager being taxed on profits in the interim. Paying taxes on profits that have not been banked, but are at risk of subsequent poor performance, is inefficient and unattractive to both the investor and the manager.

Under the current model of carried interest or performance fees, the manager is taxed each year on its share of profits. But hedge fund managers have always had the ability to share in cumulative profits over a multi-year period on a pre-tax, tax-deferred basis. Since the 1950s, Congress and the Internal Revenue Service have recognized that fair market value ("FMV") compensatory options promote a sound public policy of enabling service providers and service recipients to align themselves over a performance period longer than 1 year. The option is an "open" transaction for tax purposes until it is "closed" by the exercise (the banking) of the option, at which time the amount of the compensation is ascertained and received.¹⁶ Congress and the Service have not wavered in their support of FMV options.¹⁷ In fact, FMV

¹⁵ Assumes 16.3% annualized net return (the return of the ten managers in Figure 2 above (this equates to a 22.4% gross return assuming a 20% incentive compensation rate and 2% management fee rate). Also assumes manager tax rate of 40% on incentive compensation from annual banking and from deferred profit sharing. It also assumes that new contributions replace the redeemed contributions so that there is \$100 million of contributions at all times.

¹⁶ Internal Revenue Code ("I.R.C.") § 83(b); see also Treas. Reg. § 1.83-7(a) (compensatory option spread not taxable until the option holder exercises the option (except in rare case when an option is actively traded on an established market or has a readily ascertainable fair market value and is transferable)); see generally *Comm'r v. Lo Bue*, 351 U.S. 243 (1956) (agreeing with the government that taxable gain should be measured as of the time the options were exercised and not at the time they were granted); *Victorson v. Comm'r*, 326 F.2d 264 (2d Cir. 1964) (rejecting taxpayers' argument that the income was realized upon grant and not exercise of the right to purchase the stock); *Simmons v. Comm'r*, 23 T.C.M. (CCH) 1423 (1964) (agreeing with the government that the income in question was realized on the date the option was exercised, not upon the granting of the option); *Graney v. United States*, 258 F. Supp. 383, 386-87 (S.D. W. Va. 1966) (agreeing with the government's position that the options are taxable when exercised).

¹⁷ On October 22, 2004 President Bush signed into law The American Jobs Creation Act of 2004 (the "AJCA"). The AJCA added Section 409A to the Internal Revenue Code which layered on a new set of rules governing and restricting deferred

options have emerged as the antidote to the short-term pay practices that contributed heavily to the sub-prime mortgage fraud.¹⁸

A FMV option enables cumulative, pre-tax, tax-deferred profit sharing. For example, suppose ABC Pension contributes \$100 million to the Boomerang Fund and receives 100 shares. The Fund would grant the manager options to purchase 20 shares, each with a strike price of \$1 million. At the end of year 1, suppose the fund administrator determines the Fund NAV to be \$200 million, and the share NAV to be \$2 million. Each option would have an underlying share NAV of \$2 million, a strike price of \$1 million and a spread of \$1 million. In aggregate, the manager would have a tentative benefit of \$20 million (20 options times \$1 million spread per option).

In year 2, suppose the Fund is again up 100%, to \$400 million. The options would have the following underlying share value/strike price/spread: \$4 million/\$1 million/\$3 million. The manager's tentative incentive compensation would be \$60 million, and ABC Pension's tentative investment value would be \$340 million.

In year 3, suppose the Fund is down 50% to \$200 million. The share NAV would fall back to \$2 million and the options' values would be \$2 million/\$1 million/\$1 million. The manager's tentative incentive compensation would be \$20 million and the investor's tentative investment value would be \$180 million.

Note that the options provide an 80/20 sharing of the cumulative profits. After year 1, the \$100 million profit was tentatively divided \$80 million/\$20 million. After year 2, the cumulative profit of \$300 million was tentatively divided \$240 million/\$60 million. After year 3, the cumulative profit of \$100 million was tentatively divided \$80 million/\$20 million.

