2015 Financial Services Compensation:

Challenges of A Waning Recovery

PRESENTATION AND DISCUSSION

November 9, 2015

19 West 44th Street, Suite 511, New York, New York 10036
(212) 221-7400 • Fax (212) 221-3191

Table of Contents

- Independent financial services compensation consulting firm providing informed advice and counsel, with customized solutions starting with best practices. Expertise navigating both headwinds and inertia to develop aligned and successful programs. Common services include annual and long-term incentive designs, market data, agreements, equity and partnership considerations, and Board Committee advice
  - Balance market/best practice with firm dynamics
  - Both Board consultant and company programs
  - Experienced, opinionated and informed

- Diverse clients and issues
  - Universal and major banks
  - Asset Management and Wealth Management firms
  - Hedge Funds/Private Equity/Fund-of-Funds/Alternatives
  - Insurance companies
  - Brokerage firms
  - Trading organizations

2015 Lessons and Learnings (Beginning the Discussion)

- 2015 we believe is an inflection point
  - Existing bank business (and compensation) model not working
  - Traditional asset management faces overcapacity and fee pressures
  - Alternatives have difficulty generating adequate returns

- Global business conditions will not bail out financial services
  - Slow and uneven growth over short to medium term

- Industry needs to regain competitive edge
  - Fully shake off cobwebs from financial crisis
  - Much leaner and efficient organizations
  - “How many 360º reviews do you really need...?”

- Continue differentiating on performance and contribution
  - Voluntary turnover often needs to be higher

- Need to reconsider fundamental compensation approach
  - Is this the right model going forward?

2015 Compensation Changes Across Sectors

- Not a strong year with headlines of weaker markets
  - Highlights cost and capacity problems

- Major bank incentive compensation down
  - Fixed income -10% to -20%
  - Equities flat to +10%
  - Investment banking advisory +20%, while underwriting -5% to -15%

- Client businesses impacted by markets and returns
  - Asset management -5%
  - Wealth management -5%
  - Private equity +5% to +10%
  - Hedge funds -15%+

- European banks continue to face economic and political headwinds

- Equity and ownership continues to increase in importance
  - Stake in the future along with alignment and motivation

Rewarding Technology and Entry Talent

- For the best talent, financial services competes with brand name technology Firms and others
  - Overall compensation can be very high, but may be structured differently
  - Better aligned cultures in technology firms
  - High value placed on excellence

- Necessary to reward excellent young talent
  - Growth in capabilities can easily be 10%+ annually
  - Market opportunities more visible
  - No reason they inherit your problems

Fundamental Consideration: Must be able to have top-end talent appropriately rewarded. If not workable, requires reassessment of compensation paradigm

Behavioral Economics*: Philosophy, Expectations, and Communication

- Compensation and reward philosophy
  - Many firms do not have a clear compensation and reward philosophy across elements (i.e., expectations, levels, process, funding, staffing, risk, contracts, etc.)
  - Erroneous to believe most professionals understand / embrace an unclear philosophy

- Expectations
  - Expectations need to be managed at right intervals, and candid straight talk almost always better than waiting

- Communication
  - Professionals place more value on what they understand and what is reinforced. Regular ongoing communication is necessary

* Behavioral economics, in simple terms states few people are really totally economically rational. Inertia, emotions, and lack of focus play a large role

Staff Compensation: Take Off the Bubble Wrap

- Staff compensation should vary with firm performance and contribution
  - In many firms unclear linkage to pay
- Variations should follow from impact and compensation levels
  - More impact for senior professionals
- Approach should be clear with less surprises

> • Working Assumption: Generally difficult compensation environment makes providing “undue” protection increasingly unworkable. Better to address directly before issue exacerbated

2016 Fearless Predictions: Significant Change

- Significant headcount reductions for banks
  - Reducing footprint and complexity
  - Overcapacity and tepid demand

- Trading does not rebound meaningfully for investment / commercial banks
  - Restrained customer flows
  - Capital requirements and overall costs

