Top 10 Myths of FMV Options as Hedge Fund Incentive Compensation

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Abstract: Institutional Investors have a major problem with the misalignment of incentives created by the hedge fund industry's performance fee structure. Misalignment has caused some investors to avoid the industry altogether and others to question the value delivered for the fees they pay. Lisa Shalett, Chief Investment Officer, Merrill Lynch Global Wealth Management, and Head of Investment Management and Guidance, commented "Hedge funds as a class of products will continue to fail in their diversification benefits because the incentives are wrong." Craig Dandurand, Portfolio Manager, Absolute Return Strategies, CalPERS, added "When you have quarterly crystallization of performance fees . . . what do you expect to happen? You are literally handing over the keys to the bank . . . . You're done before you can start." [1]

There is an easy solution to this misalignment crisis – the same FMV options that Fortune 500 companies use to reward executives for maximizing shareholders' long-term value. By using FMV options, investors and managers share cumulative profits at the end of the life of the investment (or any earlier time if the parties agree), and all the profits accumulate and compound free of erosion from interim crystallization of the manager's share. As a result, investors enjoy greater returns than they would realize from the manager's pari passu annual crystallization fund. This increase in return is Alignment Alpha®. Managers benefit as well because their compensation compounds pre-tax, tax-deferred at the gross performance of the fund.

Despite the availability of an alignment solution for several years now, hedge fund managers have been slow to convert to FMV options. Interviews with dozens of managers reveal that managers are generally unfamiliar with the technique, and that their opposition to change is rooted in misconceptions. In this article we identify the ten most egregious myths.

Myth No. 1: Fair market value (FMV) options create tax risk.

Section 457A of the Internal Revenue Code ended the ability of managers to defer their incentive compensation fees earned after 2008. In Notice 2009-87 the Department of Treasury, in clear language, explained that Section 457A, like Section 409A before, does not apply to FMV options.

Nevertheless, the conventional wisdom developed that FMV options carry tax risk. We have heard manager counsel explain that Section 457A intended to shut down tax deferral by hedge fund managers, that FMV options are tax-deferred, ergo FMV options are risky.

Congress and the IRS recognize a qualitative difference, however, between deferred compensation and FMV options. The problem with deferred compensation from a public policy standpoint is that it fails to align the manager with investors' long-term interests. Deferred compensation is simply annually crystallized compensation that is deferred for tax purposes, but not for alignment purposes.

FMV options are fundamentally different. Even though they are tax-deferred, the compensation remains at risk to the performance of the underlying stock. Until the option is exercised, the manager shares in losses on the investor's capital. Consequently, the economics are quite different than with deferred compensation.

[1] Milken Institute 2012 Global Conference, May 1, 2012, Panel on "Diversifying Risk through Asset Allocation"

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Conversations with officials at Treasury and the IRS confirm that the both the letter and spirit of the law authorize hedge funds to use FMV options as incentive compensation. Thousands of companies have used FMV options over the past 50 years to align executives with shareholders' interests in long-term wealth creation. The tax rules governing FMV options are straightforward and easily followed.

Myth No. 2: FMV options provide less compensation than the current annual crystallization model.

The advantage of annual crystallization 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 crystallization is that the manager accumulates 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, should be longer than a single investor's investment duration. It spans many investors. By receiving FMV options and deferring taxation, a manager compounds its share pre-tax, tax-deferred across investments over the long term. *Over time, the benefits from tax deferral far outstrip the benefits of compounding over the life of an investment.* Moreover, the accumulation is independent of redemptions.

The chart below compares wealth accumulation from incentive compensation assuming new contributions replace redeemed contributions so there are $1 billion of contributions at all times. It assumes a 16.3% average annualized net return, and a manager tax rate of 50%.

Tax-Paid Wealth Accumulation (in millions)

	20% Redemption Rate		25% Redemption Rate	
Accumulation Period	**Annual Crystallization Fund**	**FMV Option Fund**	**Annual Crystallization Fund**	**FMV Option Fund**
5 years	$149	$150	$144	$150
10 years	$424	$539	$404	$540
15 years	$892	$1,577	$844	$1,584
20 years	$1,690	$4,402	$1,593	$4,427

The comparison above assumes the same level of contributions and the same investment duration. But managers willing to receive FMV options, and thus align themselves long-term, should attract greater institutional capital. They will report higher returns than their annual crystallizing competitors, in up years and down years. Alignment Alpha® increases geometrically year to year. As a result, managers should retain institutional capital longer. When greater AUM and persistence is factored in, the FMV option advantage becomes even wider.

