The HEDGE FUND LAW REPORT

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COMPENSATION

How Have Industry Developments Affected the Value of Legal and Compliance Staff? An Interview With David Claypoole on In-House Compensation at Fund Managers (Part One of Two)

By William V. de Cordova

In a regulatory landscape where fund managers are subject to greater scrutiny, the market for in-house legal and compliance personnel – including general counsels (GCs), chief compliance officers (CCOs) and junior staff – has flourished. Questions have arisen, however, as to whether the compensation of legal and compliance personnel will be affected by the increasingly volatile performance of private funds.

In a recent interview with The Hedge Fund Law Report, David Claypoole, founder and president of Parks Legal Placement (PLP), shared detailed insight into the overall market for and compensation of legal and compliance personnel, based on more than a decade of compensation data. In this article, the first in a two-part series, Claypoole discusses how recent hedge fund performance may affect GC and CCO compensation; trends he has identified in legal and compliance compensation; the drivers of compensation for top legal and compliance personnel; and the backgrounds of candidates vying for these positions. In the second installment in this series, Claypoole will share his thoughts on anticipated changes to the legal and compliance landscape under the new Trump administration, including a possible repeal of the Dodd-Frank Act; the movement of in-house staff from hedge funds to other industries or practices; and characteristics of successful in-house personnel.

For more from Claypoole, see his prior two-part interview on the market for in-house compensation at hedge fund managers: "*What Is the Value of Legal and Compliance Staff?*" (Mar. 12, 2015); and "Trends in Legal and Compliance Hiring and Staffing" (Mar. 19, 2015).

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: Discussion

Survey Highlights

	Sample Size	Low	High	Median	Average	Top Quartile
All GC	90	$275,000	$3,875,000	$857,500	$1,037,367	$1,387,500
All CCO	108	$225,000	$2,500,000	$705,000	$824,044	$1,000,000
All AGC	153	$130,000	$2,500,000	$450,000	$506,589	$600,000
All Non-CCO	150	$63,500	$775,000	$180,000	$218,632	$290,000

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Discussion

HFLR: 2016 was certainly a volatile year for the hedge fund industry. What effect, if any, have you seen that volatility have on the overall market for hedge fund GC and CCO compensation?

Claypoole: At this point, the 2016 compensation is just being settled, so we haven't seen what is going to happen. If we look back into 2015 and years prior to that, those who don't have an equity component to their compensation will be fairly flat in a bad year – even at the GC or CCO level.

We get a lot of calls this time of the year from GCs who are looking to appropriately compensate their staff, and we also receive calls from COOs or principals who are looking to appropriately compensate their GC or chief legal officer. Those conversations about compensation are happening right now and will generally run from December to February. Thus, we will not see the effect of 2016 fully shake out until March or April.

HFLR: Although not settled, do you expect legal and compliance compensation to remain relatively flat as fund managers enter or remain in "cost-cutting" mode considering the past year? Or, are legal and compliance personnel at risk of having their compensation cut?

Claypoole: I don't think that we are going to see – and we haven't historically seen – managers cut legal or compliance compensation dramatically during a bad cycle.

First, keep in mind that 2016 was good for some and bad for others. Some of our clients did well, while some of them did terribly. In the aggregate, however, the numbers within the industry for legal and regulatory professionals remained flat.

Overall, the idea that there's a huge reaction to bad performance that manifests itself in lesser compensation for legal and regulatory professionals is slightly overstated. Legal and compliance personnel don't really share in either the upside or the downside of the fund's performance. As I was saying earlier, if you're an equity participant of the manager – and more GCs these days do participate in the manager's equity than 10 or 15 years ago – then, yes, you will see a dip. If not, however, and you only receive a base salary and discretionary bonus, then your compensation will remain flat, which is regarded as the "new down."

HFLR: You've been compiling compensation information for in-house legal and compliance staff for years. Looking at that data over time, what trends have you seen with respect to the overall market for GC and CCO compensation?

Claypoole: In general, over the 12 years that we have been tracking legal and compliance compensation, we have not seen large aggregate moves from year to year. We recently looked back at the last five years, from 2011 through 2015, to see if any trends could be identified.

