



**Re-Thinking the
Traditional Incentive Compensation Model for
Institutional Hedge Funds:
*Creating True Alignment and Manager Sustainability***

Current Model of Incentive Comp (IC)

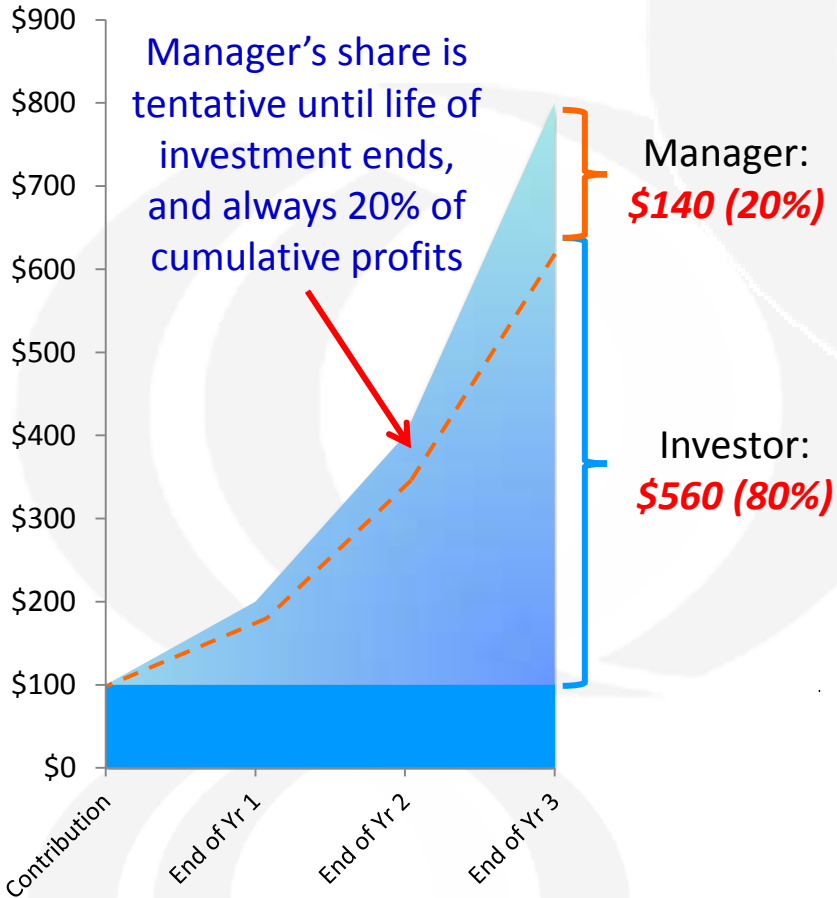
- Annual Banking: Manager's 20% share of profits is banked and taxed each year
- Little or no multi-year alignment:
 - If investment longer than 1 year, Manager's share of cumulative profits is ***always greater than 20%*** and Investor's share is ***always less than 80%***
 - Only the ***after-tax*** amount of IC is available for clawback
 - Carried interest exacerbates misalignment
 - Manager cannot provide tax-deferred compensation to its "alpha generators" and align them long-term with Investors
 - Institutional (long-term) Investors are often commingled with short-term Investors

Fair Market Value (FMV) Options

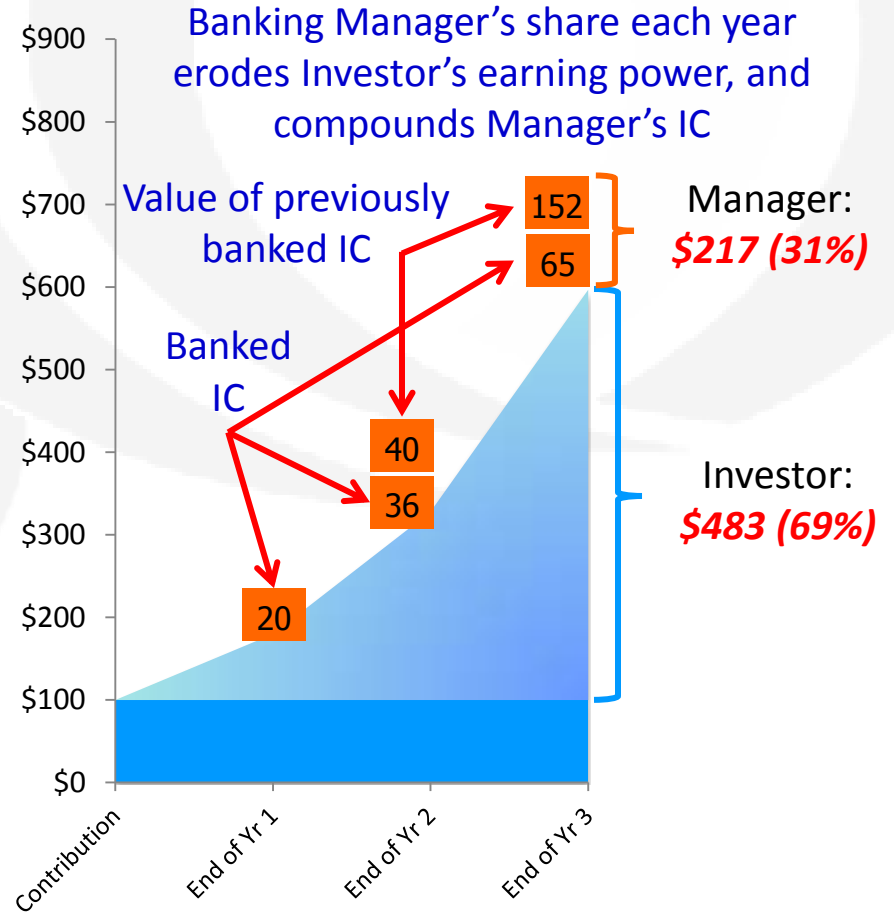
- Manager receives call option on profits of 20% of Investor's shares: Manager's profits not crystallized, or taxed, until Manager exercises option
- **Result:**
 - All capital and profits stay invested until redemption
 - Cumulative (terminal), *pre-tax* profits always split **80/20**
 - No loss of future profits from periodic banking/taxation of profits
 - Investor always has **full clawback** against accrued pre-tax IC (clawback tentative until redemption)
 - Investor's cumulative return increases significantly
 - Manager can provide tax-deferred compensation to its key alpha generators and thereby align them long-term
 - Investor is either only Investor or commingled exclusively with other like-minded, long-term Investors

