2016 Financial Services Compensation:

Driving Performance in a Challenging Environment

PRESENTATION AND DISCUSSION

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- Independent financial services compensation consulting firm providing informed advice and counsel, with customized solutions starting with best practices. Expertise in developing aligned successful programs. Common services include annual and long-term incentive designs, market data, performance measures and goals, equity and partnership issues, 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
  - Asset Management and Wealth Management firms
  - Hedge Funds/Private Equity/Fund-of-Funds/Alternatives
  - Major banks and units
  - Insurance companies
  - Brokerage firms
  - Trading organizations

2016 Compensation Changes Across Sectors

- 2016 continued weakness from 2015
  - Fee and revenue pressures
  - Incremental cost reductions inadequate

- Client businesses mounting fee pressures and uneven markets
  - Asset management: -5% to -10%
  - Wealth management: -5%
  - Private equity: flat
  - Hedge funds: -5% to -15%

- Major bank incentive compensation down
  - Fixed income: flat to -10% (with some improving trends)
  - Equities: -5% to -15%
  - Investment banking advisory: -5% to -10%, while underwriting: -10% to -20%+

- Insurance companies impacted by low interest rates

- Increased focus on differentiation

Technology Sector as Guide for Entry Talent

- Financial services selectively competes with technology firms for the best talent
  - Compensation very high with meaningful equity
  - High value placed on excellence

- Financial services has positively changed in rewarding entry level talent
  - Recognize need for higher % changes early in career
  - Willing to differentiate earlier
  - “Great performer equals two average professionals”

- Importance of real feedback
  - Direct simple frequent feedback

- Provide market compensation for contribution/expertise
  - Visible opportunities elsewhere, less slack to under-reward

- High-end value adding technologist will be up for 2016

Low Turnover – False Signals and Myths

- Less turnover is always better
  - Can result in clogged organization
  - Comfortable/less demanding environment
  - Overpay average/weaker performers

- Test of compensation system
  - What is turnover of better performers?
  - How many have “quit” and stayed?

- Targeted turnover
  - Few firms have explicit turnover targets by performance and level
  - Key part of long-term staffing model

- Recognition turnover often too low
  - Pockets of entitlement
  - Overly concerned about average performers

Incentive Funding and Performance Allocations

- Usually more motivational to have fixed funding vs. budget attainment
  - Examples: % of profit, margins, and growth
  - Great results vs budget ensures next year goals unattainable
  - Regardless of approach must monitor risk taking/design

- Incentives should be aggressively differentiated
  - Excellent performers 2X as valuable as average performer
  - If excellent incentive at 125% of average, large contributors underpaid

- Top down funding vs. bottom up
  - Top down funding encourages lean staffing across mature units
  - Bottom up approach most effective in new investment businesses

- Funding analysis melds business and compensation expectations
  - Balance of returns, market compensation, and headcount