The one thing that jumped out when we looked at that period was that the most highly compensated senior people saw dramatic increases in what they were getting paid. For example, during those five years, the top quartile of GCs saw an increase of nearly 40% in what they were being paid. During that same period, however, associate general counsels (AGCs) saw their compensation decrease.

If you look at the same data broken out from a seniority standpoint, we saw that more senior people saw increases in their compensation, while junior staff saw their compensation decrease.

As a disclaimer, note that our sample is constantly changing and self-selecting. We get data from our clients' human resources departments and also from individual lawyers (although we make sure not to double-count anyone). Consequently, since the sample is constantly growing and it self-selects, it's hard to put a huge amount of stock in the above trends, although they do make a lot of sense for a variety of reasons.

HFLR: What would you say those reasons are, or what could account for those trends?

Claypoole: Well, the first thing is that we're seeing larger, more developed legal departments at fund managers. The people on top of those departments – the top quartile that I mentioned earlier – have more frontline responsibilities because they are managing larger groups in a challenging regulatory environment. It's not surprising that, as they get more senior and the group grows beneath them, they'd be earning more.

We must also look at the other side of that question: why those on the bottom – the AGCs – have experienced a downward trajectory in their overall compensation over the same five years. The answer to that has more to do with the size of the sample and the number of people doing that job. It is basic economics – the supply of jobs at the lower end is greater than it used to be. We have more people coming into the sample tasked with lower-level work.

As I've said time and time again, one of the main drivers of compensation for legal and regulatory professionals is complexity. The work at the top is getting more complex over time in terms of regulation over the last 10 years. Meanwhile, the lower-level staff coming into the sample are doing work that is less complicated.

HFLR: Has the compensation for top legal and compliance personnel increased in part to offset the increased risk of things like personal liability? For example, the topic of CCO liability has been hotly debated. [See *"SEC Commissioner Speaks Out Against Trend Toward Strict Liability for Compliance Personnel"* (Jun. 25, 2015); *"SEC Commissioner Issues Statement Supporting Hedge Fund Manager Chief Compliance Officers"* (Jul. 16, 2015); and *"Commissioner Gallagher's Dissent in SEC Enforcement Action Against Hedge Fund Manager Misses the Mark"* (Jul. 30, 2015).] Are top personnel receiving greater compensation to make up for the fact that they are at greater risk than junior staff?

Claypoole: That is a complicated question. CCO or GC liability is not a real risk for which people are being compensated. After all, how many times have we seen a CCO really taken to task by the SEC, absent outside circumstances?

Direct regulatory action and its related penalties, including jail, financial sanctions or simply being fired is not the real risk that GCs and CCOs face. Rather, the chief risk is the loss of future employment if the fund fails because of regulatory malfeasance in a public way. Whether you are the CCO, GC, AGC or junior compliance associate, in that situation, the taint of that fund's failure is going to get on you, and you are going to have a very difficult time finding another position in the industry.

Consequently, the threat of not working again is the thing that scares legal and compliance staff the most. Are they being paid more because of that risk? The answer is no.

Conversely, are people being paid more because things are much more complex and complicated, and therefore risky? The answer to that is yes, even though when taken with the above, that sounds completely paradoxical.

HFLR: Can you explain that relationship between the increased complexity of funds and compensation a bit further?

Claypoole: At one point, when funds were less complicated, managers did not need as sophisticated legal and compliance staff as they do now. Fifteen years ago, managers could employ people who weren't lawyers or who lacked appropriate training. Now, however, managers need their top regulatory person to be akin to a top equity partner at a major New York firm.

Hiring someone of that caliber comes with opportunity cost – if a manager wants someone who could be the head of a regulatory group or investment fund group at a major New York law firm, that manager must pay him or her what he or she could be making as a partner at that firm. That is why compensation at the top levels has steadily increased.

HFLR: Do you see these trends continuing? In other words, will compensation continue to rise? Or, looking at your data, will legal and compliance compensation flatten out going forward?

Claypoole: We came out of the 2008 financial crisis, and there was a readjustment in terms of what people were getting paid in this space – in all areas, not just in legal and compliance. Thus, we are in what I consider to be a "new normal" – the point where we have a lot of established managers and where there is a lot of transparency into what people are being paid.