Options Bank Terminal, Not Interim, Profits

Option Fund*



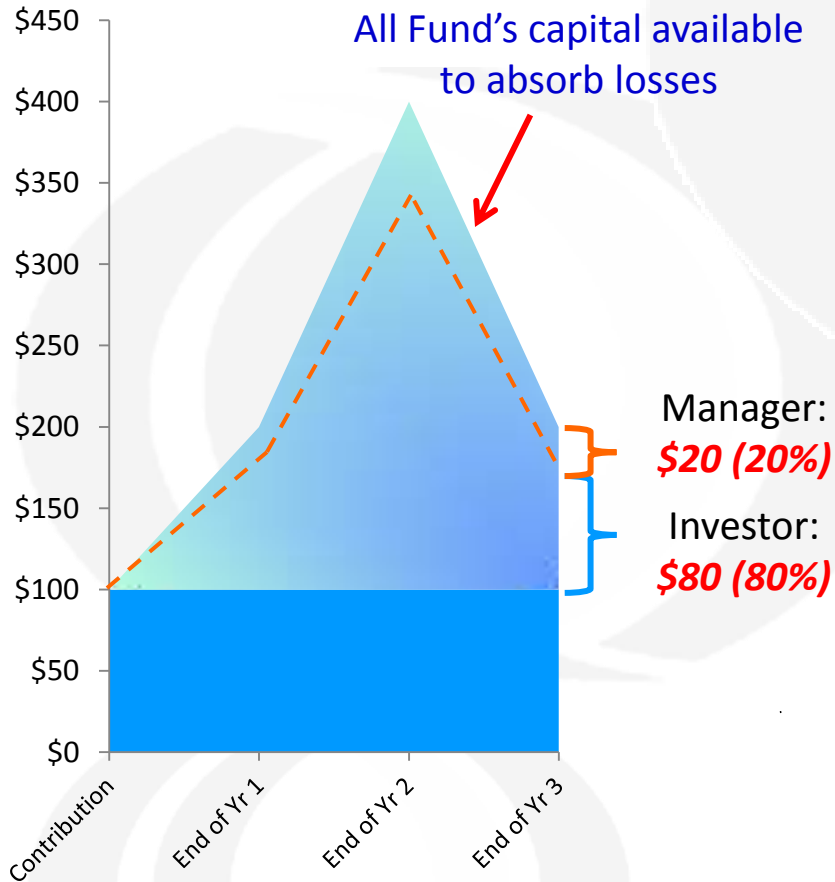
Annual Banking Fund



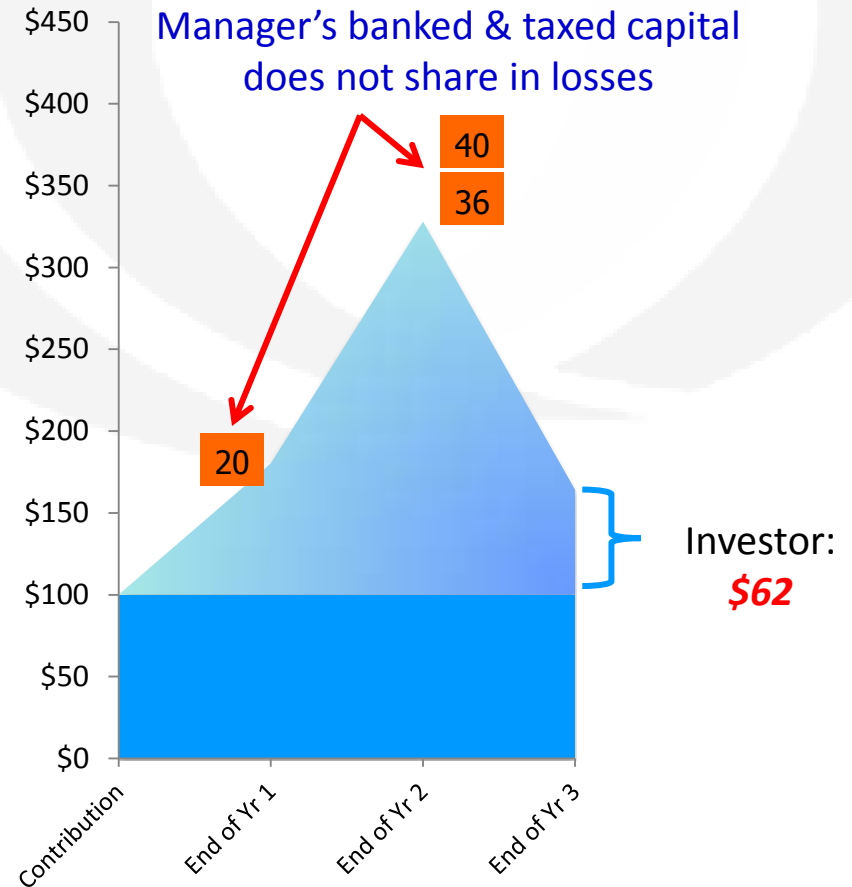
* No New Growth Options

Options Claw Back Interim Profits

Option Fund*



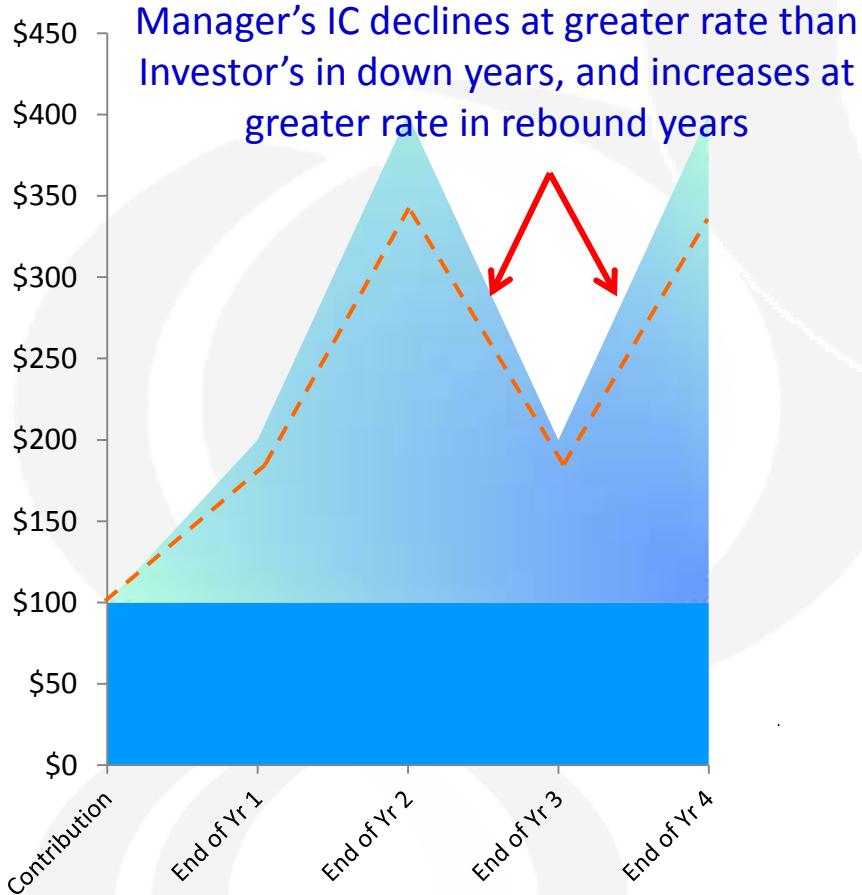
Annual Banking Fund



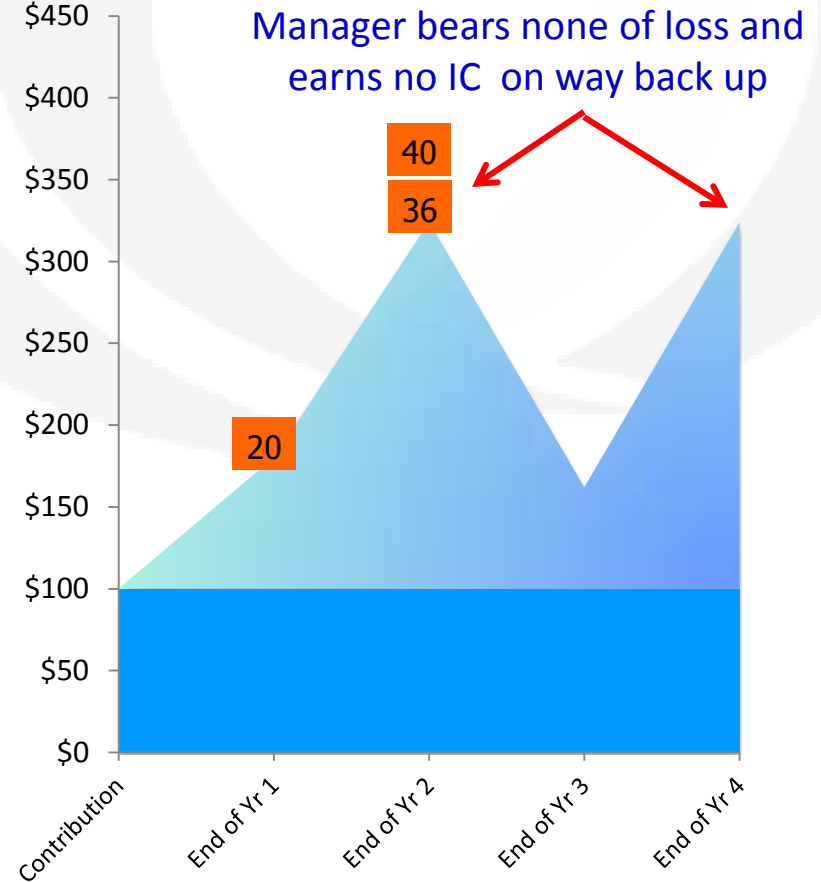
* No New Growth Options

Claw Back Can Be Earned Back

Option Fund*



Annual Banking Fund



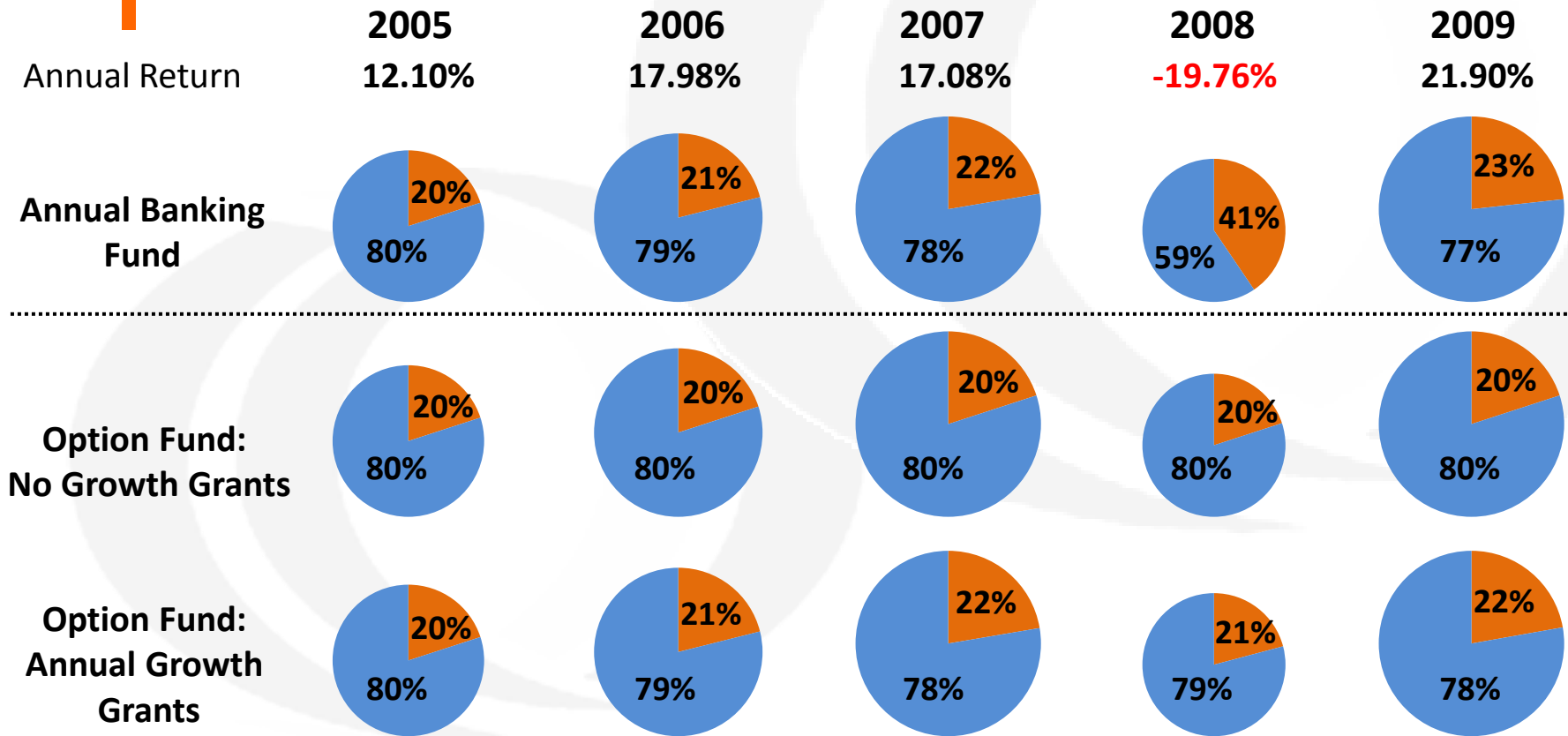
* No New Growth Options

Option Design – Two Issues