Dos and Don'ts of Incentive Design

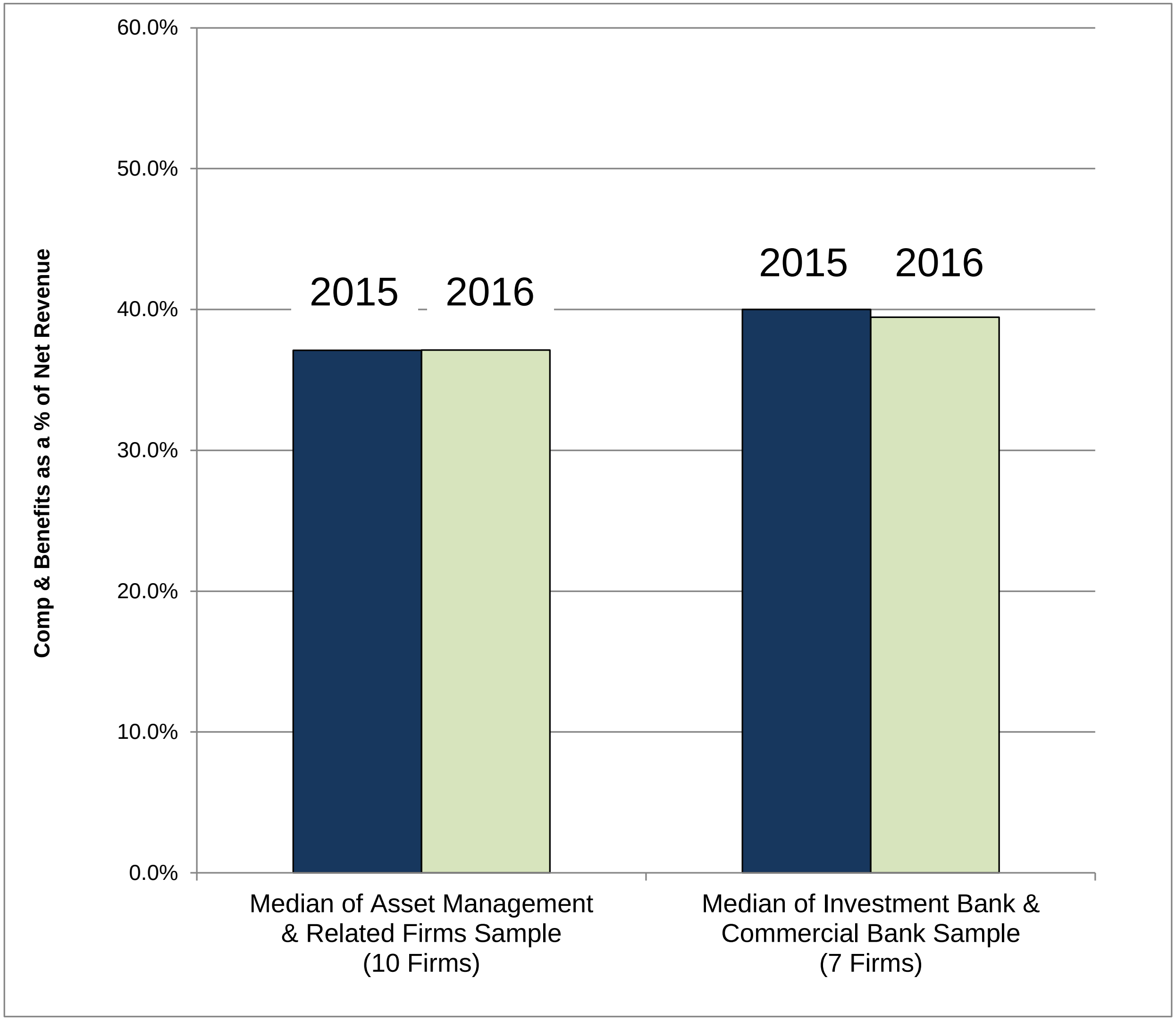
Factor	Better	Less Effective
Potential Magnitudes	Significant	Competitive
Performance Measures	Controllable/Line of Sight	Non-Controllable/Distant
Understandable	Clear	Only Lawyers Understand
ISS/Glass Lewis Acceptance	Reluctant/Okay	Generic Measures/Plan
Participation	Key Group	Overly Broad
Scenarios Considered	Detailed Analysis	Standard Outcomes
Market Prevalence	Customized/Creative	Common Practice

2017 Fearless Predictions: Change Intensifies

- Asset/wealth management down 10%
  - Fee impact of passives/ETFs pervasive
  - DOL regulations hamper higher fee products/ broker compensation
  - Cost reductions on higher expense base
- Headcount reductions broaden
  - Impact of technology, over capacity, and complexity
  - Shifting headcounts to lower cost locations
  - Cumulative impact of softening in recent years
- Even greater differentiation (meaningful improvement)
  - Both in compensation and opportunities
- Continued improvements in performance management
  - More focused/less time consuming
- Progress on better use of equity/deferrals
  - More diverse plans/ideas
- Fallout from Wells Fargo continues
  - Stops modest momentum for regulatory relief