- Asset / wealth management down moderately
  - Weaker 2016 start with AUM below 2015 average
  - Fee impact of passives / ETFs continues
  - Renewed cost focus on higher expense base

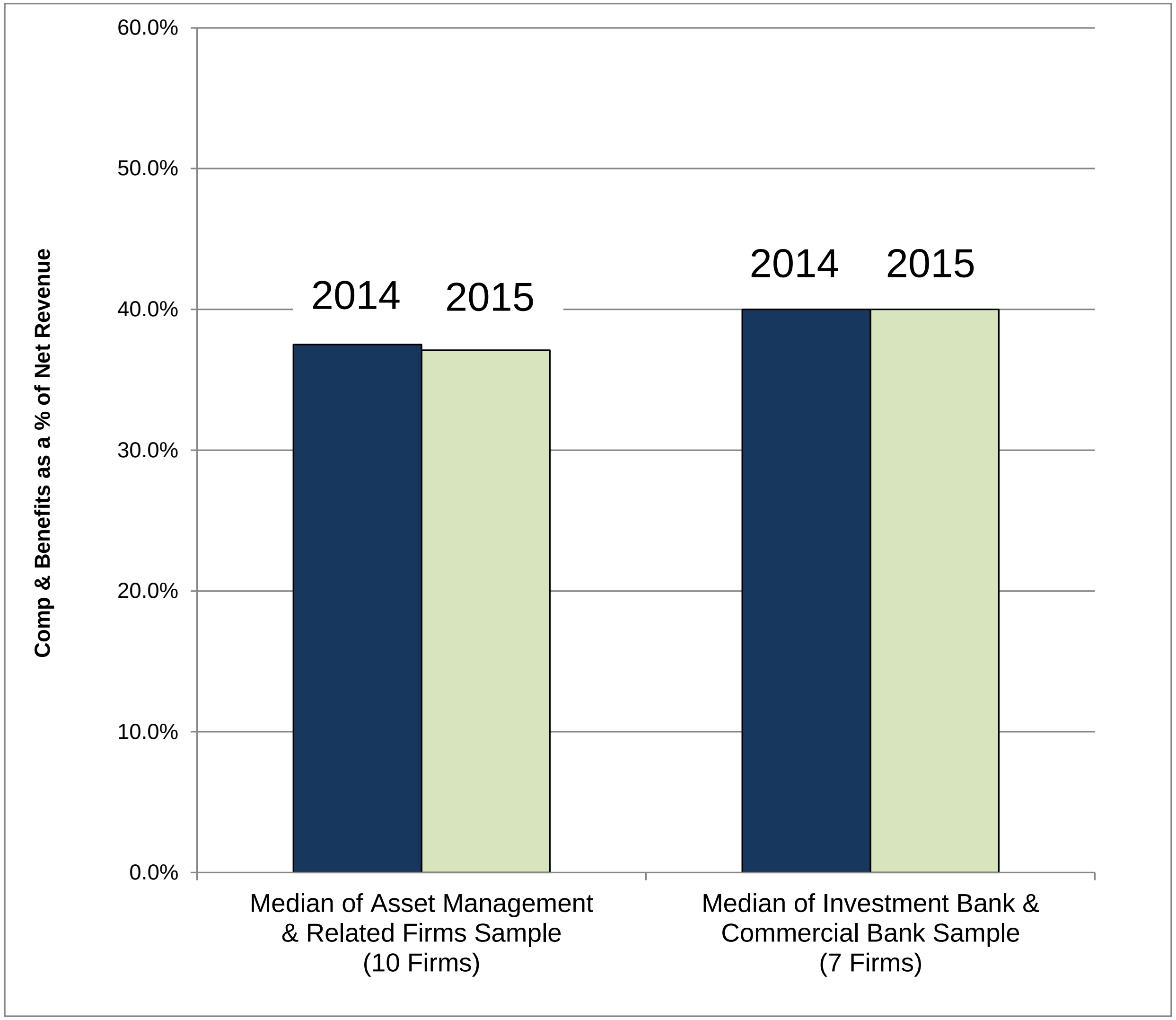
- Movement continues towards non-bank compensation and careers
  - Perceived as having better cultures and greater alignment
  - Ownership (i.e., equity, partner, impact, and creation)

