

2009 Compensation and the Way Forward

*Wall Street Compensation
and Benefits Association*

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Introduction

Johnson Associates	3
Lasting Effects of the Financial Crisis	4
2009 Broad Recap	5 – 6
2009 Typical Incentive Changes (Value of Cash Bonus & Equity)	7
2009 vs. 2008 Compensation as % of Pre-Tax Pre-Comp Income	8
Year-to-Date Compensation as % of Net Revenue	9
Incentives from 1998 – 2009	10
Prominent Question: Has Anything Changed?	11
2010 Fearless Predictions	12 – 13
Compensation Transparency and Communication	15
No More Bonus . . .	25
Base Salary Levels – Progress	16
Clawbacks and Risk Adjustments	17
Individual Clawbacks “After the Fact”	18
Executive Compensation	19
Long-Term Incentives	20
Investment Banking	21
Asset and Wealth Management	22 – 23
Hedge Funds – Important Year	14
Private Equity – Problems Continue	24
Summary and Advice	26

- Independent financial services compensation consulting. In-depth expertise and candor across businesses and cycles. Sound practices and philosophy, incentive designs and goals/measures, market levels and funding, and equity/carry allocations
- Diverse Clients and Experiences
 - Investment and commercial banks
 - Asset management firms
 - Hedge Funds/Private Equity/Alternatives
 - Insurance companies
 - Brokerage firms
 - Trading organizations

Lasting Effects of the Financial Crisis

- Distrust and real anger over financial services compensation
 - Began with risk considerations, and morphed into populism debate
 - Corrosive impact of the word “bonus”
 - Industry response generally ineffective
- Abnormally heavy equity deferral rates
 - Need more diversification in vehicles
- Clawbacks
 - Over-promised, vague
- Expectations for lower executive compensation
- Focus on overall firm/business payout ratios
 - Often not well understood
- Higher base salaries in a changing compensation mix
- Risk considerations in compensation designs and monitoring