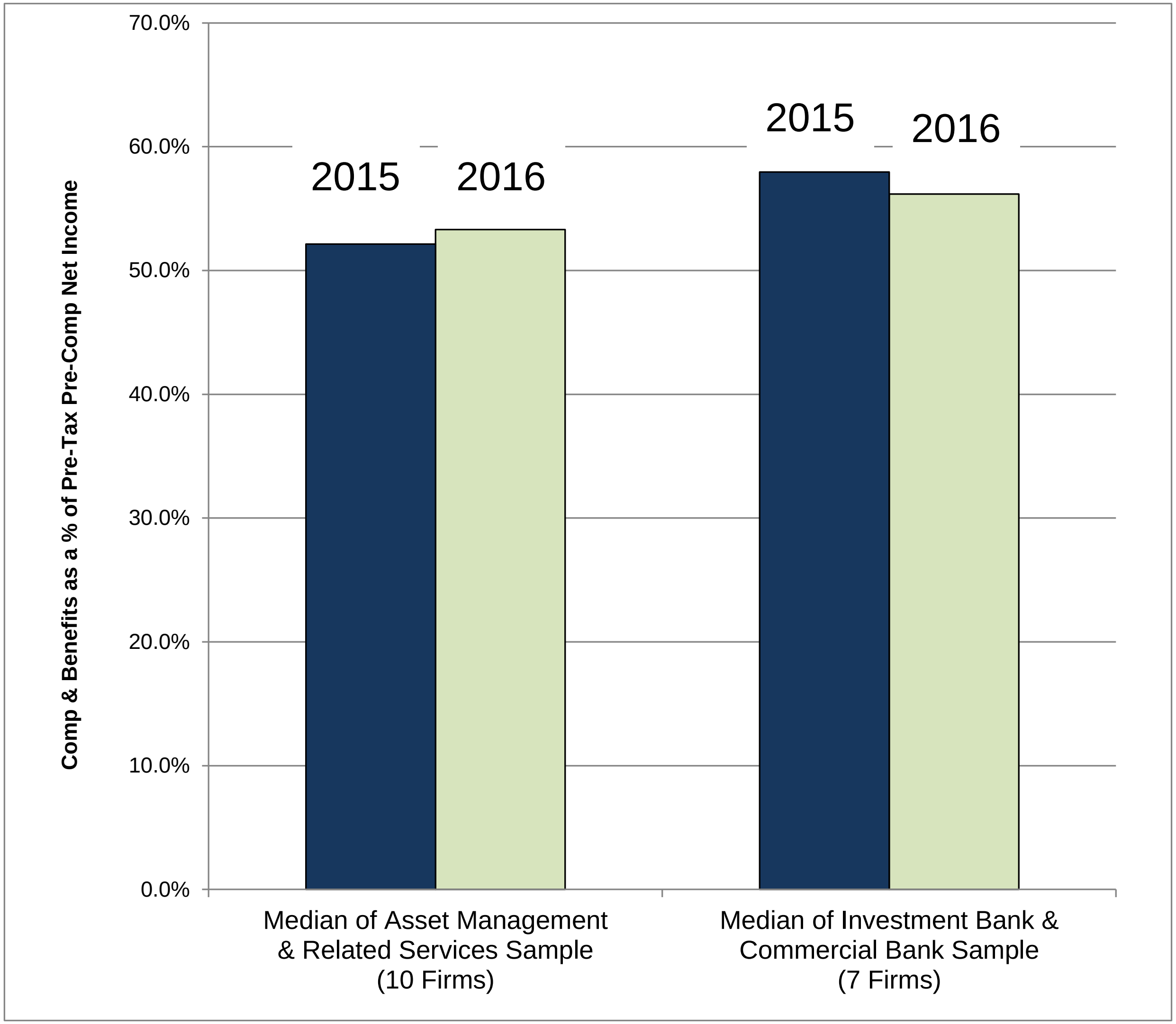
2016 vs. 2015 Compensation as % of Net Revenues