- 🌀 **Mutual Banking Rights** – When Can Each Party Liquidate (No Hard Locks)?
 - A. Design A: Each party can redeem at any time -- no early redemption fees (ERFs)
 - B. Design B: Investor can redeem at any time subject to ERFs (Manager can redeem at any time and forgo ERFs on related investment)
 - C. Design C: Hybrid – a part is ERF-free and a part is subject to ERFs

- 🌀 **Compounding** – New Growth Option or Not?
 1. Design #1: No New Growth Options, so cumulative profit-sharing remains 80/20 for life of investment
 2. Design #2: Annual New Growth Options provide Manager compounding but Investor retains full clawback

Case Study: Division of Cumulative Profits



The charts above assume an investment on 1/1/2005 in a Fund that performed at the same rate as the Dow Jones Credit Suisse Long/Short Index.

Options vs Annual Banking

Average Return of Following Periods	Investor's Profit* / Manager's Comp**			
	Design No. 1 (No New Growth Options)		Design No. 2 (Annual New Growth Options)	
Last 15 5-Yr Periods	5%	-21% to -6%	1%	-13% to 4%
Last 10 10-Yr Periods	34%	-27% to -9%	7%	-8% to 14%
Last 5 15-Yr Periods	118%	-31% to -10%	26%	-2% to 29%