Compare the option results with what happens under the current model that allows the manager to bank its incentive compensation each year. The year 1 results would be the same: \$80 million for ABC and \$20 million for the manager. After the manager banks its fee, though, the Fund's assets drop to \$180 million. The Fund NAV at the beginning of year 2 is \$180 million. When the manager generates a 100% return in year 2, the Fund's assets double to only \$360 million (as compared to \$400 million under the option model). The manager then banks 20% of the \$180 million second year profit, or \$36 million. ABC has only \$324 million after year 2 under the annual banking model, as compared to \$340 million under the option model. This is because the pension loses its share of the earnings the Fund would have made had the manager's assets remained at risk in the Fund (80% of the \$20 million profit the Fund would have made, or \$16 million).

The example above shows that after two consecutive years of positive performance under the annual banking model, the manager takes more than 20% of the cumulative profits. If the manager had not

compensation. The Treasury Department promulgated final regulations that exempt from Section 409A fair market value (FMV) stock options, namely stock options that (i) are granted with respect to "service recipient stock," (ii) are granted by an "eligible issuer of service recipient stock," (iii) upon exercise, pay compensation no greater than the excess of the fair market value of the underlying stock on the date of exercise over the fair market value of the stock on the date of grant (and the number of shares of underlying stock is fixed on the grant date), (iv) have a strike price that is never less than the fair market value of underlying stock on the date of grant, and (v) does not include any other feature for the deferral of income.

Congress added Section 457A to the Code effective January 1, 2009. It prohibits hedge fund managers from banking and deferring compensation from a nonqualified entity – namely a fund located in a tax haven or a fund that is a domestic flow-through entity (e.g., partnership) with significant ownership by tax-exempt entities. Again, the Treasury Department exempted stock options, provided they satisfy the FMV stock option exemption set forth in the Section 409A regulations.

¹⁸ On July 31, 2009, the U.S. House of Representatives passed the Corporate and Financial Institutions Compensation Fairness Act, H.R. 3269. Section 4 would require "covered financial institutions," including certain investment managers, to have compensation structures that (i) properly measure and reward performance, (ii) are structured to account for the time horizon of risks; and (iii) are aligned with sound risk management. FMV options satisfy these requirements.

banked, the cumulative profits would have been \$300 million. ABC received only \$224 million, or 74.67% of the cumulative profits. With FMV options, ABC has \$240 million of the cumulative profit, which is exactly 80%. This demonstrates how annual banking hurts investors even when performance is positive for consecutive years.

In year 3, the Fund drops by 50% from \$324 million to \$162 million. Compare this to the \$180 million ABC has under the option model. Under the annual banking model, ABC Pension bears all the risk of loss (\$162 million). Under the option model, the manager bears its pro rata share of the loss (20% of \$200 million or \$40 million).

Figure 9 below summarizes this example, and assumes that in year 4 the Fund earns a return of 100%:

Figure 9. Illustration of Annual Banking vs. Deferred Profit Sharing (\$ in 000,000s)

End of Year	Fund Return	Annual Banking Fund				FMV Option Fund			
		Fund NAV	Investor		Manager's Banked Incentive Comp	Fund NAV	Investor		Manager's Tentative Incentive Comp
1	100%	\$200	\$180	80%	\$20	\$200	\$180	80%	\$20
2	100%	\$360	\$324	80%	\$36	\$400	\$340	89%	\$60
3	-50%	\$162	\$162	-50%	\$0	\$200	\$180	-47%	\$20
4	100%	\$324	\$324	100%	\$0	\$400	\$340	89%	\$60
Total									\$56

In short, because an option is an “open” transaction until closed at exercise (which must follow redemption unless the investor agrees to an earlier exercise), both the investor and the manager bear their proportionate share of the profits and losses over the life of the investment. Options avoid the risks associated with paying managers before the investment returns are actually realized by the investor – namely the risk of the manager profiting after a positive year even though the investor’s cumulative returns are flat or negative. Paying the manager only upon redemption also mitigates the risk of overpaying the manager based on unrealized gains.