Note: Reflects available year-to-date data

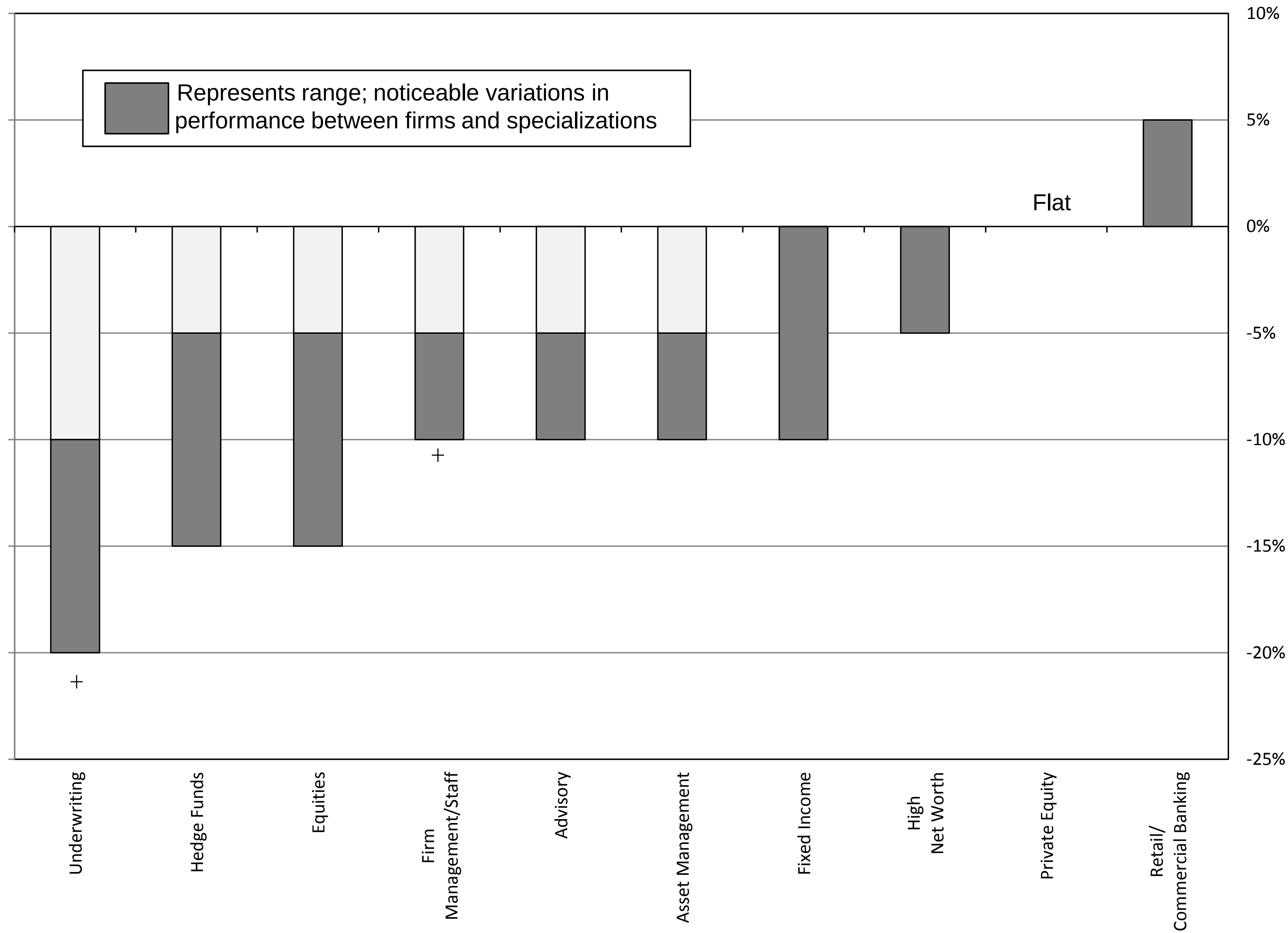


2016 vs. 2015 Compensation as % of Pre-Tax, Pre-Comp Income

Note: Reflects available year-to-date data



2016 Typical Incentive Changes (Cash & Long-Term / Equity)



*Excludes proxy executives impacted by firm specific circumstances

Impact of DOL and Dodd-Frank Underappreciated

- DOL rules on retirement investments
  - Fiduciary rule impacts investment selections and fees
  - Broader impact on fee levels across many products
  - Risk of expanded litigation over medium/long-term
  - Reduced ability to “buy book” for recruited brokers
  - Bigger impact than many imagine; creates natural comparisons on fees

- Dodd-Frank on deferrals/clawbacks
  - Impact visible even before likely January 2019 effective date
  - Why work for institution subject to harsh terms?
  - Perception politics will play heavy role in application of clawbacks
  - With Wells Fargo, and other scandals, unlikely terms change significantly

- From structural standpoint unclear how to address issues
  - Probably some combination of human resources, risk, and finance

Ownership to Drive Performance

- Select initial participants who can meaningfully impact value
  - Other participants can be added later

- Common annual restricted stock often has limited motivation
  - No leverage
  - Future awards at higher prices
  - Vesting and taxes reduces ownership

- Up-front grants for both economics and signaling
  - Share greater % of upside
  - Performance vesting linked to strategy

- Vehicle selection(s) and terms matter
  - Stock options (at the money, out of the money)
  - Profit units
  - Combinations

- Timeframes and measurement
  - 4/5 years often better than 3 years
  - Point-to-point vs. overlapping cycles

Asset Management – Systemic Change

- 2016 compensation down (we believe second year of five-year trend)
  - Fee pressures and index/ETF products
  - Overcapacity
  - Lack of real innovation

- Pockets of entitlement
  - Some vibes feel like major banks pre-crisis
  - Overstaffing common due to over optimistic projections and technology impact
  - Often not enough "good" turnover among average performers
  - Need more focused differentiation

- Clarify compensation funding % and exceptions
  - Additional funding available for growth initiatives and product development
  - Funding % encourages leaner staffing (i.e. $ over fewer people)

- "Field of Dreams" often not working
  - Good investment returns not leading to asset flows
  - Renewed focus needed on sales and marketing

Private Equity – Perspectives on Carry

- Two landscape changes
  - Broad political push to eliminate capital gains tax treatment
  - Products with reduced/no carry