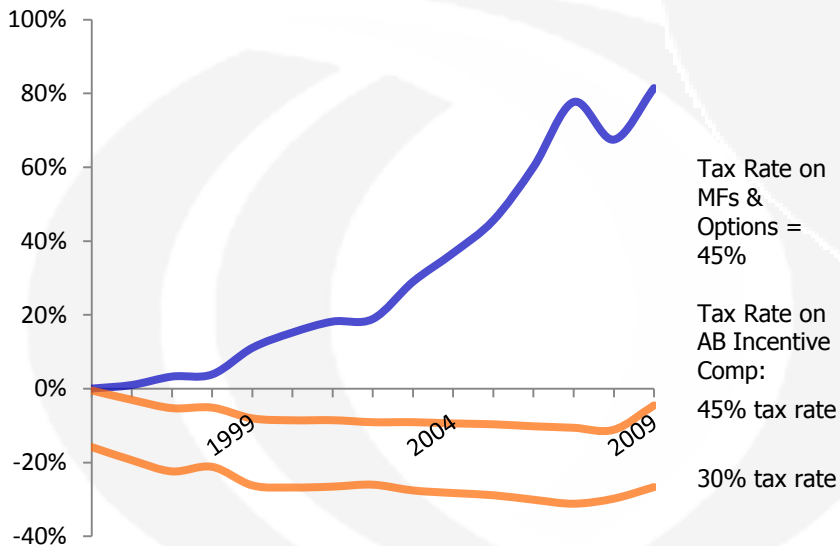
Assumes Fund's return same as Hennessee Hedge Fund Index, 20% incentive comp rate and 2% management fee based in Investor's account.

* Incremental cumulative return from investing in Option Fund versus Annual Banking Fund.

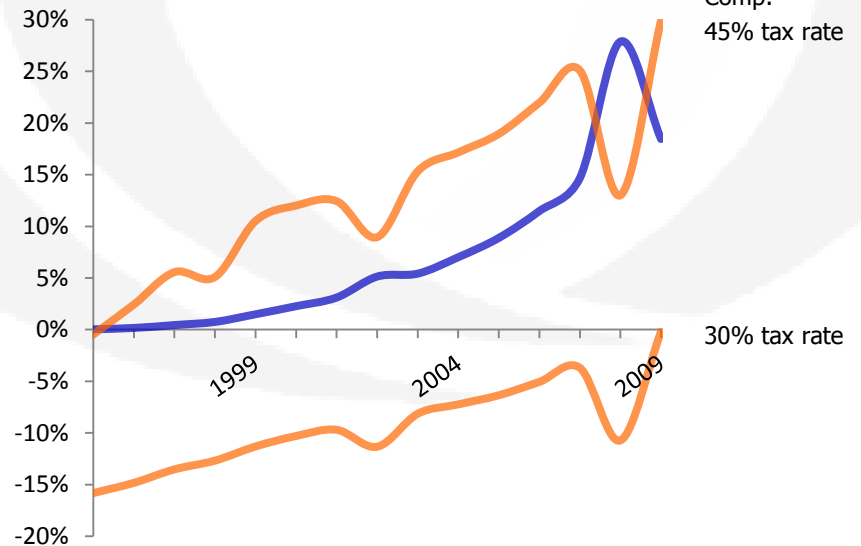
** Percentage increase (decrease) of Manager's total after-tax compensation from Option Fund over (from) Annual Banking Fund, assuming 45% tax rate on management fee and Option incentive comp and 30% to 45% on Annual Banking Fund incentive comp.

