Global Sage White Paper Series
Compensation and Evolving Regulatory Reform

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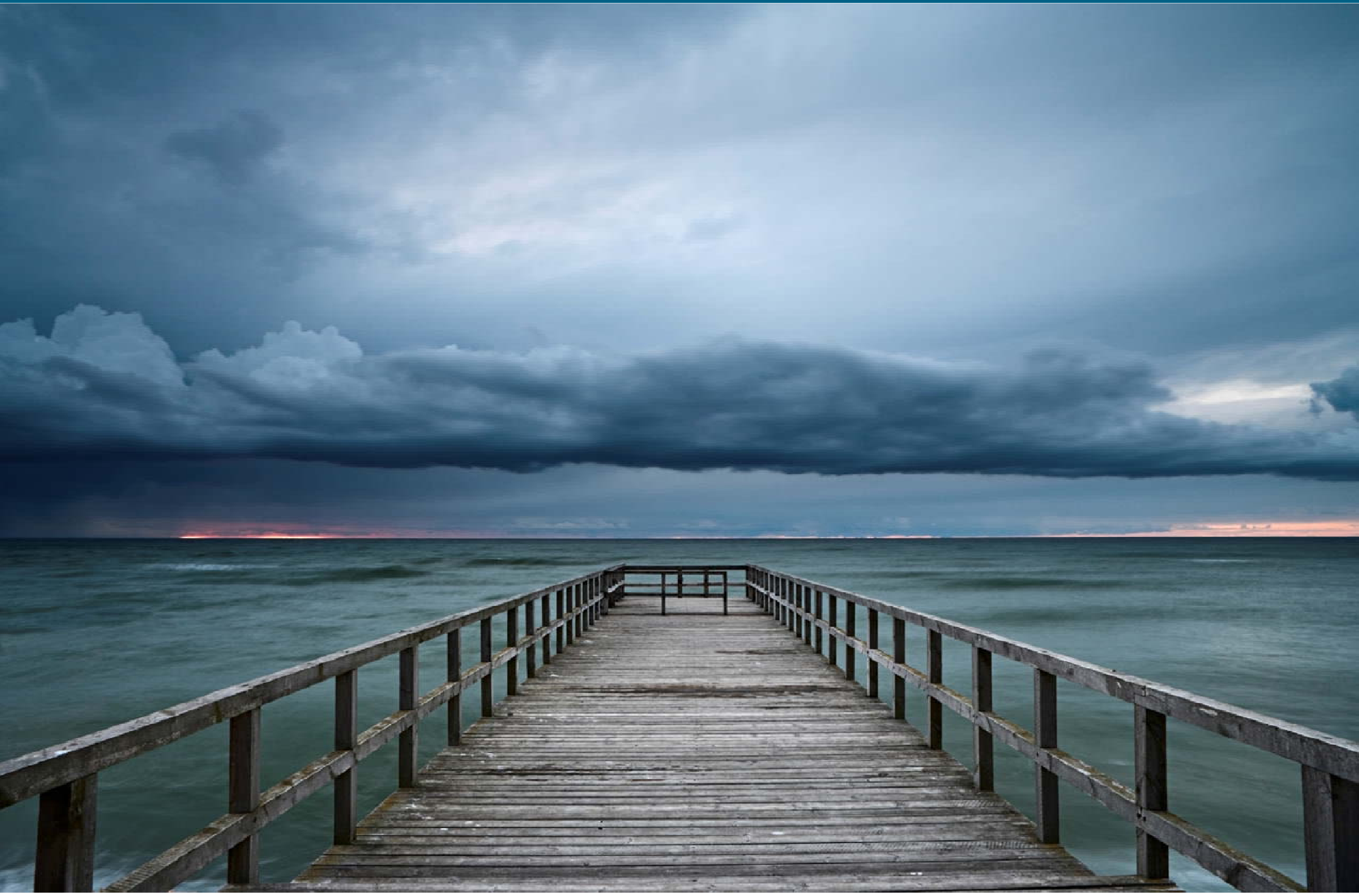
The Coming "Perfect Storm"



Global Sage

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"A PERFECT STORM"

THE BACKLASH AGAINST BAILOUTS AND BONUSES AND THE RESULTING REGULATORY IMPACT

"A perfect storm" will hit the United States in the first quarter of 2010, which we believe will significantly accelerate, broaden and deepen the financial services regulatory reform process currently underway and will result in substantial and far-reaching regulatory reform, both in the United States and around the world.