The comparison above also assumes the same rate of incentive compensation – 20%. There is growing pressure on managers to lower the rate. Astute managers will realize that offering alignment is an alternative to cutting fees.

Myth No. 3: The only economic benefit FMV options provide to investors is sharing of losses.

The sharing of losses is only one side of the alignment coin. The economic benefit in "up" years is equally important. FMV options produce greater profits for investors by enabling them to capturing their share free of erosion from managers' interim crystallizations.

The chart below illustrates the difference between annual crystallization and end-of-performance crystallization, assuming an incentive compensation rate of 20%. With annual crystallization, the investor loses

the 80% share of the profits it would have made had the manager's 20% not been crystallized. With end-of-performance crystallization, all the profits remain invested and the investor receives 80% of all the profits.

End of Year	Return	Annual Crystallization Fund NAV	Annual Crystallization Profit (Loss)	Annual Crystallization Incentive Comp (IC)	**Annual Crystallization Fund NAV after IC**	End-of-Performance Crystallization Fund NAV	End-of-Performance Crystallization Profit (Loss)	If Redemption Occurs: IC	**If Redemption Occurs: Fund NAV**	**End-of-Performance Crystallization Advantage**
1	100%	$200	$100	$20	**$180**	$200	$100	$20	**$180**	**$0**
2	100%	$360	$180	$36	**$324**	$400	$200	$60	**$340**	**$16**
3	100%	$648	$324	$64	**$584**	$800	$400	$140	**$660**	**$76**
4	-50%	$292	($292)	$0	**$292**	$400	($400)	$60	**$340**	**$48**

The table below shows how FMV options provide end-of-performance crystallization.

End of Year	Return	**Fund NAV**	FMV Option: Option Underlying Shares	FMV Option: Strike Price	**FMV Option: Spread**	**Investor's Balance**
1	100%	**$200**	$40	$20	**$20**	**$180**
2	100%	**$400**	$80	$20	**$60**	**$340**
3	100%	**$800**	$160	$20	**$140**	**$660**
4	-50%	**$400**	$80	$20	**$60**	**$340**

The increase in return can be significant. We analyzed 10 leading funds to quantify the Alignment Alpha® investors would have realized had the manager been compensation with FMV options. Assuming a 10-year investment, investors' average annual returns would have been 1.6% higher, and the cumulative return would have been 94% greater. This means that for every $1 billion invested, the investor would have realized $940 million of additional profit.

	$1 Billion Invested for 10 Years					
	Annual Crystallization Fund		**FMV Option Fund**		**Alignment Alpha®**	
Fund (10 Top Funds)	**Annualized Net Return**	**Cumulative Profit ($ms)**	**Annualized Return**	**Cumulative Profit ($ms)**	**Annualized Return**	**Cumulative Profit ($ms)**
Paulson & Co.	26.2%	$8,640	29.1%	$11,410	2.9%	$2,770
Pershing Square	25.0%	$8,140	27.8%	$10,700	2.7%	$2,560
Viking Global	17.3%	$3,780	18.9%	$4,550	1.7%	$760
York	17.3%	$3,800	18.9%	$4,570	1.7%	$770
Canyon	14.5%	$2,790	15.8%	$3,290	1.3%	$500
King Street	14.4%	$2,770	15.7%	$3,230	1.3%	$460
Elliott	14.4%	$2,780	15.7%	$3,240	1.3%	$460
Brevan Howard	13.6%	$2,490	15.2%	$3,060	1.6%	$560
Greenlight	10.4%	$1,530	11.1%	$1,740	0.7%	$210
D.E. Shaw	9.8%	$1,420	11.0%	$1,740	1.3%	$330
Average	**16.3%**	**$3,810**	**17.9%**	**$4,750**	**1.6%**	**$940**

In addition, FMV options reduce the investor's downside volatility and thus provide the manager an easier way to recover incentive compensation given up during a draw down. The corollary is that investors should be more loyal and persistent during down times. The investor's return is higher, and is comforted by the fact that the manager is more incented than ever to continue and earn back its incentive compensation. In contrast, after 2008 many managers were so far below their high water mark that they had little incentive to continue.

