2008 Compensation Update

July, 2008

LEHMAN BROTHERS

2008 Control Total Status

- At the beginning of 2008 we established a compensation Control Total framework that monitored hiring across all division of the firm
- Due to the market environment, divisional control totals were adjusted to reflect the events of March and May
- As of June 30th, we are collectively operating ~$105mm over our revised Control Totals (after considering pipeline)
- If we continue to run at this level, this impacts our ability to pay NGNNH by ~2%

($ Millions)	June 30 Runrate	Pipeline Adds/(Terms)	2008 Recruiting Incentives (RI)	Total Runrate & RI	Control Total	Net Excess / (Overspend)
Salary & Bonus [(a)]						
FID	$ 1,719	$ 12	$ 22	$ 1,753	$ 1,711	$ (42)
Equities	1,105	(12)	7	1,101	1,085	(15)
PS	231	(2)	1	230	238	8
IBD	1,291	13	13	1,316	1,278	(38)
IMD	608	(13)	3	598	578	(20)
PI	24	(0)	-	24	26	3
MCD	184	(10)	1	175	174	(0)
Exec	142	5	1	148	139	(9)
SPA	17	(0)	-	17	16	(1)
SF Corp	358	(3)	1	355	356	0
IL Corp	1,241	3	7	1,251	1,261	10
Total	$ 6,920	$ (8)	$ 55	$ 6,967	$ 6,863	$ (105)

(a) Excludes Formula based employees

2008 Compensation Adequacy

$ Millions	Q1 2008 Actual	Q2 2008 Actual	1H 2008 Actual	Projected 2H 2008	FY Comp Projection
Salary	697	667	1,364	1,230	2,594
SW Cap	(18)	(9)	(26)	(14)	(41)
Production Comp	123	115	237	245	482
Prior Year Equity Amortization	374	414	788	731	1,519
GTS Partners Return	28	(18)	10	(10)	-
Benefits	454	441	895	712	1,607
Total OC&B	857	836	1,693	1,433	3,126
Bonus					
Guarantees	37	80	117	138	256
Investment Reps	23	19	42	41	84
NB Production Bonus	-	2	2	2	4
2008 Equity Award	-	-	-	25	25
Other July '08 Equity Award	-	-	-	24	24
Prop	15	47	62	66	128
GTS & COG	42	(4)	38	(12)	26
Mid Years	-	101	101	(9)	92
Total Fixed Bonus	117	246	362	275	637
Total Fixed Comp	**1,775**	**1,855**	**3,630**	**3,168**	**6,799**
Discretionary Bonus	**66**	**470**	**536**	**858**	**1,394**
Total Comp	**1,841**	**2,325**	**4,166**	**4,026**	**8,193**
Revenues	**3,507**	**(668)**	**2,839**	**5,200**	**8,039**
C&B Ratio	52.5%		146.8%	77.4%	101.9%
Total Comp					*8,330*
% pay to Discretionary Population					*-26%*

2009 Compensation Cost Structure Changes

Saves

Equity Award Roll-Off
- OWS Acceleration
- R3 Acceleration
- Neuberger Berman

Formula Based Compensation
- MCD

Severance

Salaries to Permanent Terms

Increases

Equity Award Increases
- Q1 Specials
- Mid Year Specials

Formula Based Compensation
- Principal Groups
- IMD

Pension Plan

Introduction

- Well structured, the compensation framework can be a significant source of competitive advantage for the Firm
  - Aligns pay with performance and provides more accountability
  - Allows managers to manage their world to optimize performance
  - Helps build valuable franchises for the Firm
  - The big question .... Is the Firm ready for change?

- The current compensation framework is perceived as being broken, which results in frustration and desire for change across the Firm
  - Compensation model is not a good predictor of actual compensation levels
  - Framework is not sufficient in encouraging most productive use of resources
  - Funding sources are currently too small to support ambitious growth strategy

- This document will address Divisional compensation models
  - Review current approach
  - Identify alternatives assessing pros and cons

Compensation Models

- In 1997 we instituted compensation models for each of the major business units of the Firm (FID, Equities & IBD)
  - Since then we have implemented similar models for IMD and MCD
- These compensation models were driven off pre-comp profits before taxes (PCPBT)
  - Included Revenues, NPE and Dedicated Allocations
  - Based on an incremental productivity approach
  - Used different marginal accrual rates each division (ranging from 18% to 40%) depending on maturity of business and equity usage
  - Incented divisions to grow revenues and/or decrease expense
- The Firm was able to pay the divisions on these models in 1997. Since then, investments and adjustments were made to get to the business unit actual compensation. These investments and adjustments were never recaptured