- Greater intensity around high-performers
  - Balance available funds and opportunities, with still too high headcount

- Greater pushback over often unfocused time consuming HR practices
  - 360º reviews / performance appraisals / titling and promotions

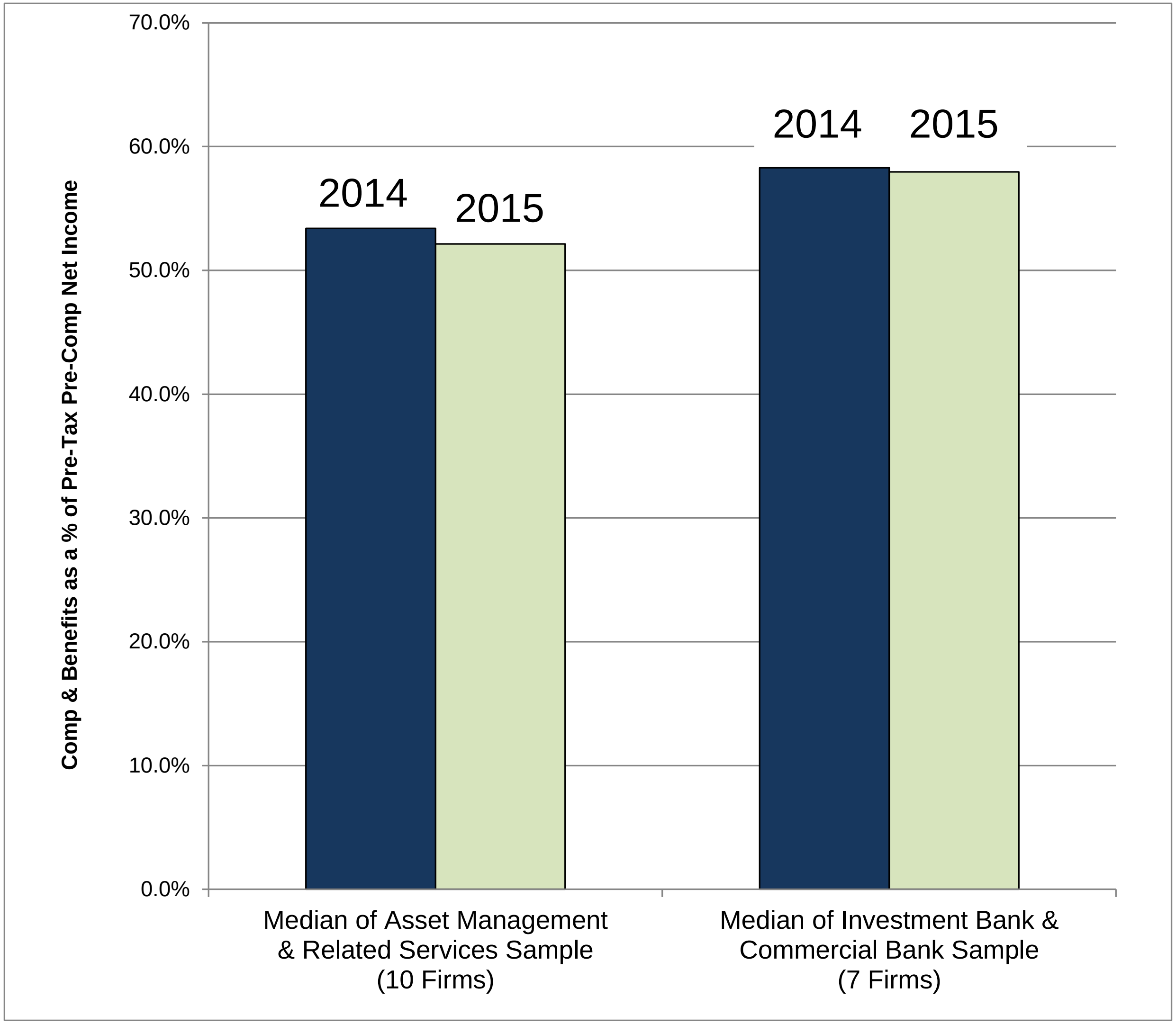
2015 vs. 2014 Compensation as % of Net Revenues