Option vs Annual Banking (cont'd)

No New Growth Options



Annual New Growth Options



Assumes investment from 1995 through 2009 in Fund with return same as Hennessee Hedge Fund Index, 20% incentive comp rate and 2% management fee based on Investor's account.

Incremental cumulative return from investing in Option Fund versus Annual Banking Fund.

Percentage increase (decrease) of Manager's total after-tax compensation from Option Fund over (from) Annual Banking Fund.

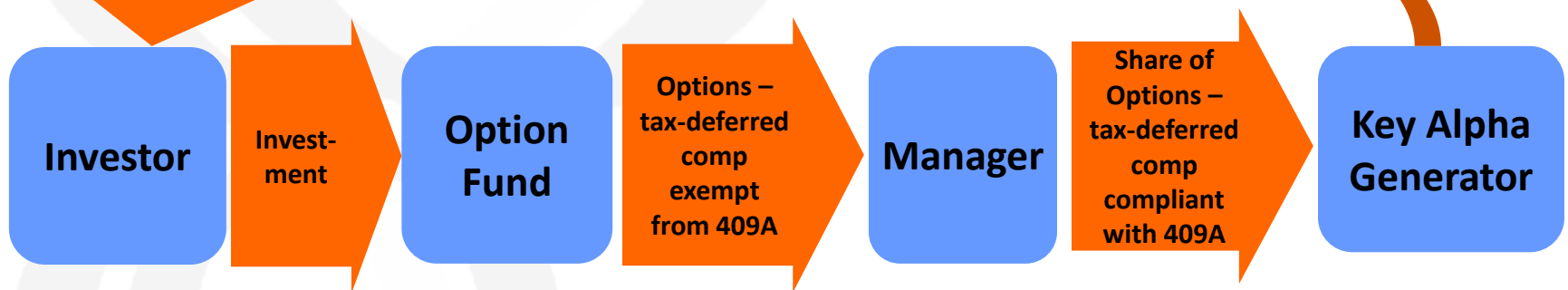
Manager Benefits

- **Greater AUM:** Differentiation enhances ability to attract institutional Investors
 - Offering true alignment
 - Reporting higher returns than Annual Banking peers
- **“Stickier” AUM:** Investors should stay longer
 - Investors’ cumulative return advantage grows geometrically over time
 - The longer the investment, the greater the downside protection
 - Option Funds are restricted to long-term, institutional Investors, thereby mitigating redemption risk, whether from commingling or market risks
- **Improved Sustainability:** Option Funds pay greater Management Fee to fund operations and enable Manager to use “golden handcuffs” to attract and retain top talent and complete the alignment story (see next slide)

Aligning Manager's Alpha Generators

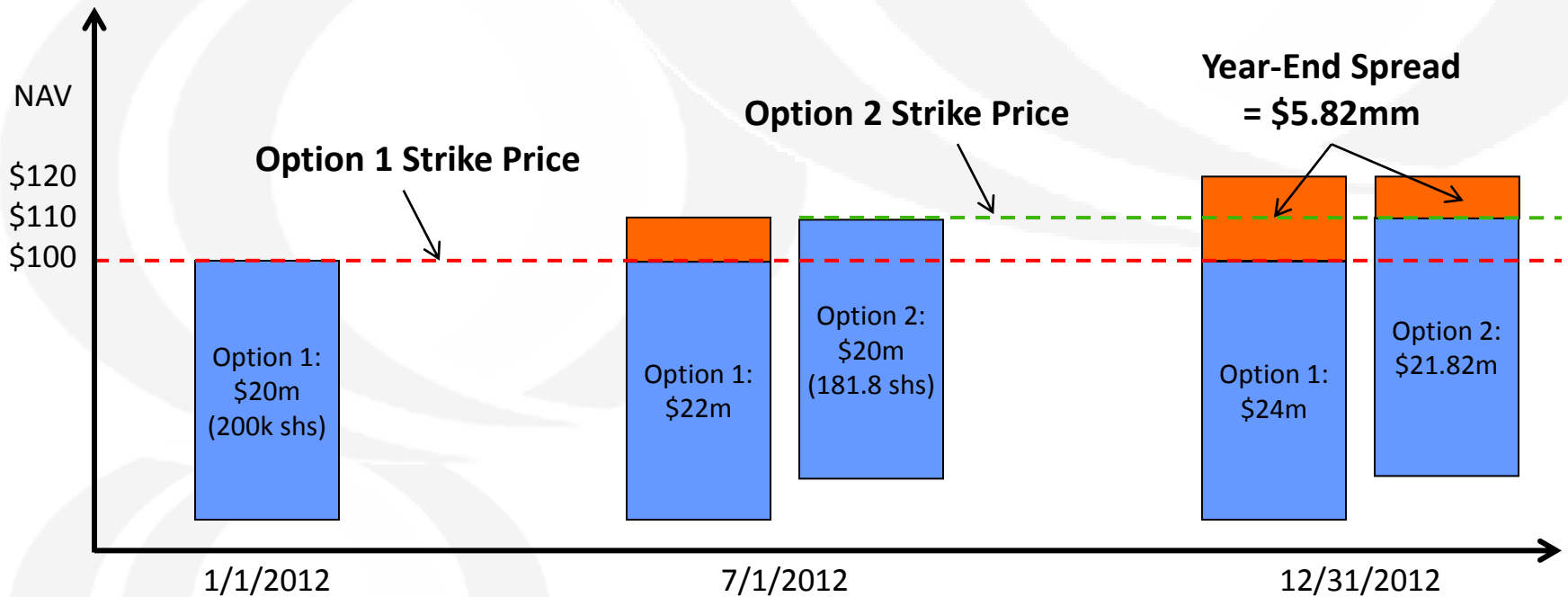
- Under Annual Banking Fund, it is too costly for Manager to provide deferred compensation to its key Alpha Generators
- Options are tax-deferred and enable Manager to provide tax-deferred compensation to attract and retain top talent