Myth No. 4: Any manager that is willing to align long term is admitting to weakness.

We have heard this more than once – from managers. Curiously, we have never heard an investor say it would not invest with a manager willing to align long term. Craig Dandurand of CalPERS commented, "It speaks volumes also I think about a manager to the extent they are willing to wait to get paid." He went on to say that CalPERS uses willingness to align long term as a litmus test of manager confidence.

Myth No. 5: The inherent clawback of FMV options poses a risk that cannot be managed or mitigated.

Under the current model, managers share in profits but not in losses. FMV options divide end-of-performance cumulative pre-tax profits. Thus, managers share in profits and losses side by side with investors. Understandably, managers are circumspect about jumping on the FMV option bandwagon. They are concerned about investors leaving after a drawdown, and defeating the manager's opportunity to earn incentive compensation.

As discussed in Myth No. 3 above, managers willing to share in losses should foster greater loyalty and persistence. Such sharing lowers investors' downside volatility. As compared with similar funds providing annually crystallized incentive compensation, FMV options will report higher returns in down periods.

FMV options are a flexible tool and the parties can craft an agreement on each party's respective liquidity that addresses each party's particular objectives. In exchange for Alignment Alpha®, it is reasonable to expect investors to agree to soft lock-ups, not only for a period of time after the contribution is made, but for a period time after draw downs.

Note that after a draw down and claw back, the manager's return on its share of the profits is highly leveraged. Using the example above, suppose in year 5, after the 50% loss in year 4, the fund is up 100%. The manager's spread would increase by 125%.

			FMV Option			
End of Year	Return	**Fund NAV**	Option Underlying Shares	Strike Price	**Spread**	**Investor's Balance**
1	100%	**$200**	$40	$20	**$20**	**$180**
2	100%	**$400**	$80	$20	**$60**	**$340**
3	100%	**$800**	$160	$20	**$140**	**$660**
4	-50%	**$400**	$80	$20	**$60**	**$340**
5	100%	**$800**	$160	$20	**$140**	**$660**

Myth No. 6: Changing to a FMV option model would be disruptive.

FMV options work only for investors who are pensions, foundations, endowments and sovereigns. Conversion to FMV options requires the formation of an onshore fund for state pensions that are indifferent about UBTI, and an offshore fund for U.S. private pensions, foundations and endowments, and sovereigns. The manager would trade each fund *pari passu* with one another, and with the annual crystallization onshore fund for high net worth individuals.

Nothing is more disruptive than losing capital through redemptions. By providing long-term alignment, redemption rates should fall. As discussed above, in exchange for the opportunity to realize Alignment Alpha® investors should be willing to make a stronger and longer commitment to the manager.

Instead of being disruptive, a FMV option fund should complement the manager's annual crystallization funds for high net worth individuals and other taxable investors. The FMV option fund should exhibit lower

redemption rates and lower volatility. Astute managers appreciate that improving capital stability and duration increases manager value.

Myth No. 7: Managers cannot use deferred compensation to retain key traders, portfolio managers and analysts without incurring tax cost.

Currently, few managers use deferred compensation to retain key alpha generators. Because of the Section 404 "matching rule," the manager's partners incur a tax cost when the firm defers the compensation payable to employees. For example, suppose the firm realizes $10 million of incentive compensation, and wishes to provide alpha generators with a $1 million deferred bonus in which the employee will vest if he or she remains employed by the firm for the next 4 years. If the firm paid the bonus currently, the partners would have $9 million of taxable income. By making the bonus deferred, the partners would have $10 million of taxable income.

The firm can avoid this tax cost by receiving incentive compensation in the form of FMV options. The partners would not have taxable income until it exercised the options and received funds. It can time the exercises to coincide with payment of deferred bonuses, and thus match the timing of income and deductions.

Myth No. 8: FMV options are illiquid until the investor redeems.

This is a matter of agreement between the manager and each investor. The parties can make any agreement they want about each party's privileges to withdraw funds. The investor is likely to want some partial redemptions rights that are exempt from early redemption fees. Likewise, the manager is likely to require some partial option exercise rights that are free of early exercise fees.