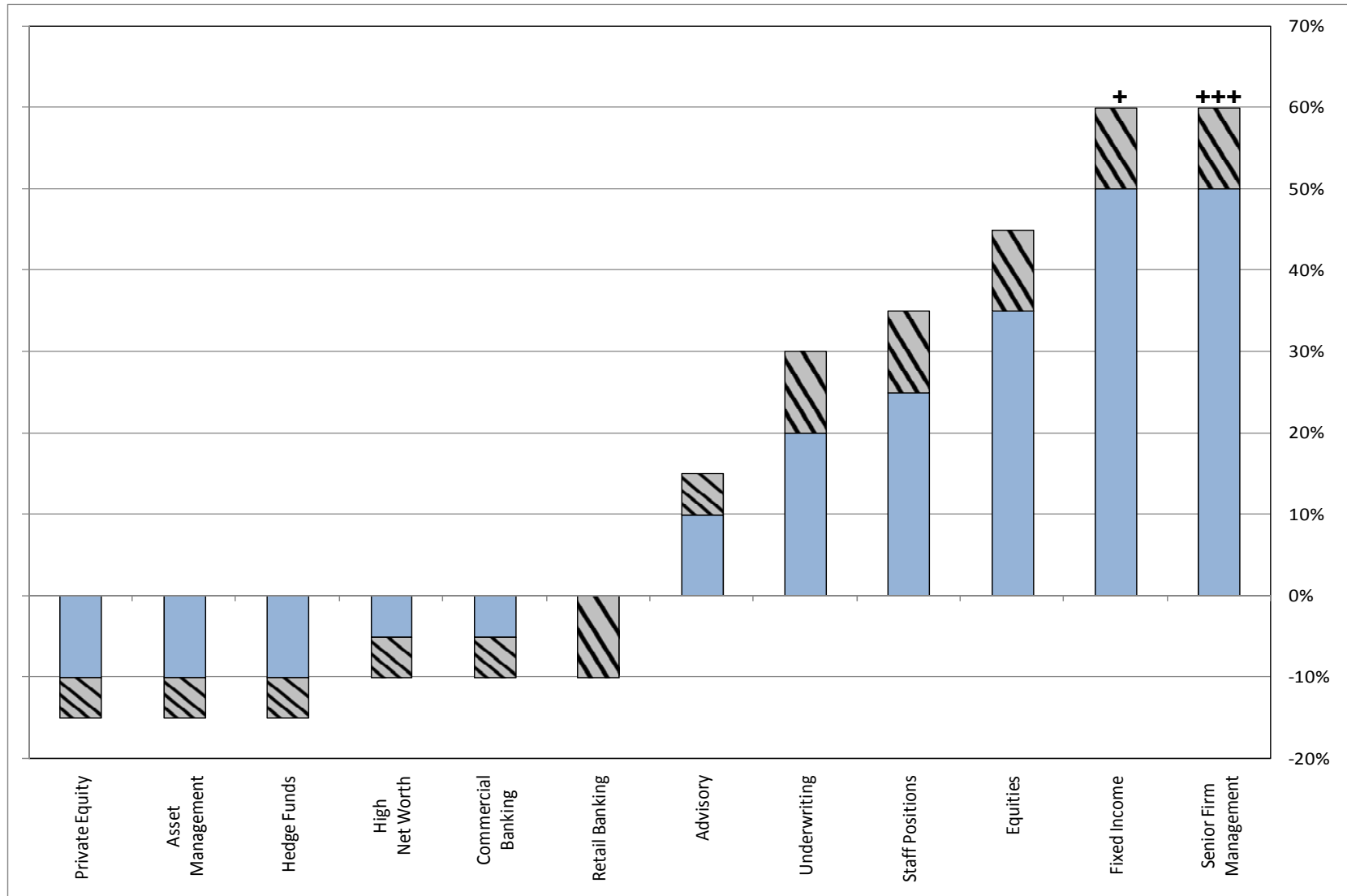
2009 Broad Recap

- Significantly higher compensation for traditional Wall Street
 - Lower for asset and wealth management
 - Insurance moderately lower
- Regulatory and political ramifications
 - U.S. TARP and the Pay Czar
 - 2008 - 2009 downward pressure on proxy pay
 - Deferral magnitudes
 - Clawbacks
 - “Say on pay”
 - Higher base salaries
 - Discouragement of multi-year guarantees
- Fixed-Income had overall extraordinary 2009
 - Slowing in 4Q2009 and into 2010 on narrowing spreads
 - Strong equities and proprietary trading
 - Weak absolute banking, but slowly improving

2009 Broad Recap

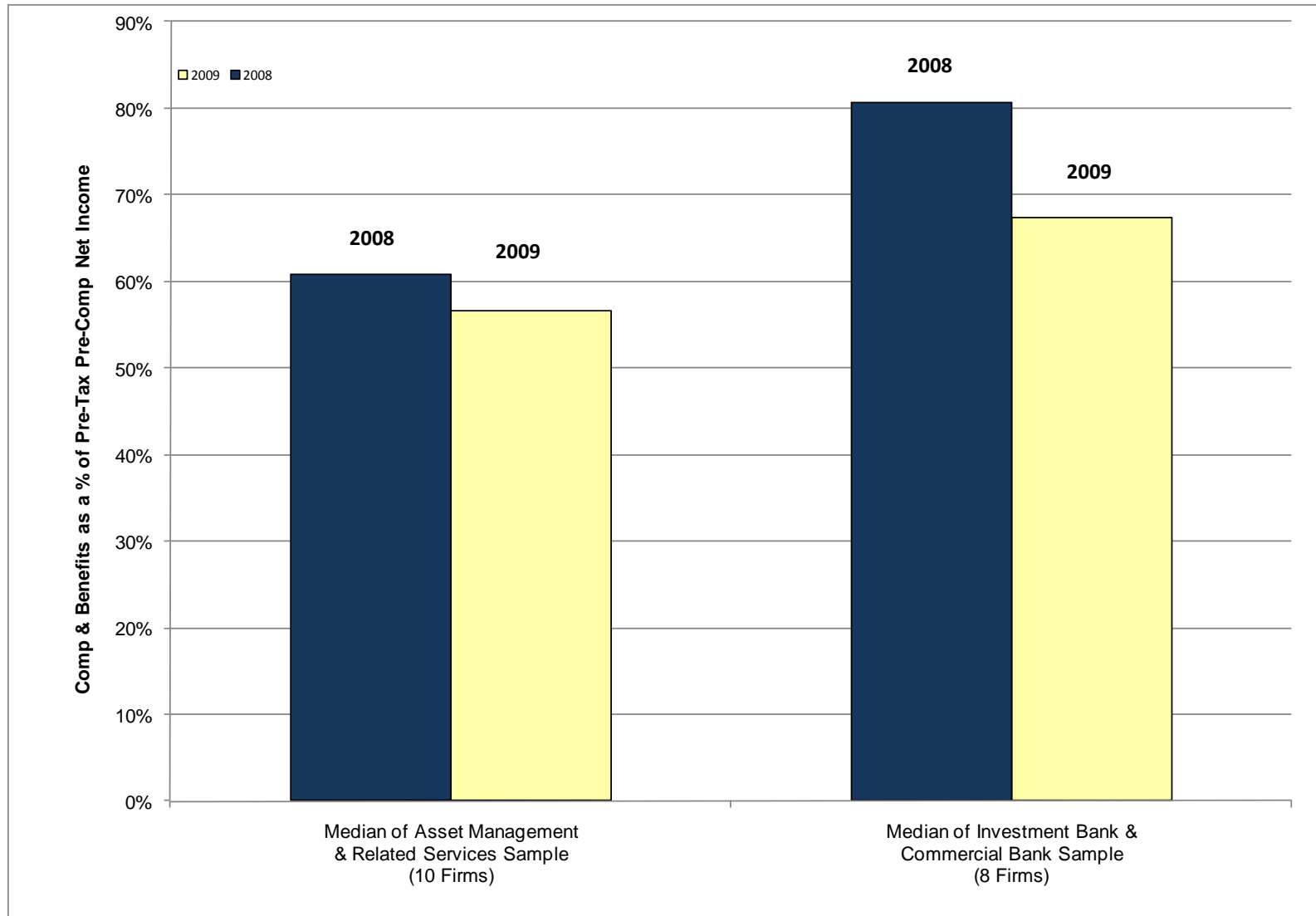
- Less real changes in compensation ratios than some expected
 - Trading businesses generally have lower payouts
 - Heavy deferrals push expenses into future years
 - Important nuance: using less capital is de facto reduction in ratio/opportunity, but less transparent
- Asset and wealth management down on lower AUM
 - Incentives down 10% - 15% in 2009; down 35% - 40% from 2007 high
 - Expect significant 2010 rebound due to increased average AUM
- “Frozen” labor market improving throughout 2010
 - Expect gradual improvement
- Improving risk practices and oversight
 - Recognize combination of quantitative and qualitative
- Hedge funds recover after poor 2008
 - However, many still below “high-water mark”
- Existing single CEO model not adequate
 - Heavyweight, relevant full-time Chairman for additional voice and balance