Note: Reflects available year-to-date data

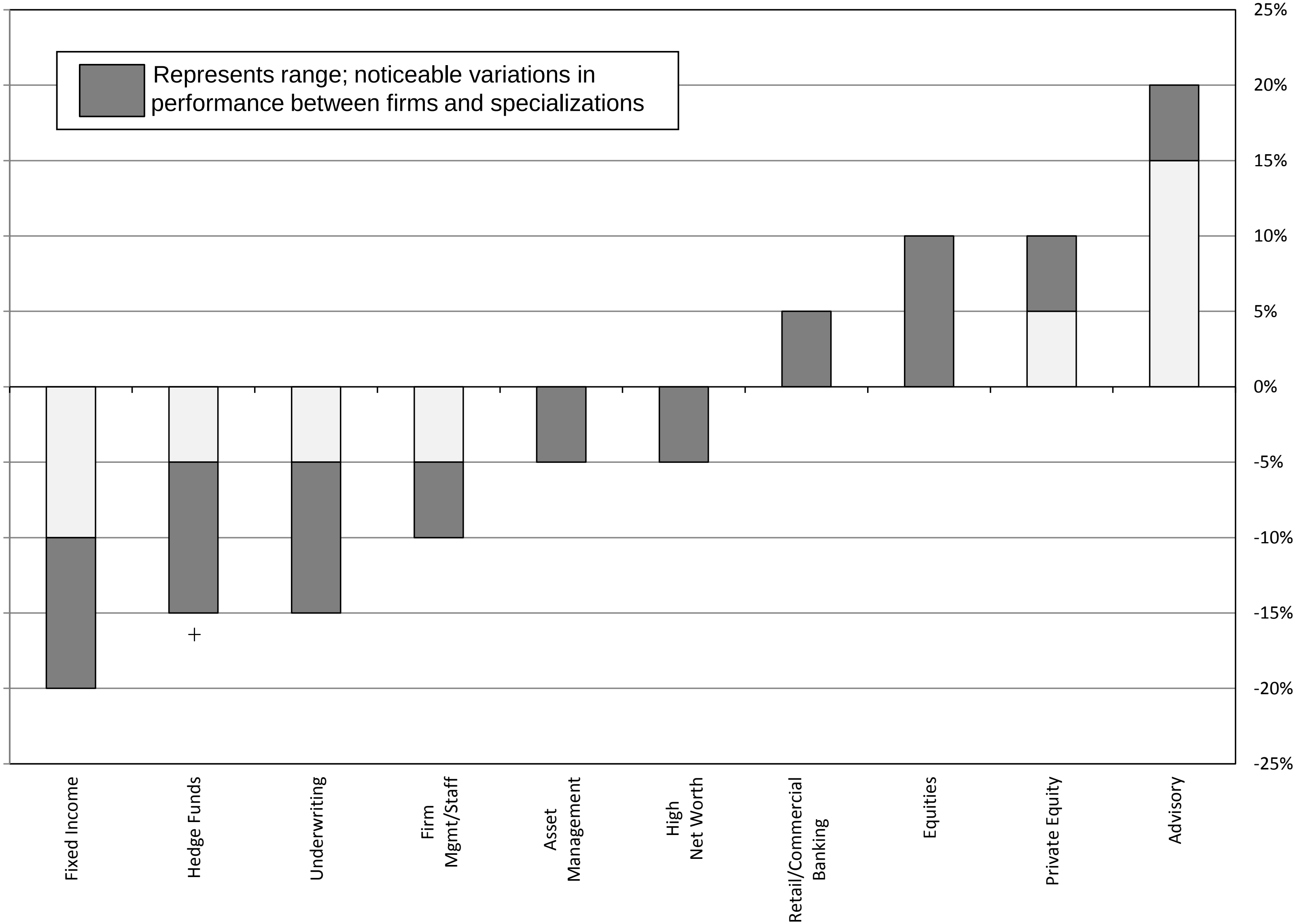


2015 vs. 2014 Compensation as % of Pre-Tax, Pre-Comp Income

Note: Reflects available year-to-date data



2015 Typical Incentive Changes (Value of Cash & Long-Term / Equity)



*Excludes proxy executives impacted by firm specific circumstances

Banks: Compensation in a Challenging Environment

- Sharpen compensation accrual methodologies for bank and units
  - Market percentages of profits
  - Monthly / quarterly accrual process to reinforce directions
  - Involvement and buy-in of Compensation Committee

- Ensure clear methodology for differentiating between professionals
  - Expectation for compensation changes by performance / rating
  - Link indirectly to desired turnover

- Heavier use of real analytics
  - Need deeper insights into relationship between business economics, market compensation and funding across professional levels
  - Far more than year-over-year changes with existing headcount

- Embed “no scholarship” concept
  - Senior professionals have to live and die with results

Asset Management: New Challenges

- Mildly down 2015 – but it feels worse
  - Added costs and global build out / investment
  - Recognition of a more difficult environment going forward

- Increasing need for high-end support (just not too many)
  - More resources needed in challenging environment
  - Creating / maintaining partnership feel to reinforce criticality to team
  - Equity structure and design key variables

- Investment return data needs to be increasingly refined
  - Key rule: measures should reflect client perspectives

- Significant focus on sales compensation design
  - Commission vs. hybrid vs. subjective

Executive Compensation Structures

- Public firm designs driven by ISS/Glass Lewis models
  - Heavily objective and little discretion
  - Performance-based equity
  - CEO analyzed heavily in comparison to broad peer groups
- Less focus on equity ownership
  - Unfortunate residual of financial crisis and its aftermath
- Little innovation across public firms
  - No stock options / subsidiary equity / growth investments
- Richer variety among private firms
  - Partnership objective (many methods)
  - Business / unit formulas
  - Subsidiary equity
  - Stock options / growth units
  - Heavy ownership
  - Allocation / cross fertilization of carry / incentives
  - Sunset provisions on equity