Financial Service companies operating in the United States, no matter whether they are US domiciled or foreign, need to be intimately aware of what is going on in Washington and around the world to be able to influence events as well as effectively shape their strategies and the way they do business to be successful in the future.

We believe that the combination of events in the first quarter of 2010, including a backlash against the expected financial institutions compensation payouts, the advent of the U.S. election cycle and the scheduled Congressional investigations into the causes of the recent financial crises, will turbo-charge broad-based and significant regulatory change in the United States. Financial institutions failing to monitor and participate in this process do so at their own peril.

THE GLOBAL BACKDROP: COORDINATED EFFORTS AT SIGNIFICANT REGULATORY REFORM ARE UNDERWAY

As a backdrop to this "perfect storm" in the United States, governments and regulators around the world have been working in a coordinated way to implement changes designed to strengthen the global regulatory system as well as rein in the excesses that are seen to have led to the recent international financial and economic crisis.

The Group of 20, representing the major industrialized and developing nations, has endorsed plans to significantly raise capital standards and implement strong international compensation standards. Both of these measures are aimed at ending excessive risk-taking, and addressing resolutions of systemically important global firms. The G20 endorsed the proposals by the Basel Committee of the Bank for International Settlements for higher capital, liquidity, and leverage requirements, and committed to developing the new standards by the end of 2010 and implementing them by the end of 2012. These new levels of capital will have a major impact on the global financial services competitive landscape.

In addition, the European Commission has adopted a series of proposals to strengthen financial supervision in Europe, including the creation of a European Systemic Risk Board and a European System of Financial Supervisors, composed of national supervisors and three new European Supervisory Authorities for the banking, securities, and insurance and pension sectors.

All these global initiatives are impacting the regulatory proposals of the U.S. regulators, and will fundamentally change the competitive environment for all financial institutions over the next several years.

THE APPROACHING "PERFECT STORM"

In the near term (over the next several months), we believe that a series of unique events will set off a new and powerful political firestorm in Washington aimed at Wall Street and the financial services industry. The rising anger generated by these events will significantly accelerate the regulatory reform process in the United States. These first quarter events / forces include:

1. Selected major financial service firms will announce the payment of billions of dollars of employee bonuses in compensation for 2009. These large bonuses will come at a time when national unemployment is above 10 percent and "Main Street" is still struggling. The media coverage of these bonuses will stoke the populist anger with the financial community.

2. The 2010 U.S. midterm election year political process will begin in earnest. All 435 Members of the House and more than one-third of the Senate will be running for election and vilifying the financial community will strike a strong chord with the media and public.

3. The Financial Crisis Inquiry Commission will begin a series of high-profile, public hearings across the country on the causes of the recent financial and economic crisis. These hearings will further exacerbate the public anger towards the financial community that already exists.

With nearly 80 percent of the U.S. public believing that financial institutions are responsible for the financial and economic crisis, the industry will be subjected to renewed, heavy criticism and calls for immediate and substantial reform. Populist anger will grow across the country as a result of these three events/forces. In turn, this will produce a bipartisan backlash in Washington against the bonuses and bailouts, and lead to demand for significant regulatory reform. With the financial services industry's reputation and influence in Washington at its lowest level in years, and with the populist support for the regulatory proposals currently moving through Congress expected to rise owing to increased public anger with "Wall Street." we believe the probability of major regulatory change being enacted in 2010 will rise significantly.

THE FOCUS OF REGULATORY REFORM

The bills currently moving through Congress calling for significant regulatory reform fall into three major areas:

1. Limits on executive compensation arrangements
2. Tax increases aimed at Wall Street activities
3. Structural reforms aimed at reducing the size and risk-taking ability of major firms.

