The Hedge Fund LAW REPORT

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COMPENSATION

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By William V. de Cordova

Compensation of legal and compliance personnel at hedge fund managers is a complex and opaque topic. In a recent interview with The Hedge Fund Law Report, David Claypoole, founder and President of Parks Legal Placement LLC (PLP), shared detailed insight into the overall market for and compensation of legal and compliance personnel, including general counsels (GCs), chief compliance officers (CCOs) and junior legal and compliance personnel. In this article, the first in a two-part series, Claypoole discusses the factors that affect GC and CCO compensation; the current market standard compensation for legal and compliance personnel; how compensation of dual-hatted employees compares to compensation of single-role GCs and CCOs; trends in how GCs and CCOs are viewed by employers; compensation of junior legal and compliance personnel; when junior people reach their "legal bar mitzvah"; what makes an "exceptional" legal or compliance candidate; and how compensation of hedge fund GCs and CCOs compares to compensation of similar personnel at private equity and other types of managers.

In the second installment in the series, Claypoole will share his thoughts on the relationship between fund performance and compensation; trends in legal and compliance compensation, including with respect to junior compliance personnel; investments by legal and compliance personnel in the funds for which they work; and reporting lines for GCs and CCOs. See also "*How Much Are Hedge Fund Manager General Counsels and Chief Compliance Officers Paid?*," The Hedge Fund Law Report, Vol. 7, No. 28 (Jul. 24, 2014); and "*Annual Greenwich Associates and Johnson Associates Report Reveals Trends in Compensation of Investment Professionals at Buy-Side Firms*," The Hedge Fund Law Report, Vol. 6, No. 48 (Dec. 19, 2013).

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Summary of Compensation Information

Claypoole provided the following excerpt from PLP's latest survey of the compensation of legal and regulatory professionals at alternative asset managers:

Survey Highlights

	Sample Size	Low	High	Median	Average
All GC	77	$150,000	$8,375,000	$850,000	$1,036,611
All AGC	103	$200,000	$2,325,000	$450,000	$572,018
All CCO	89	$150,000	$2,325,000	$750,000	$811,090
All Non- CCO Compliance	80	$70,000	$503,500	$174,000	$191,167

Discussion

HFLR: What are the determinant factors that go into compensation packages for hedge fund GCs? In other words, what roles do manager size, assets under management (AUM) and strategy, as well as candidate experience, play in determining the size and structure of compensation packages?

Claypoole: Complexity plays a much more important and determinative role in GC compensation than I think a lot of people realize. Assets, while important, are not as determinative as the ratio of profits to the number of people that are being paid. The GC of a highly-complex $2 billion fund with a 2-and-20 fee structure that has 20 employees will frequently make more money than the GC of a $20 billion fund that has offices worldwide with 300-400 employees, because the latter ratio of the number of people who have to get a piece of the pie is not as favorable.

So, when GCs are looking for opportunities and where the opportunities to make the most money are, it's really a question of taking a look at the AUM, the fee structure and the returns and then seeing how many senior professional executives and investment professionals have to feed off that pie.

Another set of factors that affect GC compensation is how the principals view and value legal and compliance and basically how generous they are. Some principals really believe their GCs and CCOs are valuable members of the executive team – that they insulate the firm from regulatory risk, which is as much of a risk for people these days as market and portfolio risk. Those folks compensate people better.

Some people want to pay their legal and compliance department, and other people just view it as a back-office/clerical function, taking an "it's not going to happen to me" attitude, even though that attitude may not be prudent when the SEC decides to audit that firm.

HFLR: Taking all of the above into account, in terms of structure and dollar levels, what is the current "market" for compensation of a hedge fund GC?

Claypoole: When you get down to specific numbers, they are all over the place. In PLP's most recent survey, across the 77 data points for GCs, the lowest amount of compensation was $150,000 and the highest was over $8 million. That's a huge, huge range, and obviously, both of those numbers are outliers. The $150,000 is from a fund that is basically cratering and represents that person's base salary with no bonus. The data point represents a person who in the past made seven figures, but when there are no profits and thus no incentive fee, there is no pay.

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HFLR: If we could apply the same questions to CCO compensation, do the same determinant factors apply, and what do you see as the current market for CCO compensation?

Claypoole: CCO compensation is very similar; the same factors go into determining compensation. In addition, if a manager goes through an SEC audit or similar event, a CCO may pick up a little extra that year. However, of the 77 GCs that we talked about, 49 also have the CCO title. In a lot of instances, particularly in small funds, the GC and the CCO are the very same person, so the determining factors are pretty much the same.

As for the market for CCO compensation, in general, something that I have observed is that when a fund reaches a certain size, as a rule of thumb, the GC makes about twice what the CCO makes. And, if you want to extend that from there, I've noticed the chief operating officer (COO) makes about twice what the GC makes. So, if you're a CCO and you're taking a job somewhere, you might want to try to find out what the GC makes. After all, if the GC is earning $800,000, your prospects

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of earning a seven-figure salary – which is a very achievable number for a CCO these days – are not good.