Myth No. 9: FMV option funds are as expensive to operate as managed accounts.

The costs of operating a FMV option fund are commensurate with those of any commingled fund, and less than those of a managed account. Moreover, FMV option funds can be sponsored by a third party platform provider that specializes in these types of funds. Using a third party provider can lower costs, enable the manager to avoid the burden of operating a fund or a managed account and instead focus on its core and most profitable business – investment advisory.

Myth No. 10: Alignment is a fad that will pass.

If the industry does not voluntarily reform its incentive compensation model, alignment may be forced by regulation. The EU has already started. The European Securities and Markets Authority (ESMA) recently published final guidelines (Guidelines) on sound remuneration practices under the Alternative Investment Fund Managers Directive (AIFMD). The Guidelines seek to implement the AIFMD principles, which include the following:

- Performance-related compensation must be based on the performance of the manager overall, the relevant business unit and the individual (including non-financial criteria).
- Performance must be assessed in a multi-year framework.
- Guaranteed variable compensation must be exceptional, only occurring in the context of hiring new staff and is limited to the first year.
- Fixed and variable compensation must be appropriately balanced.
- Severance payments must reflect performance over time and not reward failure.

- Where appropriate, a substantial portion, and in any event at least 50%, of both deferred and non-deferred variable compensation must consist of units or shares of the fund.

- Such units or shares must be subject to an appropriate retention policy.

- A substantial portion of variable compensation, and in any event at least 40% (or 60% where compensation is particularly high), must be deferred over a minimum period of three to five years.

- There must be a power or mechanism to adjust variable compensation to take into account negative financial performance of the manager or fund.

These principles apply to EU managers. US managers marketing funds in Europe will have to disclose certain information about remuneration in the annual report of the fund.

A key feature of the Guidelines is that they apply a "look-through" of the compensation principles to entities in which the portfolio management or risk management activities have been delegated. This means that EU fund of funds managers can delegate only to US managers that are subject to remuneration principles that are equally as effective as those applicable under the Guidelines, or that have entered into contractual arrangements preventing circumvention of the AIFMD.

In the US, Dodd Frank contains similar compensation requirements, but these have yet to be enacted. In 2010, the Dodd-Frank Act mandated that financial regulators jointly develop rules or guidelines governing incentive-based compensation practices at "certain financial institutions" – including certain broker-dealers and investment advisers – with total assets of $1 billion or more. In particular, the Act requires the SEC, the Federal Reserve, OCC, FDIC, OTS, FHFA, and the NCUA, to jointly write rules or guidelines that:

- Require these covered financial institutions to disclose to their appropriate federal regulator the structure of their incentive-based compensation arrangements so the regulator can determine whether such compensation is excessive or could lead to material financial loss to the firm.

- Prohibit any type of incentive-based compensation that the regulators determine encourages inappropriate risks by providing excessive compensation or that could lead to material financial loss to the covered firm.

On March 2, 2011, the SEC and other agencies proposed a rule that would require these covered financial institutions to disclose the structure of their incentive-based compensation practices, and prohibit such institutions from maintaining compensation arrangements that encourage inappropriate risks. Specifically, the rule would:

- Require reports related to incentive-based compensation that they would file annually with SEC.

- Prohibit incentive-based compensation arrangements that encourage inappropriate risk-taking by providing excessive compensation or that could lead to material financial loss to the firm.

- Provide additional requirements for covered financial institutions with $50 billion or more in assets, including deferral of incentive-based compensation of executive officers and approval of compensation for people whose job functions give them the ability to expose the firm to a substantial amount of risk.

- Require covered financial institutions to develop policies and procedures that ensure and monitor compliance with requirements related to incentive-based compensation.

It is unclear whether the proposed Dodd-Frank rule would be considered "equally as effective" as the AIFMD principles. The proposed Dodd-Frank rule incorporates certain "balanced compensation" principles originally developed by U.S. banking regulators which include a significant focus on aligning incentive compensation

awards to the time horizon of the risks taken. In this regard, the proposed Dodd-Frank rule continues the heightened focus on proper alignment of interests – precisely the goal of FMV options.