2009 Typical Incentive Changes (Value of Cash Bonus & Equity)*

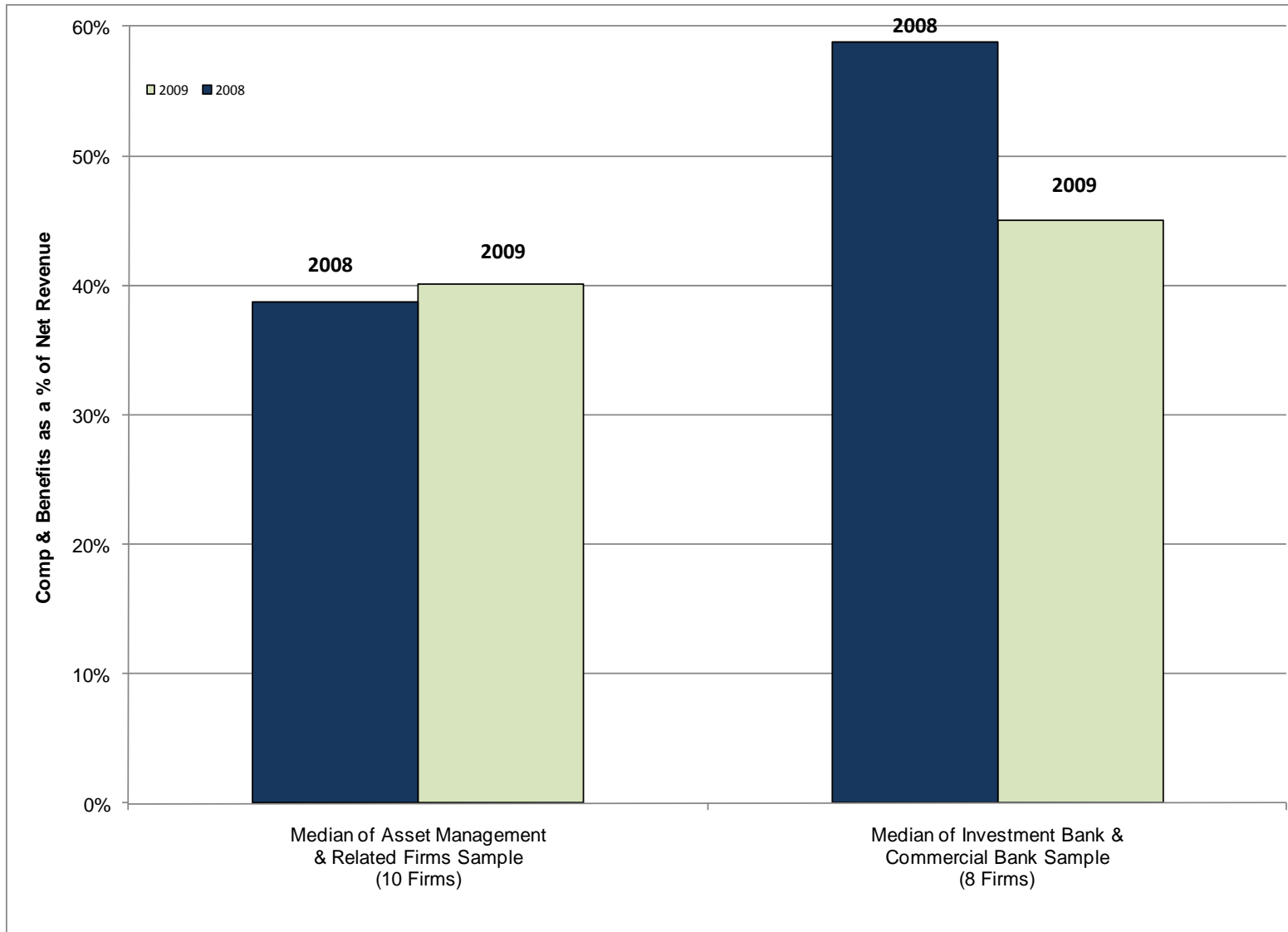


* "same store" basis

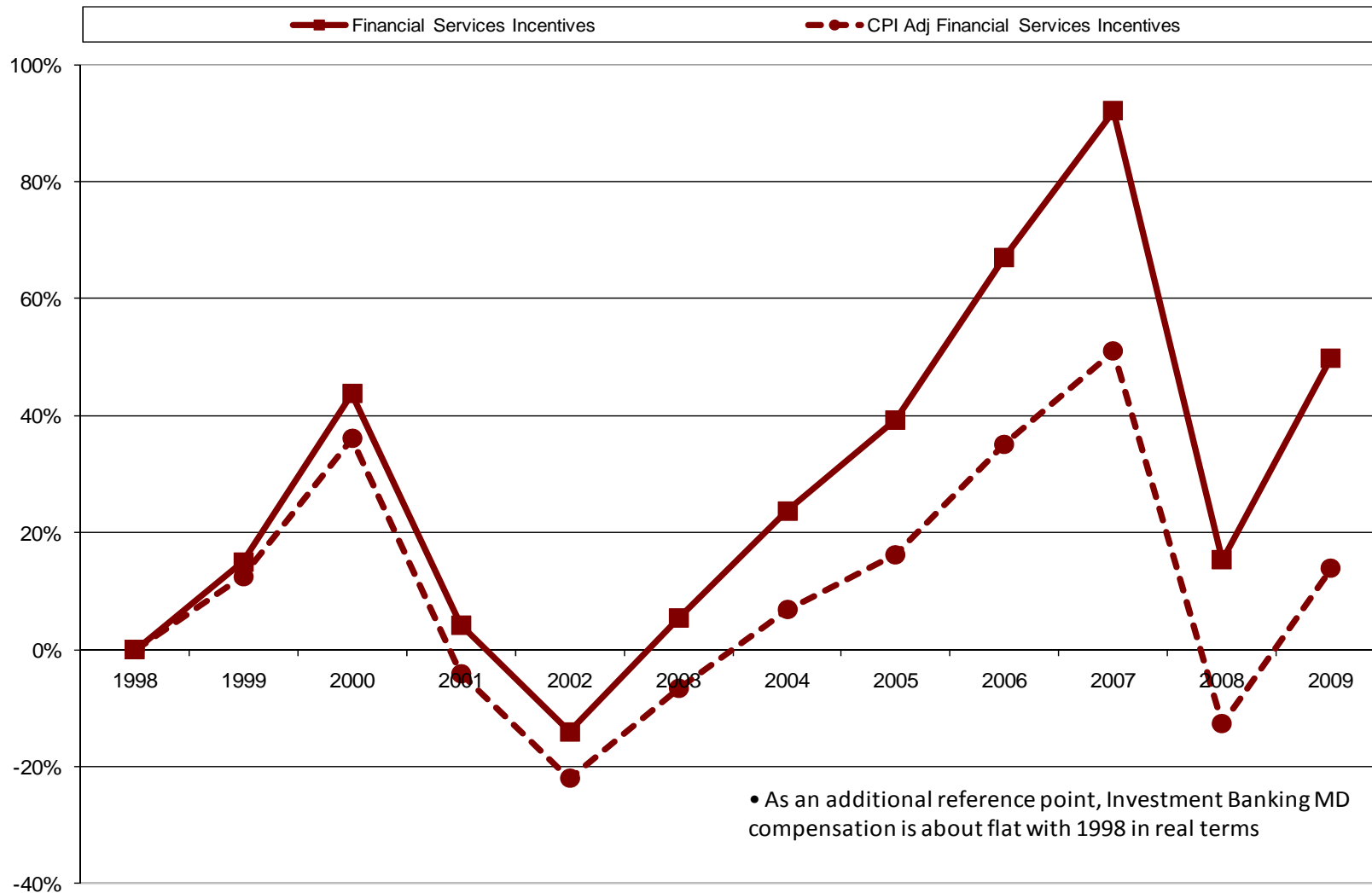
2009 vs. 2008 Compensation as % of Pre-Tax, Pre-Comp Income



Year-to-Date Compensation as % of Net Revenue



Incentives from 1998 – 2009



Prominent Question: Has Anything Changed?