Section 457A

Section 457A was enacted as part of the Emergency Economic Stabilization Act of 2008. It ended the ability of hedge fund managers to bank their incentive compensation and also defer its taxation – i.e., it ended manager “deferred compensation.” Section 457A makes clear, however, that the prohibition against deferred compensation does not apply to FMV options.¹⁹ FMV options are fundamentally distinct because, even though taxation is deferred until the option is exercised, the compensation is not banked before it is taxable. Option spread is tax-deferred until exercise, but also remains at risk of *leveraged* loss from subsequent poor performance. Consequently, Congress and the Service have not treated FMV options as “deferred compensation.”²⁰

If the manager in the example above had deferred its first two years of incentive compensation, it would have had \$76 million of deferred compensation at the beginning of year 3 (or 25.33% of the cumulative profit). In addition to the \$36 million it banked for year 2 performance, the \$20 million for year 1 would have doubled to \$40 million. After the 50% decline in year 3, the manager would have \$38 million in deferred compensation, which is 38% of the cumulative profit. Under the option model, the manager’s

¹⁹ Notice 2009-8, I.R.B 2009-4 (January 26, 2009); also at <http://www.irs.gov/pub/irs-drop/n-09--8.pdf>; see also “Compensating Hedge Fund Managers with Stock Options: A New Path to Alignment of Interests with Investors,” James E. Earle, *BENEFITS LAW JOURNAL*, Vol. 23, No. 3 (Autumn 2010).

²⁰ *Id.*

tentative share after 2 years is \$60 million (20% of the cumulative profit). After year 3, the manager's share is \$20 million, or 20% of the cumulative profit. Thus, because the deferred compensation has been banked, it does not share in the losses on the investor's capital. With options, on the other hand, the manager's option spread bears its proportionate share of the loss on the investor's capital.

Senator Orrin Hatch, the ranking member of the Senate Finance Committee, has sponsored a technical clarification to Section 457A to remove any doubt that options are permissible.²¹

When the statute is read against the backdrop of the legislative history, however, Congressional intent is clear.²² In Notice 2009-8, the Service made it crystal clear that options are permissible (emphasis added):

As provided in § 457A(d)(3)(A), the term *nonqualified deferred compensation plan* also includes any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient. . . . **However, the exceptions from coverage under § 1.409A-1(b)(5)(i)(A) (exception for nonstatutory stock options on service recipient stock issued with an exercise price not less than fair market value at the date of grant and with no other deferral feature) and § 1.409A-1(b)(5)(i)(C) (exception for statutory stock options) apply.** . . . In addition, for purposes of applying the exception from coverage under § 1.409A-1(b)(5)(i)(A) to an equity interest in a non-corporate entity (meaning a right to purchase actual equity in such entity, and not a mere right to an amount equal to the appreciation in such equity), the rules of § 1.409A-1(b)(5)(i)(A) are applied by analogy.²³

In short, both the letter and spirit of Section 457A authorize FMV options. As long as the manager's share of profits remains at risk to losses on investor capital, the compensation is not deferred compensation but compensation that is not earned until it is crystallized or banked.

Manager Value and Risks

With deferred profit sharing, managers bear the risk of redemptions after a down year and thereby losing incentive compensation they would have banked under an annual banking model. The astute manager will appreciate, however, that investments in a deferred profit sharing fund are likely to be "stickier" than in an annual banking fund. Just as the manager's accumulated incentive compensation grows exponentially, alignment alpha grows exponentially as well. With each passing year, the next year's growth in alignment alpha is likely to be a multiple of the year before. Such exponential growth provides an incentive for investors to stay with a manager. If the pension redeems and reinvests in another deferred profit sharing fund, its expected annual increase in alignment alpha is likely to be significantly lower.

The pension's return in a down year will be greater than the return it would have received in a *pari passu* annual banking fund. Such outperformance should also provide an incentive to stay with the manager.

²¹ Letter from Senator Orrin Hatch (R) to Senate Finance Committee's Chairman Max Baucus (D) and Senator Charles Grassley (R), ranking minority member, dated November 23, 2010 ("Enclosed is a letter sent to me by the Utah Retirement Systems, which collectively cover approximately 175,000 retired and active workers in Utah. This letter outlines a serious issue in connection with section 457A of the Internal Revenue Code. Specifically, the . . . section appears to be unclear as to the treatment of stock options even though *the legislative history contemplates and the guidance released by Treasury and the Internal Revenue Service allows the use of certain stock options as permissible compensation.* . . . It seems to me that the concerns raised by URS are legitimate and significant. It is my understanding that other pension administrators are also concerned with this issue. . . . I request that you and your staffs take a look at this issue and work with me to include a correction in the appropriate legislative vehicle at the soonest reasonable opportunity." (emphasis added)).