Because the key trader's, portfolio manager's or analyst's incentive compensation consists of a share of the Investor's *cumulative* pre-tax profits over life of investment, the key Alpha Generator is directly and truly aligned with Investor.



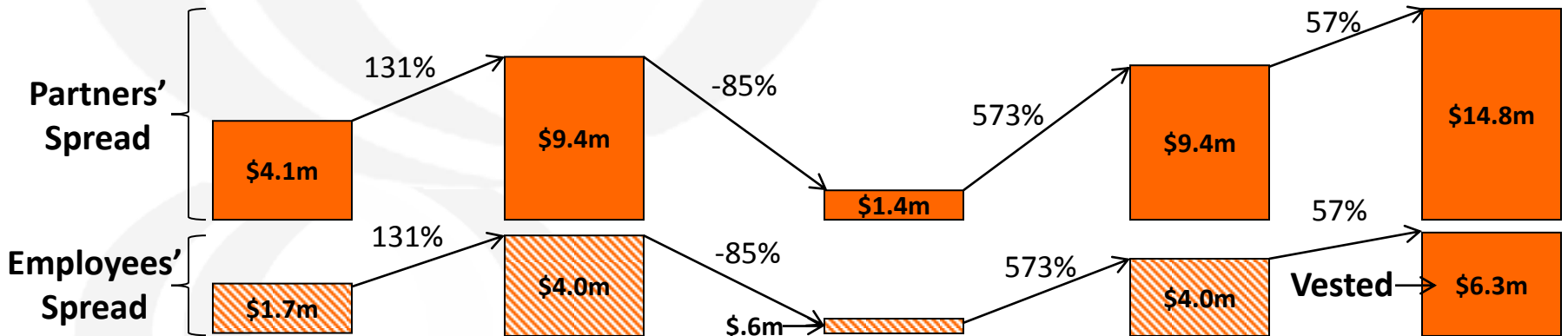
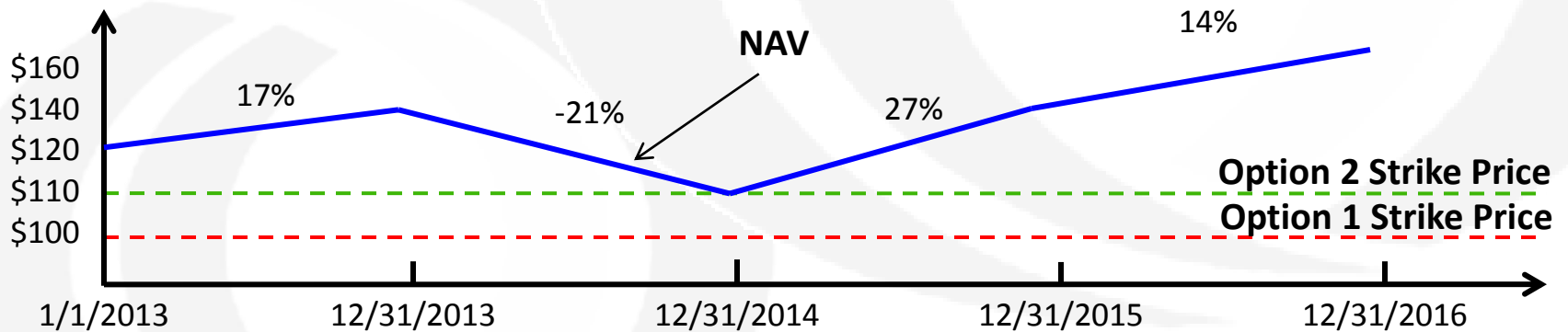
Aligning & Retaining Alpha Generators