COMMON EXPECTATIONS

REALITY

<ul style="list-style-type: none">• Compensation permanently and substantially reduced<ul style="list-style-type: none">– Fairness	<ul style="list-style-type: none">• Compensation on results/market<ul style="list-style-type: none">– Competitive market
<ul style="list-style-type: none">• Payout ratios reduced drastically<ul style="list-style-type: none">– Blunt assessment of sharing	<ul style="list-style-type: none">• Real payout ratios marginally reduced<ul style="list-style-type: none">– Nuance of capital/risk utilized
<ul style="list-style-type: none">• Harsh clawbacks<ul style="list-style-type: none">– Simple, broad link to micro multi-year results	<ul style="list-style-type: none">• Significant clawbacks<ul style="list-style-type: none">– Mixed clarity and thoughtfulness– Need to avoid witch-hunts
<ul style="list-style-type: none">• Less/no current cash<ul style="list-style-type: none">– Heavy deferrals	<ul style="list-style-type: none">• Less current cash<ul style="list-style-type: none">– Heavy deferrals
<ul style="list-style-type: none">• Higher base salaries	<ul style="list-style-type: none">• Evolving higher base salaries

2010 Fearless Predictions

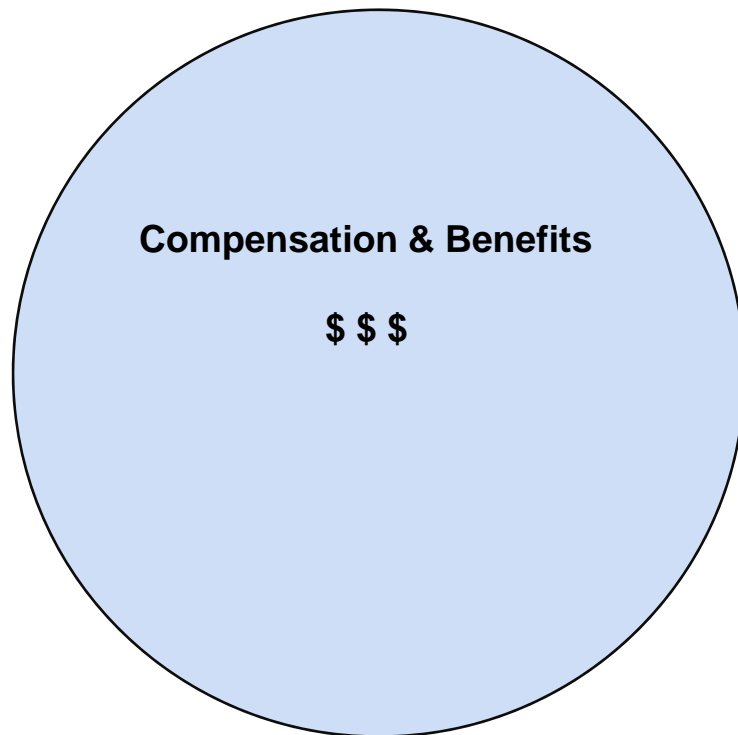
- 2010 incentive compensation increases moderately from 2009 (i.e., +15%)
 - 2009 profit-driving fixed-income business to decline significantly on reduced spreads
 - Reduced write-offs and accounting charges linked to own debt
 - Equities flat
 - Investment banking up from a lower base
 - Commercial and retail banking moderately up from 2009
 - Asset and wealth management up significantly due to AUM effect
 - Reduced proprietary trading due to markets/capital
 - ∴ Mix of business will drive outcomes
- Overlay of continued residential and commercial real estate issues
- Proxy compensation returns to market levels
 - Hard transition from 2008 – 2009
 - Many major CEOs in \$15 – \$25 million range
- Heavy deferrals continue
 - Some reduction in middle of organization
 - Greater utilization of asset management and alternative vehicles
 - Continuation of some non-annual vesting (i.e. quarterly, semi-annual)

