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For Advice on Pay, the New Money Turns to Wall Street

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EVEN though the world of hedge funds and private equity is very hush-hush, it is no secret that its top traders and deal makers have made huge fortunes. Less well known, however, is that these new kings of Wall Street are turning to a growing class of kingmakers for compensation advice.

A small but influential group of pay consultants and lawyers has emerged in recent years, negotiating employment contracts for hedge fund and private equity executives and providing the same kind of peer surveys and \$625-an-hour counsel that has long been relied on by executives at big public corporations.

Robert M. Sedgwick, an executive pay lawyer at Morrison Cohen in New York, said his practice was a case in point. Seven years ago, most of his business involved negotiating the compensation of chief executives of publicly traded corporations. Today, roughly a third of his practice represents hedge fund and private equity firm principals, including those recruited to run a firm's portfolio companies. They are on the prowl for pay packages totaling at least \$1 million — and often 10 to 40 times that amount.

“There is an endless supply,” said Mr. Sedgwick, who has negotiated executive contracts at more than a dozen big hedge fund and private equity firms, including the Fortress Investment Group, SAC Capital and the Blackstone Group.

“For every billionaire, there are large numbers of hundred-millionaires,” he added. “And there are so few people who do what we do.”

The idea of hiring a compensation adviser might appear to fly in the face of longstanding claims made by hedge fund and private equity managers that their stratospheric pay is purely market-driven and that they only make huge sums of money when their investors do.

But with many hedge funds and private equity firms no longer led by just two or three people, there is often intense debate on how to divvy up those hefty profits. And as these firms have grown into large institutions and more senior partners have entered the mix, they need the kinds of compensation infrastructure found on Wall Street.

Some big hedge funds are wrestling with how to set performance goals for their portfolio managers that are aligned with an investment strategy, like lowering monthly volatility. Private equity firms are exploring different ways to carve up their investment profits among the partners. And top deal makers and portfolio managers are requiring contracts that outline severance packages and other guarantees before they will agree to start a new job.

There is still one big difference between private equity and hedge fund principals and the executives of public corporations: the number of zeroes on their paychecks.

On Wall Street in 2006, a typical chief executive of a big investment bank took home about \$30 million, according to an analysis by Equilar, a compensation consulting company. Last year, some top deal makers might have received \$20 million to \$25 million. But a typical managing director at a top investment bank made \$1.7 million to \$3.5 million in 2006, according to a recent study by Johnson Associates, another consulting firm.

All those princely sums, however, pale in comparison with the earnings of principals in private equity and hedge funds. Stephen Schwarzman, the chief executive of Blackstone, for example, earned an estimated \$300 million in 2005. Owners of large hedge funds, like Steven A. Cohen of SAC Capital, took home an estimated \$550 million in 2005, according to the latest annual survey by Alpha magazine, which is published by Institutional Investor.

Senior managers can make out well, too. While hedge fund pay can be all over the map, a top portfolio manager easily could have reaped tens of millions of dollars in last year's booming markets. A typical managing partner at a big buyout firm made \$2.2 million to \$8.3 million, according to a 2006 private equity pay analysis by R. Michael Holt, a consultant who specializes in the industry. With deals at record levels, paychecks could increase by 25 percent or more this year.

Of course, principals in private equity and hedge funds are not paid the same way as executives of public companies. The pay for hedge fund managers is based largely on absolute performance, not on whether they outperformed their rivals or a stock market index. Investors typically pay fees of 2 percent to 3.5 percent of the assets under management, and let management take a 20 percent to 35 percent cut of the profits if performance targets are met.

Private equity has its own pay scale. Investors generally pay 2 percent to 4 percent of their assets for so-called transaction or management fees. This money is usually used to help pay salaries and bonuses, which can total more than \$1 million each for a firm's top partners.

But the biggest payoffs come from what is known as carried interest, or performance fees, the roughly 20 percent cut of net investment profits, assuming the firm's invested assets achieve a target rate of return upon exiting a deal. A \$1 billion fund that doubles its money over three years, for example, could yield a total carried interest of more than \$150 million. The multimillion-dollar question then becomes, how do you split that money up?

A decade ago, only partners would have gotten part of the carried interest, pay experts said. But today, even associates are demanding a small piece of the action. Mr. Holt, the pay analyst, said that about a quarter already got it.

Top rainmakers, like former government officials or influential investment bankers, can demand much more.

"If you have a particular heavy hitter, it wouldn't be atypical for someone to get 20 percent of the carried interest pool," said Michael J. Segal, an executive compensation lawyer. "It all depends on negotiating leverage and what the person brings."

And buyout firms are figuring out new ways to sweeten the pot. They offer top deal makers bigger payouts based on the number of transactions the firm ultimately achieves, and they offer co-investment opportunities, allowing private equity partners to plow their money into a highly leveraged investment pool. Firms will usually lend partners \$1 to \$3 for every \$1 they contribute, helping them to enhance their personal returns.

So far, only a few executive pay advisers are focusing on this lucrative niche. Many firms still negotiate compensation packages on their own. But working off the annual survey data, lawyers and pay consultants are drafting severance agreements, vesting schedules and noncompetition clauses for private equity and hedge fund principals — as they once did for public company executives. They are also helping their clients negotiate a percentage of the carrying charge or investment profits.

Of course, they do not spend much time haggling over super-size pension plans, golf club memberships or the personal use of company jets. Unlike many corporate executives, the new kings of Wall Street generally do not receive lavish retirement benefits and other perks.

“It’s all cash,” said Michael S. Melbinger, an executive compensation lawyer at Winston & Strawn in Chicago. The attitude is, “If you want to join a country club, we are paying you more money than God, you can do it.”