If I could peer into a crystal ball, I wouldn't predict another 40% increase in compensation for the top quartile like I observed in my five-year look-back. The market may have hit a fairly soft ceiling with respect to compensation. Legal departments – including the compliance function – at fund managers of certain sizes are starting to look more alike than they used to. When things start looking alike and there's more transparency, you find fewer rogue outliers and compensation becomes much more predictable.

HFLR: Have you identified any other trends or nything else in your five-year look-back?

Claypoole: The increase in top-level compensation was the biggest thing that jumped out of the data. One other thing to note is that there was a significant bump in firm lawyer compensation in 2016, which could result in an increase in compensation for lower-level legal and compliance staff.

In 2014, law firm bonuses effectively doubled. That translated into somewhat of an increase in in-house compensation, although that was possibly offset by people entering the space doing lower-level work and earning less as a consequence. In 2016, on average law firm associates received an increase of approximately $30,000 on their base salaries – growth of roughly 15 percent.

Today's law firm associates are tomorrow's hedge or private equity fund AGCs. This salary increase may thus apply some upward pressure on the low-end compensation, at least at some of the more established managers.

HFLR: Speaking of bonuses, certain fund managers have discussed moving toward a compensation structure where their in-house legal and compliance staff receive larger base salaries and smaller bonuses, arguing that legal or compliance staff should not be dependent on performance-based bonuses (and thus more likely to sign-off on risky propositions that carry great potential for reward). Are these managers outliers, or are you seeing a similar trend in the overall market?

Claypoole: With respect to my client base and my own observations in the market, I haven't seen this happen. What I see almost exclusively, is that if an AGC was making $400,000 at a law firm (comprising $315,000 base salary plus $85,000 bonus), when that person joins a fund, that $400,000 will be split up into a base of $175,000 and a bonus of $225,000 or a base and bonus of $200,000 each.

The idea that there is a financial incentive for people to engage in risky behavior at this level is, I think, absurd. Someone making $450,000 as a GC/CCO of a $2 billion fund is unlikely to suddenly do something that could potentially destroy his or her career for an extra $25,000 bonus (and it's unlikely that the manager is suddenly going to award an extra $2 million bonus to the GC for facilitating any transaction, no matter how lucrative).

So to me, this compensation structure is very theoretical; until I see this happening somewhere – which I really haven't – I'm not going to believe that it is a trend. Keep in mind, however, that a large portion of my clients are privately held single-managers whose business models and management are, for a variety of reasons, different than those of the larger, publicly traded managers.

HFLR: Are you seeing any changes in the background or experience of candidates for in-house positions? For example, are more senior people competing for these jobs, or has the mix of candidates remained static?

Claypoole: There is definitely a greater market today than there was 10 years ago for more senior and seasoned legal talent at managers that aren't sitting in the top chair. This is because, as legal departments have grown, so has demand for different types of specific experience within funds. Consequently, funds today are hiring lawyers versed in mergers and acquisitions, restructuring, tax, finance and structured finance. That has led to more opportunities for senior people to work at these firms.

In addition, the GC of a hedge fund in 2005 was usually a sixth- to seventh-year associate who left a major fund practice at a law firm. That person was 33 years old, with six or seven years' experience. He or she wasn't going to hire someone with 10 years' experience to work for him or her.

Today, the GCs who have been at their seats now for 10-15 years are very confident and comfortable in who they are professionally and how they fit into their organizations. Therefore, they don't give pause to hiring somebody with 8 to 10 years' experience, worried that person will come in and unseat them.

HFLR: What about candidates for lower-end legal and compliance positions? Are the candidates for these positions generally the same as they have been previously?

Claypoole: I mentioned earlier how law firms have, over the last three years, dramatically increased the compensation of their associates by first doubling bonuses in 2014 across all classes and raising salaries in 2016 by an average of $30,000 to associates. This may influence the market for lower-level positions.

In the past, if my clients were looking for someone with five to seven years' experience and money were no object, they would want a candidate with in-house experience. That would enable them to avoid the adjustment period when the candidate moves from a large law firm with resources (such as a pool of paralegals and word-processing department) to a small, leanly staffed fund manager.