2010 Fearless Predictions

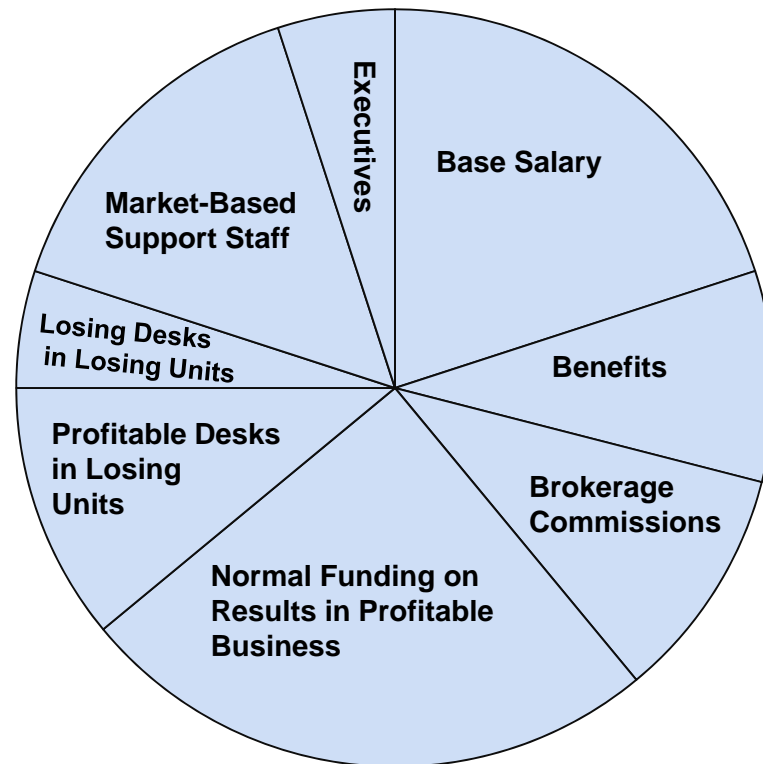
- Labor market improves (i.e., so-so)
- Base salary increases continue as changes to pay mix
- Firms rethink management structure and Chairman role
- Clawbacks put to first initial tests and found wanting
- Poor external communication of basic compensation model and magnitudes

Compensation Transparency and Communication

Today (2010)

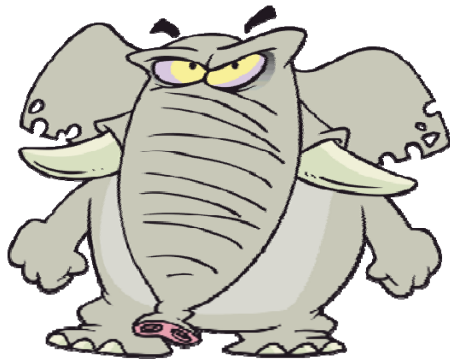


Future



Current model cannot be explained or justified. It is necessary to have compensation system that can be explained and defended.

The New Nomenclature:



Incentives – YES!

Bonus – ~~NO!~~

Base Salary Levels – Progress

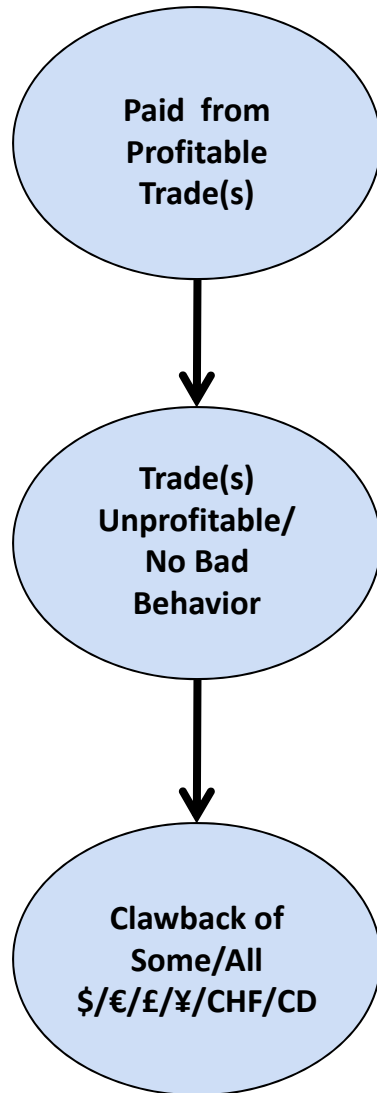
- Artificially low base salaries have been unhelpful
 - No one believes firms don't have fixed costs
 - Incentives as makeup are costly (i.e., 2x shortfall)
 - At odds with desired risk profile
 - Inflates incentive pools to external audiences
- ∴ Benefit impact of base salary increases moderate. Plans can be modified, but requires effort
- To date, changing the pay mix has been well received
 - Little real entitlement impact