HFLR: You mentioned that 49 out of the 77 GCs you studied also had the CCO title. So, with respect to dual-hatted GC/CCOs, is it typically more advantageous for a candidate to serve in a dual-hatted role? Do such people typically earn more?

Claypoole: This is an issue. You'll see basically that GCs generally make more than GC/CCOs. If you think about it, a lot of people say, "Well, that doesn't make any sense. If you're doing two jobs, you should get paid more than someone who's just doing one job." But, at the end of the day, the funds that tend to have people in dual roles are smaller funds, less complex funds and funds with lower assets. When you become the GC, it means that there's a CCO that's working for you. It's likely that there's a whole legal department that's built out, so you're leading a larger team. You're in a more mature and developed, frequently more profitable fund, because a fund doesn't go out and hire complementary legal and regulatory personnel unless it is doing well and views itself as sustainable in the long term.

Most funds start out with a GC/CCO. I've worked with a lot of well-known funds that started ten years ago with a GC/CCO at $4 billion under management. Now, they have tens of billions of dollars under management and legal and regulatory functions spanning the globe with ten, twenty or thirty people in them. They're almost like small legal boutiques with diversified practices within the funds.

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Similarly, when I started recruiting compliance professionals in 2003-2004, a strong number for a CCO was $300,000-350,000. Today, there are many people earning over a million dollars, and not just the global CCOs of gigantic international asset managers. There are people who are the CCOs of $10 billion shops who are making $1 million. There are people who aren't lawyers who are making at or close to that, which is pretty amazing given where compensation for such positions started.

HFLR: Related to the foregoing, have you seen trends in how GCs and CCOs are viewed by their employers? Have you seen them being viewed in a more valuable light over time?

Claypoole: Yes, we're seeing more GCs sharing in the equity at their firms. We're seeing more GCs making partnership. We're also seeing GCs who – frequently in smaller shops – are handling a lot of the overall operations. Because, sometimes a manager will have two principals – two chief investment officers (CIOs) who don't want to be co-CIOs and so instead appoint one to act as COO. In such a situation, where the COO is an investment professional supervising operations, the operational side of the business often falls into the lap of either the chief financial officer (CFO) or the GC. In other instances, you will see people hold joint titles – COO and GC – or you will see the GC actually become the COO.

So, in terms of whether legal and compliance staff is more valued, I think that answers the question. If those personnel are being pulled over to help day-to-day with the business, then that shows they are valued.

HFLR: We've been talking so far about GCs and CCOs and their compensation. How does compensation compare with respect to more junior positions – such as associate GC positions or junior compliance personnel?

Claypoole: I'm glad you brought that up. Something that I didn't focus on earlier was how seniority plays into what people are making. In essence, the compensation for associate GCs at our clients, while most of the time greater than the compensation at the top law firms, basically tracks it.

This remains the case until you reach the point of what I like to call your "legal bar mitzvah" – the point at which you are viewed in the marketplace as a full-fledged professional. This is demarcated in the law firm space by when the major firms make equity partners (versus contract partners). This used to occur at eight years, but now it is at ten or twelve. And, the recent explosion of bonuses for associates at law firms is related to the fact that the partnership track has been extended, so associates that are at the mid and senior levels need to be recognized with higher compensation.

That higher compensation is already leaking over into funds. Frankly, right now we are in a bit of a grey area because a lot of funds and larger asset managers had come up with their budgeting before the bonuses exploded at the end of last year. So, a fund looking to hire a lawyer with 5-7 years prior experience in fund formation and some regulatory background may find when it goes out to recruit that the expected compensation is $25,000-50,000 more than what it thought it would have to pay. So for the first time ever – and this will probably only last for a very short time – you have funds looking at associates at law firms making more than the funds had planned to pay.

Once you have had your legal bar mitzvah, however, compensation ceases to be determined by seniority. Rather, at that point – once you have about 10 years of experience – it becomes all about you. Once you have achieved a certain level of experience, while you might gain some additional maturity or wisdom, if you've been practicing law for 10-15 years at a high level in this space, there isn't really much more that you're going to see. Accordingly, some of the most highly-compensated people that we've come across aren't the most senior people; they're the most exceptional people.

HFLR: What are some of the factors that determine whether someone is one of these "exceptional people"?

Claypoole: It really comes down to personality, almost more than anything. Yes, work ethic and the usual things are important. But, everybody that we're dealing with in this industry looks exceptional on paper. They went to top schools and worked at a major firm, but that doesn't necessarily mean that they "get it." What makes people exceptional in this space is that they "get it."

My clients, for the most part, want binary decision makers – 0 or 1, yes or no, black or white. Many, many lawyers – particularly lawyers coming out of firms – are trained to think of every single possibility. Accordingly, if you ask them a question, they will say, "Well, you know, it could be this or it could be that. You might want to think of this; let me study it a bit more." My clients – the fund managers – want answers; they want yes or no. So, you could be the smartest person in the room, but if you don't have the personality, the character and the confidence in yourself to make snap judgments on complex issues – and also be right almost all of the time – then this isn't for you. And that's what separates people.