Despite this preference, however, before law firms increased associate compensation, my clients would frequently take a sixth- or seventh-year associate out of a firm because there was a considerable cost savings over hiring an equivalent level person from in-house. Managers were willing to take a law firm associate and train them through that adjustment period, netting more experience for their dollar, rather than trying to hire someone who was making up to $100,000 more in-house.

Now that firms have dramatically increased associate compensation, however, it could hurt firm lawyers looking to go in-house. Effectively, the increase in associate compensation means that, from a fund manager perspective, money now is no object. Law firms have raised compensation to the point where it is the same as, or in some cases more than, in-house compensation.

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COMPENSATION

Will Industry Deregulation Affect the Value of Legal and Compliance Staff? An Interview With David Claypoole on In-House Compensation at Fund Managers (Part Two of Two)

By William V. de Cordova

Following the enactment of the Dodd-Frank Act, the market for in-house general counsels (GCs), chief compliance officers (CCOs) and junior legal and compliance personnel at fund managers bloomed. As the Trump administration has pledged to roll back Dodd-Frank, many wonder whether the opposite effect will be seen and whether the market for – and compensation of – in-house legal and compliance staff will decrease.

In a recent interview with The Hedge Fund Law Report, David Claypoole, founder and president of Parks Legal Placement, shared detailed insight into the overall in-house legal and compliance market, based on more than a decade of compensation data. In this article, the second in a two-part series, Claypoole shares his thoughts on anticipated changes to the legal and compliance landscape under the new Trump administration, including a possible repeal of the Dodd-Frank Act; the movement of in-house staff from hedge funds to other industries or practices; and characteristics of successful in-house personnel. In the first article, Claypoole discussed how recent hedge fund performance may affect GC and CCO compensation; trends he has identified in legal and compliance compensation; the drivers of compensation for top legal and compliance personnel; and the backgrounds of candidates vying for these positions.

For more on ways the Trump administration may affect the industry, see *"How the Trump Administration's Core Principles for Financial Regulation May Benefit the U.S. Funds Industry (Part One of Two)"* (Feb. 16, 2017); and *"How Tax Reforms Proposed by the Trump Administration and House Republicans May Affect Private Fund Managers"* (Feb. 9, 2017). For more on compensation, see also *"Hedge Fund Manager Compensation Survey Looks at 2014 Compensation Levels, Job Satisfaction and Hiring Trends"* (Jan. 22, 2015); and *"Annual Greenwich Associates and Johnson Associates Report Reveals Trends in Compensation of Investment Professionals at Buy-Side Firms"* (Dec. 19, 2013).

HFLR: When the Dodd-Frank Act was enacted, many managers increased their in-house legal and compliance staff to ensure they could comply with the host of new regulation. With the Trump administration pledging to eliminate Dodd-Frank, do you predict that this trend will reverse?

Claypoole: We have actually seen this before – in 2006 when *Goldstein v. SEC* was decided and vacated the SEC's rule requiring registration of hedge fund advisers. When Goldstein came out, everyone believed that managers would dismantle their legal departments. After all, the thinking was that if they didn't have to be registered, they weren't likely to be registered.

In reality, however, between 2006 and 2007, the number of registered advisers increased rather than decreased. The same thing happened in 2007 and again in 2008; each year, the number of registered advisers increased. Ultimately, there were 700 more advisers registered than before Goldstein.

This shows that there is historical precedent that managers are not going to unwind their legal and compliance functions – or value them less – simply because they are no longer legally required to register. Rather, managers may choose to voluntarily remain registered, and they will continue to need their legal and compliance staff accordingly.

HFLR: With respect to this "historical precedent," what factors drive managers to decide to remain registered absent a requirement?

Claypoole: Regulatory risk is very real – as real as portfolio risk. Investors focus on it, and a fund can be cratered by a mere hint of regulatory impropriety. Having a strong legal and compliance department is not simply a best practice; it's a huge insulation against regulatory risk.