Clawbacks and Risk Adjustments

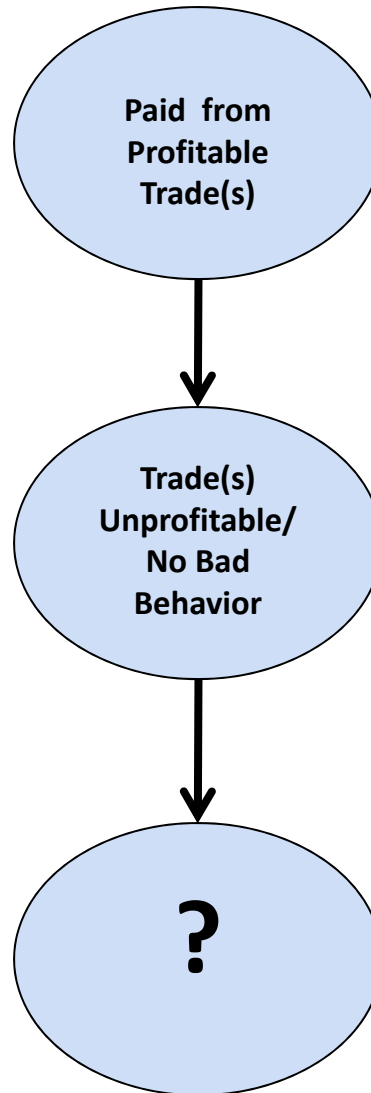
- Compensation clawbacks in regulator reports
 - Appropriate for willfully violating legal or risk standards
 - Difficult to consider future losses due to shared decision-making/selective application/documentation
 - For future performance, should be carefully calibrated at higher than individual level (i.e., desk, unit, business, or firm)
- Substitute for clawbacks can involve three fundamentals:
 - Heavy stock ownership by professionals
 - Plain vanilla stock options (i.e., “poor man’s” adjustment for future income declines)
 - Stock retention beyond termination for senior executives
- Pool risk adjustments difficult to fully implement formulaically
 - Risk fiendishly hard to measure “before the fact”
 - Key subjective component for incentive pools

Individual Clawbacks “After the Fact”

Perception Easy



Hard Reality



Participant Arguments*

- Joint/Senior decision in first place
- Suggested hedging
- Firm told to sell
- My role changed
- I wanted position increased
- The position was mismanaged
- Firm made \$ on other side of trade
- My current year is best ever
- Let's go to arbitration

*Many fully documented

Executive Compensation

- 2008 - 2009 dramatic compensation reduction
 - No bonus/low levels unsustainable
- 2010 expectation of market levels on results
 - Will be difficult if 2010 results uneven
 - “How do you pay CEO significantly more when results down/flat?”
 - Heavy deferrals continue
- Objective systems could be communicated and manage external expectations
 - CEO as a maximum .X% of earnings above 8% ROE adjusted for risk and relative returns
- Need significant ownership guidelines
 - Retain shares for two years beyond termination

Long-Term Incentives

- Very heavy deferral rates continue/no longer surprising
 - Need planned approach addressing amounts and vesting
 - Ad hoc terms erode confidence
- Shaken confidence in firm equity as attractive holding
 - Equity restricted stock and “one-off awards”
 - Stock options out of favor, but good for clawback advantages
- For large diversified firms, single stock increasingly difficult
 - Deferrals into funds by asset management participants
 - Fund ownership by alternative professionals
 - Growth of subsidiary plans
 - Grants into asset pools
- More sensible and specific termination provisions
 - Need better plan language documentation
 - Early retirement continues to be problem