²² See, e.g., Blue Book 2009: Joint Committee on Taxation's General Explanation of Tax Legislation Enacted in the 110th Congress, p. 529.

²³ Paragraph A-2(b) of Notice 2009-8.

The manager can mitigate the risk of early or untimely redemptions through agreements for the investor's payment of redemption fees under specified conditions. Alternatively, the manager could receive a higher profit share in the event of certain redemptions. This can be provided through additional FMV options with defined exercisability terms.

Managers must also consider the ramifications to their existing business. Offering deferred profit sharing to one investor may trigger "most favored nations" agreements. As discussed below, there are ways to mitigate this risk.

Generally, pensions will expect the manager not to exercise its options until the pension redeems. The manager, on the other hand, may want to retain a degree of liquidity. Again, the liquidity of the options, as well as the liquidity of the pension's investment, are subject to negotiation.

FMV Option Fund Initiation

To date, managers have perceived minimal net value in offering a FMV option fund. Most managers are in the process of learning about FMV options, and have yet to develop an understanding of the capital accumulation advantage of FMV options. They are also learning about ways to mitigate perceived risks. Last, FMV options require a change in the capital structure of a fund and option administration. For these reasons, managers are likely to be slow to adopt FMV options.

Given the opportunity for managers to accumulate greater wealth, pensions have a relatively easy opportunity to seize alignment alpha. Instead of waiting for managers to offer alignment, pensions can initiate an option fund infrastructure that is built and operated independently of the manager. In addition, if they make alignment alpha a top priority, an allocation to a particular manager will be truly incremental. If the manager has no prospect of diverting the capital to its annual banking fund, the incremental value of the offer to the manager is maximized.

A fund that is independent of the investment manager and restricted to pension or other institutional investors mitigates the manager's costs and risks, and thereby increases the manager's incremental value. The manager avoids the time and expense of forming and operating an option fund. The manager can control the extent to which its assets under management convert to deferred profit sharing. For example, the initial investor and the manager could agree that the fund is limited to such investor (a "fund of one").

An independent fund infrastructure offers not only alignment alpha, but enables investors to mitigate other risks inherent in a manager-controlled fund infrastructure. Under the traditional structure, investors of all types invest in the same fund. Consequently, long-term investors such as pensions, foundations and endowments commingle with short-term investors such as high net worth individuals and funds of funds. Short-term investors hurt long-term investors. By controlling the fund infrastructure, investors can be limited to like-minded long-term investors, or be limited to one investor.

In addition, by separating investment management from fund management, investors can be assured of independent governance (including independent valuation), calculation of manager's compensation and visibility to portfolio characteristics.

Some pensions have started down the road of controlling infrastructure. To address concerns about commingling with short-term investors, lack of transparency and lack of independent governance, pensions have implemented investor-owned accounts managed by hedge fund managers. Although this approach addresses those concerns, it fails to provide alignment alpha.

Conclusion

Pensions have the power to capture alignment alpha now from their hedge fund investments. Alignment alpha is significant. Managers will benefit from cumulative pre-tax profit sharing that aligns them long term with their investors. Once managers appreciate the power of FMV options to attract and retain institutional investors, and to accumulate their own capital, managers will begin initiating FMV option funds. In the near term, however, investors will have to initiate the fund. By supporting an option fund infrastructure independent of the manager, pensions are guaranteed to increase returns, regardless of whether performance is up or down. Deferred profit sharing is insurance that mitigates drawdowns significantly. In addition to alignment alpha, an independent infrastructure addresses other key risks inherent with a manager-controlled infrastructure.

ⁱ Rick Ehrhart, JD, is President and CEO of Optcapital, a firm specializing in optimizing incentive compensation payable to hedge fund and private equity managers, as well as other types of independent contractors. It administers more than \$2.5 billion of incentive compensation for a select group of elite managers. Before co-founding Optcapital in 1998, Mr. Ehrhart practiced as a tax and benefits attorney for 18 years.

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