Additionally, until the government defunds the SEC, a manager is still going to have to comply with the securities laws, even if that manager is not required to register as an investment adviser. Accordingly, investors are going to insist that managers have a robust legal and regulatory function. As the industry continues to experience a bit of a roll-up, it is seeing larger and larger managers all chasing the same institutional investors – including pensions and endowments. Those investors in particular place strong emphasis on managers having strong legal and regulatory support.

Consequently, I have a contrary – albeit slightly self-serving – view than those who fear the imminent dismantling of legal and compliance departments. I believe that people are going to continue to hire legal and compliance professionals. Even if Dodd-Frank is dismantled, that will lead to different regulations, all of which will need to be interpreted. Thus, Dodd-Frank's demise may even lead to an increase in legal and compliance hiring, as managers will need to bring in additional staff or put more intellectual firepower and time into charting the new regulatory landscape.

HFLR: What other effects do you think the Trump administration could have on the in-house legal and compliance market?

Claypoole: This is something that I have thought about but haven't been able to come to any real conclusion on, frankly. It isn't completely clear to me – or to a lot of others in the industry, I think – where the new administration is going to go and how this isolationist foreign policy, combined with Brexit, is going to play out.

The funds industry is very international in terms of distribution and investments. It is uncertain how the new administration, coupled with Brexit and what's going on in Europe, will affect things.

[For more on Brexit, see our two-part series: *"Effect of Hard vs. Soft Brexit on Hedge Fund Managers"* (Jul. 7, 2016); and *"Hedge Fund Marketing and Distribution Opportunities in a Post-Brexit World"* (Jul. 14, 2016). See also our two-part series on Dechert partners' discussion of the E.U. post-Brexit: *"Cross-Border Marketing Options and the Viability of Domiciling Funds in Luxembourg"* (Nov. 10, 2016); and *"Domiciling Funds in Germany or Ireland to Access the E.U. Post-Brexit, the Possible Introduction of PRIIPs and the Rising Prominence of UCITS Structures"* (Nov. 17, 2016).]

Ultimately, the effect will likely be minimal with respect to legal and compliance personnel. If I were to look at my data three or four years from now, I don't believe I would see, in the aggregate, any significant change in the size of managers' legal and compliance departments. Nor do I think there will be any significant changes in terms of what the compensation looks like for legal and compliance personnel.

This is a new frontier, however, so it is very difficult to make concrete projections. The safest proposition is that the situation is going to remain as it has been, through thick and thin, for the past 10 years.

HFLR: Considering the volatile hedge fund market, with numerous funds and managers closing, many in-house staff are looking for other opportunities. Are you seeing people moving from hedge fund to hedge fund, despite the tight market, or are people looking to migrate to other areas?

Claypoole: One thing that we have been seeing at the higher level – which we rarely saw in the past – is a fair number of people going back into private practice from in-house positions at hedge or private equity funds. In the past, this happened when funds failed and closed, but it is now happening at times when the attorney's fund is healthy. If you look at the partners in some of the significant fund practices, you will find some accomplished attorneys who have spent time as GC of a fund or, in some cases, more than one fund.

These returning partners do quite well for a variety of reasons, one of which has to do with the generational makeup of the fund practices at these firms themselves. In a lot of these law firms, there is a big generational hole right down the middle of the practice group. At the top, sit very, very established, well-known, revered partners – such as Stephen Vine, Paul Roth, John Tavss and Michael Tannenbaum – who have built this business from a legal standpoint. Below them are some very good junior partners.

Between them, however, there is very little talent because in 2004, 2005 and 2006, most of the best folks in those firms were being sucked into hedge funds. Consequently, a lot of practices have somewhat of a generational divide, and many lawyers of a particular vintage are channeling back into firms to fill that void.

HFLR: You mentioned a variety of reasons why these returning partners succeed. Can you elaborate on any others besides the generational gap that may exist in law firms?

Claypoole: Those attorneys are part of a small community of GCs and fund lawyers who all know each other and who bounce ideas off each other. Therefore, when those lawyers return to private practice, they have a built-in client base.

HFLR: What else have you observed with respect to the movement of legal talent in the space? For example, in addition to returning to law firms, are hedge fund attorneys moving to other sectors, such as private equity funds or larger investment banks?