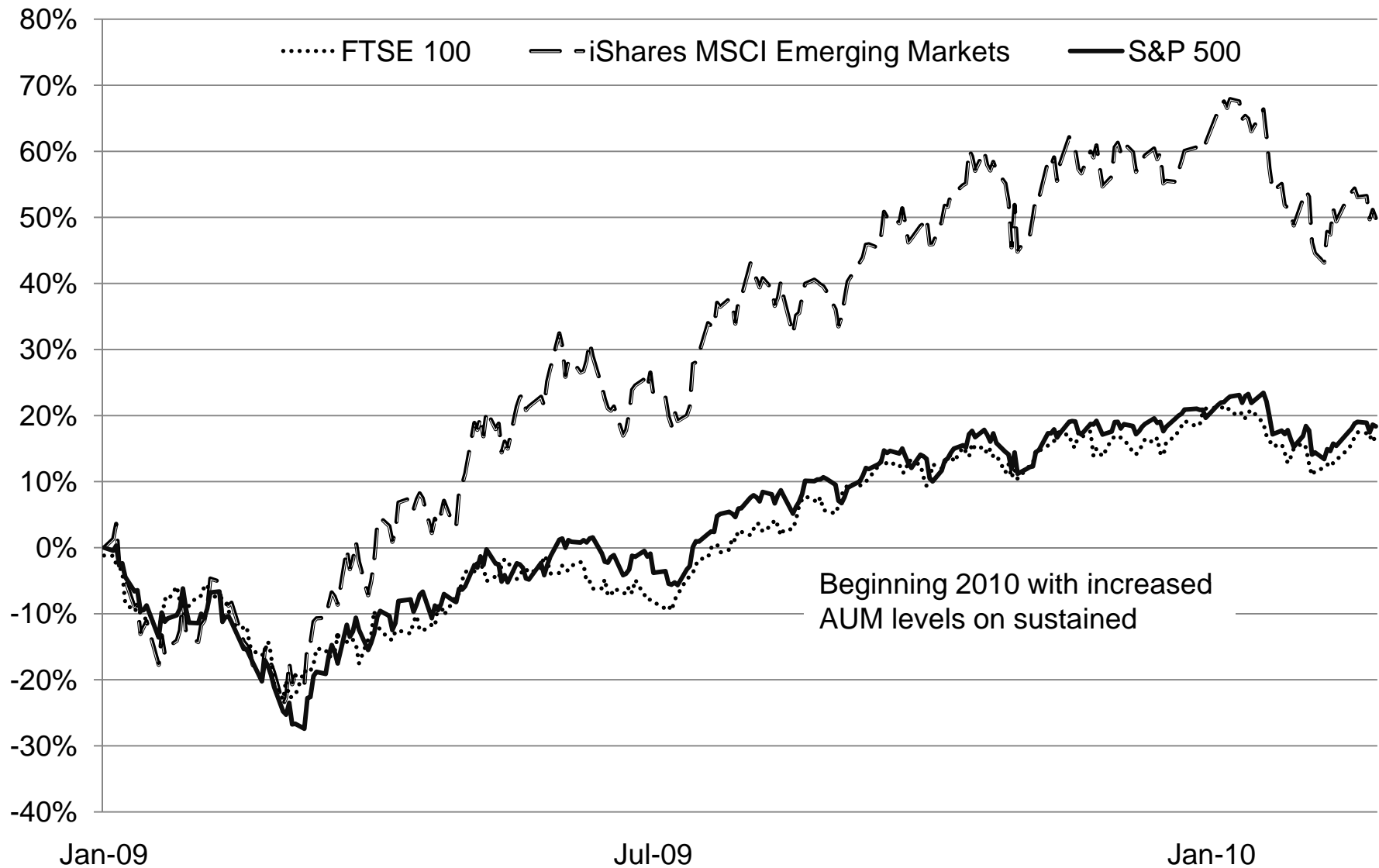
Investment Banking

- 2009 compensation much higher from low 2008
 - 2010 incentive compensation will increase again (i.e., 25%)
 - Subsidy from trading in 2009 – less in 2010
- Fee business more attractive with capital constraints
- Weak but increasing 2010 pipeline on built-out teams and resources
- Equilibrium in research
 - Two-tiered market of few visible seniors and number of lower-level. Increasingly few mid-level professionals
 - Buy-side research pays better with enhanced careers
 - Hedge funds influence weakens
- Staff size appears in equilibrium

Asset and Wealth Management

- Increase in 2010 revenues drives major incentive increase
 - Up 25% from 2009
- Trying to jam asset management into Wall Street/Insurance pay and business norms creates underperformance
 - Long-tailed business with heavy mix of structured pay
- Pre-agreed % of operating profit for incentives
 - Less discretionary and more straightforward than other businesses
- Investment management
 - Structured program at individual-/team-level on multi-year returns against benchmarks and peers
 - Deferral into funds in lieu of firm equity
- More subsidiary equity programs required
 - Investor and consultant requirements
 - Lure of independent firms

Asset Management



Hedge Funds – Important Year

- Hedge Fund returns up \cong 20%+ in 2009, after poor 2008
 - More difficult 2010 trading environment
 - Reduced leverage provided by prime brokers
 - Many firms still not at “high-water mark”
- Important to have viable 2010 pay model
 - Many firms have to reconsider historical pay practices
 - May require firm to operate at loss in 2010
 - Continue to be creative with “high-water mark” problems
- Design details, such as measuring results at fund-/product-/firm-level has crucial impact on potential risk profile and culture
 - Need to have blend of transparency, stability and flexibility
 - Ultimately will be swept up in assessment of whether compensation programs encourage excessive risk-taking

Private Equity – Problems Continue

- Structural problems in industry
 - Questionable transactions completed and huge funds raised
 - Carry in new funds generally underwater
- Long-tailed businesses and compensation
 - Appropriate carry design and governance crucial (i.e., vesting, investment and business decisions, etc.)
 - Carry at institutional firms often 10 - 15 points, reflecting firm economics and importance of fundraising support
- Viable independent competitors drive market
 - Fund sizes provide ample compensation resources
- Low interest rates and poor equity returns elsewhere have helped
 - Investors continue to look to alternatives for needed returns

- **2005 - 2007 investment vintages will suffer losses. 2008, and particularly 2009, generally better. Need to manage investors till average returns improve**

Summary and Advice

- 2010 compensation will be up moderately for many firms
 - Trading, in all its forms, can't match 2009
 - Investment banking improves
 - Asset and wealth management up significantly
- Executive compensation returns to market levels on results
 - Most/all in equity
 - Communicated formulas may be helpful
- Heavy deferrals continue
 - Need to provide diversification opportunities
- Ad hoc clawbacks will be a problem
 - Individual adjustments difficult to fairly implement
- Much-discussed compensation payout ratios will not really decline
 - Capital and risk drive changes, but less transparent
- Base salary paradigm shift continues
- Need more serious full-time Chairman
 - Single CEO model can't address both internal and external

∴ Industry must improve communication of compensation programs. Audiences are external, internal, and Compensation Committee