I know they have considered this many times before…

- Carry tax advantages wind down scenario
  - Bigger allocations to teams, in lieu of future cash
  - Ensure lower level has 2x – 3x normal
  - Longer vesting
  - Recognize non-U.S. professionals/funds may not have same issues

- Products with reduced/no carry
  - Still want alignment and retention
  - Out of management fee, create long-term payout schedule linked to returns

- Nuanced carry design discussions continue
  - Including (a) carry-at-work or (b) discounted carry payouts into total pay
  - Sizing carry for headcount and organizational structure

Hedge Funds – Performance Management

- 3rd down year in compensation for many hedge funds
  - Helping to drive needed changes

- Significantly increased focus on performance management
  - Due to typical DNA does not come naturally
  - Investment returns but also quality/quantity of ideas and analysis
  - Across time and specific view of contribution
  - Focus extends to support professionals
  - Appropriate cutbacks on 360° reviews and numerical ratings

- Technology firms provide interesting template
  - Focus on excellence
  - Wide variations in compensation with performance
  - Less emphasis on tenure and not relevant experience

- Communication and expectations of holistic results
  - Counterproductive reluctance to discuss firm results/prospects
  - Little competitors could do with most information
  - Have explainable compensation philosophy and perspective

Investment Banking – Different Approach Required

- Proposition: Current compensation inadequate to attract and motivate high-end talent to produce adequate risk-adjusted shareholder returns

- Must have lean headcount and fully utilize lower cost locations
  - No real opportunity to maintain status quo

- Compensation planning and funding more top down than bottom up
  - Clear perspective on affordability and margins

- Need varied deferral vehicles especially as Dodd-Frank approaches
  - Firm stock for most is not motivational nor creates alignment
  - Viable choices among products, businesses, and special incentive plans

Surveys and Data Analysis – Encouraging Progress

- Firms are utilizing compensation data more effectively
  - More skeptical of broad averages
  - Willing to make judgements on imperfect information

- Judgement required as firms have multiple businesses/competition

- Young professionals receiving outsized % increases
  - Recognize small dollars can be very well spent

- Some progress on analysis of turnover and differentiation
  - Need commitment from senior management

- Recognizing multiple ways to consider carry and private company equity
  - No universal simple answers
  - Expectations vs. actual payouts
  - Equity returns vs. compensation

Creativity in Deferral Vehicles and Utilization

- Gain competitive advantage by having better programs:
  - Alignment
  - Retention
  - Attractive economics
  - Positive optics for clients

Vehicle		Comments
Firm Restricted Stock Firm Stock Options Firm Products		For most participants, retention but little alignment
Business Products Business Performance Subsidiary Stock/Options		Potentially greater alignment for more participants

Senior Executive Compensation

- Best designs usually have ample discretion; regulators got this right
  - ISS/Glass Lewis prefer highly objective plans often out of sync with business needs and spirit of rewarding performance
- Significant stock ownership should be emphasized
  - Far higher than “wimpy” common multiples of base salary
- Incentive designs should focus on absolute levels rather than budget attainment
  - Establish clear standards and rewards
  - Really reward excellence and improvement
- Peer groups are important
  - Need sound starting place for judgement
  - Peers also include private firms and captive units
- Useful performance measures require careful thought
  - For example, relative performance fine concept until you realize your business moves differently across cycles

Election and Compensation Implications

- Talk and reality of higher federal taxes
  - Increases focus on differences in state taxes (i.e. California/New York vs. Texas/Florida)
  - Increases attractiveness of non-U.S. professionals and locations

- Carry on investments may lose capital gains advantage
  - Consider incremental awards to lower/mid-level participants
  - Alter team versus firm mix in future “protected” grants

- Business litigation likely to increase
  - Retail brokerage
  - DOL and retirement accounts
  - Lending and consumer issues

- Environment/cultures at banks challenged with characterization as “bad actors” and negative stereotyping continuing
  - Has implications for attracting and retaining talent

Summary and Final Thoughts

- Broadly recognized financial services business dynamics will get harder
  - Significant attractive pockets and opportunities exist, but not cyclical issues
  - Compensation trending downward for several years

- Meaningful progress on select issues
  - Greater differentiation
  - Compensating entry level staff and high-end technology
  - Simplifying/focusing performance management
  - Compensation data analysis and insights

- Work to be done
  - Syncing compensation to changing market
  - Broad staffing levels continue to be heavy
  - Addressing entitlement expectations
  - Deferral approach and vehicles

- Need good ideas and strong implementation
  - Less room for status quo
  - Opportunity for value added human resources