  - Non-competes and non-solicits

Ownership and Partnership

- Significant current interest in ownership / partnership
  - Opportunity to be more than an employee
  - Wealth building if successful
  - Alignment and transparency

- Partner title has many diverse potential meanings
  - Equal share
  - Unchanging share
  - Governance and decision making
  - Risk and capital requirements
  - Permanent position

- Lessons from other situations
  - Partners diluted overtime
  - Governance clear
  - Details really mater (i.e., termination treatment)
  - Legal documents often unclear
  - Valuation approach can drive decisions

Sales: Flexibility of Hybrid Programs

Market Approach	Highly Formulaic	Objective / Blend	Fully Discretionary
Compensation Structure	• Salary • Structured commission schedule	• Salary • Incentive with targets on assets raised or quasi-commission schedule with discretionary adjustments	• Salary • Discretionary incentive
Commentary	• Straightforward • Easily communicated • Does not account for unexpected business or market changes	• Relatively straightforward • Ability to incent additional responsibilities / broader focus (i.e., cross-selling, teamwork) • Allows for adjustments based on unexpected events	• Less transparency • More difficult to communicate • Allows adjustments for unexpected events • Lack of transparency/ expectations creates more pressure for an alternative means of certainty
Approximate Market Prevalence	**35%**	**50%**	**15%**

Long-Term Incentive Alternatives

- Meaningful toolbox of vehicles and implementation nuances

Shaded box "often utilized" vehicle

Business	Range of Potential Vehicles			
Bank	Stock	Options	Products	
Captive Unit	Stock	Ownership	Options	Profit Unit
Asset Management	Stock	Options	Products	Profit Unit
Private Equity	Stock (less)	Carry	Products	Profit Unit
Hedge Fund	Stock (less)	Incentive Fees	Products	Profit Unit
Insurance	Stock	Options		

Private Equity – Waterfall Impacts

- "Waterfall" current carry design where firm and professionals receive incentive fees after capital and cost returned. Results in elongated periods (i.e., often 5-6+ years until payouts)
  - Puts extra pressure on initial allocations, reserves and vesting terms
  - Annual compensation becomes more important

- Initial allocations and reserves crucial
  - For professional unhappy with current share, 8-10 years for payouts from next fund. Does it make sense to wait?