Claypoole: With respect to hedge fund attorneys moving to private equity, unless the manager has a very large, well-established private equity fund – a straight private equity fund, not a blended fund running private equity and hedge strategies side-by-side – it is unlikely that the manager will have a real legal function. Most private equity managers still outsource most of their legal and regulatory work, taking advantage of the ability to expense that outsourcing against the portfolio companies instead of the fund.

Likewise, I think there is a real reluctance on the part of high-end legal talent to go into the asset management division of a bank or larger asset manager. Not only is this usually a step back, compensation-wise, but once an attorney has left a large law firm and had a taste of a smaller, more dynamic organization, that attorney is less likely to want to go back to a large, less-nimble investment bank.

HFLR: In a sea of prospective candidates, are there any factors that differentiate a successful candidate vying for an in-house opportunity from an unsuccessful one? In other words, in your experience, what makes a good fund GC or CCO?

Claypoole: Number one, the key thing is the need to be a binary decision-maker. You need to be able to make "yes" or "no" decisions.

My clients are hiring people because they want the lawyer to decode the whole list of options that comes from outside counsel. Law firms do quite a good job at laying out what potential scenarios are, including the risks that are involved and how the manager might benefit. However, that is as far as they go.

As a result, the manager is, in essence, being asked to make a legal decision or, at best, a quasi-legal decision. The manager wants somebody that can make that decision for it, which is why the in-house lawyer is there.

The in-house attorney's job is to say "yes" or "no." His or her job is to make decisions and be right 98 percent of the time.

Successful in-house legal and compliance staff need to be binary decision-makers who have the confidence and personality to be able to make those decisions in that setting. This is not a combination of factors found in most attorneys. Lawyers are critical thinkers, trained to look at every single possibility, which may not translate into in-house success.

A lot of lawyers I run across are fantastic law-firm lawyers, but I think they will probably fail in-house. One of the main things I offer my clients is the ability to see that. Just because someone looks great on paper and presents very well in an interview does not mean that he or she will thrive in the actual work environment, because the trading floor is a far cry from the law library.

HFLR: In addition to binary decision-making, are there any other skills that a candidate for an in-house position should possess?

Claypoole: The second factor that I feel drives in-house success – and this is more of a characteristic than a skill – is creativity and imagination. This seems like it may be diametrically opposed to the first point, which is why finding a good GC or CCO can be so special. On the one hand, as mentioned above, managers need someone who thinks in terms of black or white; yes or no; zero or one. In addition to making decisions like a computer, however, managers also need someone who can think creatively and imaginatively.

It is difficult to find those two qualities in the same person. In my experience, when you find those two qualities in someone and you have everything else – the academic qualifications, the training, the word through your network and the industry at large that the candidate is a solid person – then you have an excellent chance that candidate is going to succeed in your organization.

HFLR: Is that it? Can GC or CCO success really be boiled down to just those two factors?

Claypoole: Over the 15 years that I've been placing legal and compliance professionals in funds, those two things – the ability to make "yes/no" decisions and the ability to think creatively – are the characteristics that the most successful people overwhelmingly have in common.

In addition to those two, there are a number of other characteristics that I throw into the "he-or-she-gets-it" pile. These characteristics all come down to whether, when you're evaluating the candidate, he or she can see the big picture or picks over tiny unimportant issues. Although I know this sounds trite and obvious, it's true. For example, if I'm speaking with a prospective candidate about a position at a significant manager and the first thing that person asks me is about the pay and benefits package, I know he doesn't get it.

Those are the three factors that I see as determining in-house success.

HFLR: Any final predictions for the funds legal and compliance market?

Claypoole: Exceptional legal and regulatory professionals in the alternative fund space will continue to be employed and well-compensated forever. For people who are truly talented in this area, there will always be interesting, highly compensated work.

Remember, before there were hedge funds, there were mutual funds. Mutual fund lawyers became hedge fund lawyers. If hedge funds were to disappear tomorrow, along with private equity funds and mutual funds, unless people start shoving money under mattresses, there will always be structures and regulations that surround the investment of the tremendous amount of capital and cash in the world.