LIMITS ON EXECUTIVE COMPENSATION

Significant changes have already been put in place on executive compensation arrangements. The Treasury Department's Special Master for Executive Compensation ("Pay Czar") announced new rules for compensation for TARP firms, and simultaneously, the Federal Reserve established similar rules designed to link executive compensation arrangements at all banks to long-term performance and risk-management processes. This effectively extended the Pay Czar's proposals to all banks. It is, therefore, clear that paying back TARP money will not exempt financial institutions from compensation guidelines. Other regulators, including the SEC, are expected to announce similar rules and some financial institutions have already announced significant compensation plan changes such as Credit Suisse as approved by the Swiss regulators.

We believe that substantial bonuses will be paid for 2009 compensation in the first quarter. We further believe that these compensation payments in the U.S. will be generally in line with Fed guidelines. Nevertheless, we believe that given rising populist anger over the payments, it is likely that there will be a new round of legislative proposals to further control and restrict financial services compensation. Proposals that have been discussed and had support in the recent past include:

- Dollar caps on bonuses and salaries
- The Pay Czar's (or similar) rules apply to all TARP firms and beyond as the Fed and other regulators outside the U.S. have begun to do within their current charters
- "Supertax" on "Wall Street" bonuses. The UK recently announced a 50% "supertax" on bonuses similar to the one implemented last year on the AIG bonuses.
- Linking bonuses to lending activities
- Curbs on deferred compensation
- Restrictions on pensions payments
- Limiting tax deductibility of compensation
- "Say-on-Pay" and "Golden Parachute" restrictions
- Enhanced shareholder proxy access to nominate directors
- Mandating independent compensation committees
- "Holdbacks" and "Clawbacks" for compensation
- Expanded SEC disclosure requirements

We believe that the result of the "perfect storm" will be that some of these initiatives will be implemented in 2010.

TAX CHANGES

In addition to executive compensation curbs, Congress is likely to consider a wide range of tax proposals designed to "rein in" Wall Street risk-taking activities and reduce the amount of money available to pay bonuses. These tax proposals will be aimed at curbing "speculative" trading and reducing leverage and risk-taking. The proposals will also help Congress pare long-term budget deficits and offset the cost of taxpayer bailouts. Some of the major changes under active discussion include:

- Imposition of a financial transaction tax (to make "Wall Street" compensate "Main Street" for the damage it has done to the general welfare.)
- Limits on debt financing and deductibility of interest payments by corporations (to encourage capital versus debt financing)

- Higher capital gains/dividend tax rates
- International tax changes

STRUCTURAL REFORMS

Support is also building in Washington to break up/dismantle/curb financial firms whose size and risk-taking "could threaten the financial stability of the economy." The structural reforms under consideration include:

- Changes in the regulatory landscape and authorities
- Re-imposition of Glass-Steagall–like restrictions, separating risk-oriented businesses from "transaction" (relatively risk-free) businesses. While many think this unlikely at the moment, there are proposals that appear to have a better chance of passage that would give regulators authority to re-impose G-S restrictions on a case-by-case basis if certain conditions occur
- Proposals to give regulators the authority to force financial institutions to restrain growth, sell or divest assets and businesses, and/or cease certain activities if capital, liquidity, or leverage requirements are exceeded

None of these legislative proposals is certain to be enacted. All of these proposals, however, are being actively considered, and in an environment of enhanced populist anger generated by the coming "perfect storm," all will have an enhanced chance of passage. Enactment of changes in these areas will fundamentally change the legal and regulatory landscape and redefine what is needed for strategic success in the future.

POTENTIAL SCENARIOS

What is the probability that there will be major regulatory change? We think there are essentially three levels of the potential intensity of legal and regulatory change in the US financial system.

1. *Limited Change*

   The first scenario suggests that changes in the regulatory environment will not be overly radical and extensive. Instead, changes will focus on minor changes in oversight and authorities, disclosure and ways to speed the payback of Government subsidized banks and restore financial stability to these firms.