HFLR: How does the compensation of legal and compliance personnel at hedge fund managers compare with managers in other industries, such as private equity or mutual fund managers?

Claypoole: That is very simple. Hedge funds and private equity funds pay pretty much side-by-side for their legal talent. However, there's much less demand in private equity funds for legal talent. The industry on the private equity side as a whole hasn't bought into having in-house legal counsel. Rather, they have always outsourced their legal function, often, primarily, to one firm through one partner who acts almost as the private equity fund's GC. He does not have the title, but in fact that is what he's doing. There are a number of partners in New York who act in a similar quasi-GC capacity for four or five private equity funds.

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Private equity funds tend to get some education for the CFO or the controller or similar officer, appoint that person as CCO and then rely on third-party service providers for testing and even some of the surveillance. Only the larger private equity funds have significant and substantial legal departments. Conversely, hedge funds bought into the model of having in-house legal counsel ten years ago and have branched out from there.

Going back to the original question, private equity funds and hedge funds pay about the same. Hedge funds have smaller bases and larger bonuses, whereas private equity funds have larger bases and carry. It makes sense for a private equity fund to pay a higher base because, if you had a $150,000 base and were waiting for your carry – which is on specific deals or funds – to be realized, you could wait a long time for that realization. At a hedge fund, compensation usually consists of a base of $200,000, and the rest is a bonus, generally discretionary. The bonus generally doesn't decrease that much, unless things get really bad.

Over time, if you want to become extremely rich, you have a greater chance of doing so at a private equity fund. The carry at a successful private equity fund, as it starts cascading over time, has the potential to make you more wealthy than just socking away the discretionary bonuses that you may receive at a hedge fund.

Those are the top places to be to get paid in general – a single-manager hedge or PE fund. Next highest would be the institutional asset managers – the large asset managers.

Conversely, mutual funds do not pay well and, with the exception of service providers (e.g., people coming in and performing compliance reviews), are the absolutely lowest-paying group for legal or compliance jobs. One exception to this principle, however, applies to investment company lawyers working at large asset managers that have registered products – mutual fund products, retail products or fixed income products – as well as a large portfolio of alternative assets and employ lawyers with strong alternative experience. Investment company lawyers at such organizations make a great deal more than investment company lawyers at traditional mutual fund complexes. The reason is that these large asset managers have to compete with single manager hedge funds for legal talent familiar with private equity deals, hedge fund formation and structure products. Accordingly, while they may not pay what a single manager hedge fund would pay, they generally will pay enough to ensure that their legal and compliance staff don't feel underpaid and look to move to a single manager hedge fund. Furthermore, if those large asset managers pay those lawyers well, they have to pay the investment company lawyers that are sitting next to them in the same band.

Unfortunately, sometimes this principle works the other way. I've seen some situations where organizations that are heavily weighted towards traditional mutual funds or insurance products or fixed income products and bonds also have alternatives as a small component of the overall asset mix. In such cases, the alternative lawyers are generally paid on the low end because, again, they're being paid in bands by an organization that feels that it is competing for the services of the vast majority of its legal staff with traditional mutual funds.

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Over time, if you want to become extremely rich, you have a greater chance of doing so at a private equity fund. The carry at a successful private equity fund, as it starts cascading over time, has the potential to make you more wealthy than just socking away the discretionary bonuses that you may receive at a hedge fund.

Those are the top places to be to get paid in general – a single-manager hedge or PE fund. Next highest would be the institutional asset managers – the large asset managers.

Conversely, mutual funds do not pay well and, with the exception of service providers (e.g., people coming in and performing compliance reviews), are the absolutely lowest-paying group for legal or compliance jobs. One exception to this principle, however, applies to investment company lawyers working at large asset managers that have registered products – mutual fund products, retail products or fixed income products – as well as a large portfolio of alternative assets and employ lawyers with strong alternative experience. Investment company lawyers at such organizations make a great deal more than investment company lawyers at traditional mutual fund complexes. The reason is that these large asset managers have to compete with single manager hedge funds for legal talent familiar with private equity deals, hedge fund formation and structure products. Accordingly, while they may not pay what a single manager hedge fund would pay, they generally will pay enough to ensure that their legal and compliance staff don't feel underpaid and look to move to a single manager hedge fund. Furthermore, if those large asset managers pay those lawyers well, they have to pay the investment company lawyers that are sitting next to them in the same band.

Unfortunately, sometimes this principle works the other way. I've seen some situations where organizations that are heavily weighted towards traditional mutual funds or insurance products or fixed income products and bonds also have alternatives as a small component of the overall asset mix. In such cases, the alternative lawyers are generally paid on the low end because, again, they're being paid in bands by an organization that feels that it is competing for the services of the vast majority of its legal staff with traditional mutual funds.