- Assume:
 - Fund receives 2 \$100 million investments during 2012
 - NAV is \$100 on 1/1, \$110 on 7/1 and \$120 on 12/31
- Below are the two FMV Options granted to Managers' Partners



Aligning & Retaining (cont'd)

- To create “golden handcuffs,” at year end Partners award key employees portion of Options and specify service required to vest
- Assume 30% to key employees with 3-year class vesting



Converting to Option Funds

- Develop customized plan for converting to Option Funds
- Develop terms regarding
 - Rates on management fees and incentive comp
 - Mutual banking rights (ERFs)
 - New Growth Options
 - Single investor or multi-investor
 - Minimum investment
- Manager forms Option Fund and Option Plan
- Investor invests in Option Fund (can be simple cashless stock swap)
- Fund issues Options to Manager

Optcapital

- Provides comprehensive design, implementation and administration of Options
- Uniquely qualified to consult on Option Fund design and implementation strategy and process
- Experts on
 - Converting existing hedge fund allocations (single-investor, commingled, SMA, Brownfield/Greenfield issues, master-feeder issues)
 - Modeling economics for Investors and Managers
 - Delivering alignment from Fund to Manager to Manager's key alpha generators
- Provides Option Plan legal documents for attorney review
- Proprietary Web-based record keeping providing 24/7 access
- Client services support
- SAS 70 (Type II) certified since 2004

Notes & Disclaimers

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- Optcapital's Managing Partners are as follows:
 - **Rick Ehrhart, JD** has 30 years experience in the deferred and incentive compensation industry. He co-founded Optcapital in 1998. Mr. Ehrhart received a BA in Economics with honors from Davidson College. He then graduated from the University of North Carolina School of Law where he was a member of the NORTH CAROLINA LAW REVIEW. He is currently a member of the Business Law and Tax Law Sections of the American Bar Association. A frequent speaker at deferred comp seminars, Mr. Ehrhart recently participated as lecturer and author at the Employee Benefits Symposium sponsored by the John Marshall School of Law. His article, *Section 409A – Treasury 'Newspeak' Lost in the 'Briar Patch'*, was published in the Fall 2005 edition of the JOHN MARSHALL LAW REVIEW.
 - **Thom Young, MBA** has 30 years experience in the financial services and hedge fund industry. Before Optcapital, he co-founded and managed Cambium Capital Management, a hedge fund that applied a conservative Jones model consisting of U.S. equity long/short positions. He is a board member of the Mint Museum of Art, Treasurer of the Board of Trustees of The Echo Foundation and a member of the Board of Visitors at Davidson College. Mr. Young earned his MBA from the University of Virginia and his undergraduate degree from Davidson College.
 - **Jim Christian, MBA** has 12 years experience in the financial services and hedge fund industry. From 1999 to 2004, he served as managing director and president of Aspen Strategic Alliance LLC, which included QED CapitalWorks LLC, an equity market neutral hedge fund, and Aspen Partners, Ltd. Mr. Christian earned his MBA in International Finance from the University of South Carolina in 1996, and his undergraduate degree in chemistry from Clemson University in 1993.

Appendices

- Appendix A – Tax Laws
 - IRC §409A
 - IRC §457A
- Appendix B – Optcapital

Appendix A — Tax Laws

- 2004 – Congress Imposed New IRC Section 409A on NQDC
 - Establishes strict, technical rules for form and operation of nonqualified deferred compensation (NQDC) plans
 - Subjects NQDC to risk of immediate taxation, interest and penalties that can take 70%+ of balances
 - Manager bears burden of proof of timely compliance
 - Back-to-back compounds complexity
 - *Congress explicitly exempts FMV Options/SARs*

Appendix A – Tax Laws (cont'd)

- 2008 – Congress Imposed New IRC Section 457A on NQDC
 - No new NQDC after 2008, and old NQDC taxable by 2017
 - *Congress explicitly exempts FMV Options/SARs settled in stock*
- 2009 – Rush to Carried Interest & Annual Taxable Fees
 - 457A bars comp periods greater than 1 year and renders traditional clawback approach unworkable
 - Many Managers convert to “carried interest”

Appendix C – Optcapital

Started in 1998, Optcapital specializes in the design, implementation, and administration of Fund Alignment Rights (FAR[®]s), the next generation of incentive compensation for Hedge Funds. FAR[®]s align mutual interests between Investor and Manager, and aid in attracting and retaining the highest quality capital and human talent, restoring the “true partnership” to the industry. The Company administers over \$3 billion of incentive compensation Plans for Hedge Fund Managers. Our proprietary Web database, automated Plan administration system, and experienced service professionals ensure compliance with 409A and 457A sections of the IRS Code. Since 2004 the Company has retained a SAS 70 (Type II) certification of its administrative systems, processes, and controls.

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