- Vesting needs to be rethought
  - Often see 20%+ vesting on realizations; will become more significant

- Argues for more funds (and fund participation) by strategy
  - Diverse firm / professional carry streams

- More differentiation required
  - Careers / titles / recognition
  - Annual compensation variation across similar roles

Hedge Funds – Implications of Low Returns

- 2014-2015 low return years for most funds (“back-to-back” modest performance)
  - Places great importance on 2016

- Testing of fundamental firm compensation model
  - Formula / discretion has different requirements and motivations
  - Really understand market economics and differences (i.e., capital, costs, clawbacks, etc.)

- Cooperation receiving more focus
  - Frustration over perceived narrow focus and line of sight
  - Rethinking organization and crediting

- “Bubble Wrap” off support
  - Greater expectations?
  - Compensation should vary

- Careful balance between payouts, ownership, and employment restrictions

Compensation Data – Deeper Analysis and Inputs

- Few important business processes rely as heavily on market information as compensation planning and delivery

AND

Often willing to accept, without adjustment, a median or other percentile from an imperfect group, incomplete data, matching issues, small sample size, unequal firm weighting (i.e., incumbents), no performance dimensions, incomplete scale dimensions (i.e., portfolio size), stale data, etc.

- The only wonder is that the audience for compensation data and analysis has not been even more skeptical
  - Demand far better work from data providers
  - Hybrid roles increasing and simple analysis unsatisfactory

- In many cases judgment and revisions should be applied to raw compensation data to produce an answer much more likely to be accurate
  - Requires more effort and knowledge to establish credibility
  - “Better to be about right than exactly wrong”

Tailored Employment Restrictions

- Protections nuanced by importance and cost
  - Details matter
  - Increasingly important for investors

Provision	Intended Purpose	Comments
Gardening leave	Short period to stop immediate solicitation of clients	Expensive and common feature often overused
Non-compete ($)	Penalize leavers (short term focus)	Nearly universal practice
Non-compete (stop employment)	Legal action for competition	Use selectively and requires compensation. 6-12 months common
Non-solicit of clients	Protect clients and firm	6-12 months common
Non-solicit of employees	Protect firm	1 year quite common
"Clawback"	Return and forfeit awards for bad behavior	Often untested broad language

Dual Roles for Effective Compensation Committee

- Compensation Committee with simple governance focus
  - Senior executive levels and addressing ISS/Glass Lewis mandates
  - Less proactive in terms of business impact

- Real governance with entrepreneurial spirit and shareholder focus
  - Accountability
  - Compensation philosophy
  - Performance metrics, goals, and measures
  - Equity strategy and ownership
  - Incentive funding approach and affordability
  - Business unit variations
  - Understanding of turnover and diversity

- Compensation committee should reconsider mission
  - Beyond minimal compliance, and consider activities with greater impact
  - Few major companies have Human Resources backgrounds on Committee

Summary and Final Thoughts

- 2015 is an inflection point
  - Weak business tides wont "lift the boats"
  - Cost and complexity have to decrease significantly
- Compensation analysis has to improve
  - Quality benchmarking requires judgment and context
- Hedge funds challenged
  - Greater cooperation required
  - Test fundamental compensation model
- Asset management facing headwinds
  - Suffers from overcapacity
  - Increase support emphasis and rewards
  - Selective headcount
- More aggressive management of human resources
  - Less wasted management time
  - Performance management / differentiation up a notch
  - Turnover expectations refined
- Going forward, can't count on upward compensation trends to help solve issues