2. *Moderate and Permanent Regulatory Change*

   In this scenario, the changes will be more substantial and permanent. These include the changes in oversight and authorities and disclosure requirements from above combined with a focus on those financial services firms that are deemed to be large enough to threaten the global or national economic security if they fail.

3. *Comprehensive Global Regulatory Change*

   This scenario envisions changes that span a wide range of areas, from enhanced and expanded disclosure, oversight and authorities, limits on compensation, tax and structural governance, shareholder rights. These will impact all financial service firms regardless of size or ownership structure (public or private).

No one can predict with certainty which of these scenarios will eventually come to pass, and some may evolve over time. However, our research and intelligence points us towards a level of regulatory and competitive change somewhere between scenarios #2 and #3. We think the forces encompassed in the "perfect storm" will push the Congress towards greater and more comprehensive reform rather than less.

WHY DO WE PREDICT THIS?

The evidence takes shape every day. TARP firms are already under strict controls as are other banks around the world that took government bailouts. While some of these provisions will ease when paybacks occur, many will remain in place. In scenario #2, the BIS and FSA have already made it clear that they do not want to approach a multi-firm "too big to fail" scenario ever again. Therefore large financial institutions will be under the watchful eye of regulators who will be armed by public furor and fearful governments with legislated teeth to govern - not just oversee activities. Therefore scenario #2 is already on the agenda; and regulators will likely have broad evaluation powers and the ability to force companies to adhere to capital and risk measures or be forced to break up, merge, sell assets, etc.

The question then is how far into scenario #3 the changes will go. Our opinion is reasonably far but not all the way. Firms of all sizes, ownership and type of business will be forced to pay very close attention to the new rules. We saw this, for example, with Rule 409A and 457A under the tax code. Rules will be enacted that have broad-reaching effects on all types of financial institutions and will force compliance across the entire industry. In addition, even if a financial institution is not a publicly traded entity but is a large capital-based firm such as one of the top 25 private equity or hedge funds, the legislation will want to capture these under their umbrella (Why? Because memories of Long-Term Capital have not been forgotten either.)

We do not predict that all firms will be subject to all the Fed or FSA rules, however it will be prudent for all to understand the rules, consciously decide to be in or out of step with them and make those decisions at their highest levels.

WHAT YOU CAN DO NOW?

What should firms be doing <u>now</u> regardless of whether they feel they are under the regulators eyes right now? We have several suggestions:

1. Be Aware and Active

Firms need to be fully informed of the changes being proposed and discussed in Washington, DC, and other capitals around the world. Make sure there are regular, informed briefings with the Management Committee and/or Board of Directors about the latest tax, structure and compensation issues being debated in the major markets in which your firm does business. Information and prior analysis will help shape better decisions if and when they are required. If this capability is not in house given the size of your firm, make sure you have competent and informed external information sources at your disposal. Moreover, engagement in the political debate through lobbying has shown in the past to lead to better governmental decisions.

2. **Take A Comprehensive Look At All Compensation Plans and Processes**

   Take a complete inventory of compensation plans already used within your firm. Many firms have multiple plans across its employee base and executives but often the number and scope of these plans have not been reviewed in some time. At larger firms, it is possible to have many dozens to hundreds of plans. These should be inventoried, reviewed for compliance to current rules and, most importantly, examined with rigor to understand what behavior they intend. It is the unintended consequences of compensation plans that should be reviewed and amended.

3. **Review Your Board and Committee Structure and Mandates**

   Take a comprehensive review of the governance rules of your firm from the board structure and mandate to the management committee and how well these governance forums interact or do not interact. Understanding all of the forums and processes used to debate new business initiatives, risk issues and related reward systems for all businesses will highlight key deficiencies.

Performing any and all of the above requires time, rigor and competent staff and advisors. At a minimum they can help to review, inventory and re-confirm how the company operates and rewards its professionals. At the maximum, firms will likely uncover some changes that need to be made to their core processes and reward systems to avoid any unintended behavior.

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