	FID	Equities	IBD	Corporate
1997	2	-	-	-
1998	55	(3)	(3)	(3)
1999	(55)	20	53	(37)
2000	52	82	165	(31)
2001	(22)	77	56	(24)
2002	(247)	(58)	(137)	(47)
2003	128	63	(36)	(6)
2004	(61)	63	(12)	(36)
2005	(20)	(55)	12	(12)
2006	164	(13)	196	30
2007	811	(245)	45	82

Compensation Models *(cont'd)*

- Beginning in 2003, we instituted an additional compensation model based on Economic Value Added (EVA)
  - Included Revenues, NPE, Dedicated Allocations, Taxes and Use of Equity Charge
  - Based on an incremental productivity approach
  - Used the same marginal accrual rates for all divisions (25%)
  - Included a benefit for change in Firm-wide PCPBT (1.5%). This new element is meant to reinforce our "One Firm" philosophy
  - Incented divisions to grow revenues, decrease expense or manage equity usage and tax planning

- Each month the Compensation Control Group meets with the divisional CAOs to review their compensation models (PCPBT and EVA)

- While the CAO's are engaged in understanding how the models work, they do not appear overly concerned with the output since they know this is only one component of how they get paid

Compensation Models *(cont'd)*

Current Process

- The final pay process is an interactive process that begins in the early part of the fourth quarter
- Based on full year revenue forecast, a presentation is made to the Executive Committee detailing compensation (expressed in terms of NGNNH) and various performance/market metrics
- Several alternatives for distribution are presented (expressed in terms of NGNNH)
  - EC reviews performance (revenue, PCPBT, EVA), anticipated pay levels of competition (defined in NGNNH terms) and prior year pay ranking
    - EC divides up pools, after considering above metrics, based on NGNNH
- Throughout the remainder of the quarter, we monitor productivity and fine tune the pay levels

Pay Process – Current

Divisional Productivity and Competitive Landscape

- The following table shows how the NGNNH population would be paid per their comp models (PCPBT and EVA), pro rata adjusted scenarios, preliminary market pay information and Lehman's rank in terms of compensation levels to our competitors

- We have also included points of comparison including revenue and headcount growth

	PCPBT Model[3]	PCPBT Pro Rata	EVA Model[1,3]	EVA Pro Rata	Change in Revenues	Headcount Growth	Current Market Trend (2005 to 2006)	2005 Market Rank[2]
FID	1%	7%	2%	8%	6%	10%	+15%	3 of 7
Equities	22%	28%	18%	25%	25%	26%	+20% to 25%	3 of 7
IBD	-3%	3%	-4%	3%	11%	14%	+20% to 25%	4 of 7
Asset Management	20%	26%	20%	27%	36%	15%	+15% to +20%	NA
PIM	2%	8%	2%	9%	9%	3%	+15% to +20%	NA
Private Equity	4%	10%	4%	11%	16%	24%	+20% to 25%	NA
MCD	-28%	-22%	-28%	-21%	-29%	-11%	NA	NA
Corporate	4%	10%	4%	10%		18%	+10%	NA
Total Firm[4]	4%	10%	3%	10%	18%	9%	NA	NA
Comp Surplus / (Deficit)	213	-	226	-				

Excerpt from the year-end Compensation presentation to the Executive Committee

Pay Process – Current

NGNNH Alternatives

- This will be a very difficult pay year
- Below are four alternatives for paying our divisions at +10% for NGNNH

	A	B	C	D	Current Market Trend (2005 to 2006)
FID	7%	6%	10%	9%	+15%
Equities	26%	25%	15%	20%	+20% to 25%
IBD	3%	11%	15%	13%	+20% to 25%
Asset Management	26%	25%	10%	17%	+15% to +20%
PIM	8%	9%	10%	9%	+15% to +20%
Private Equity	10%	16%	20%	13%	+20% to 25%
Total IMD	19%	20%	13%	14%	
MCD	-10%	-10%	-5%	-5%	NA
Corporate	10%	6%	5%	5%	+10%
Total Firm	10%	10%	10%	10%	NA

Excerpt from the year-end Compensation presentation to the Executive Committee

Pay Process - Current

Current Process

Pros	Cons
◆ Allows Firm to balance competitive pressure	◆ Paying NGNNH feels like a disconnect from performance
◆ Allows divisions to understand where they are paying compared to competitors, which is typically expressed in year-to-year terms	◆ Does not incent divisional managers to manage their population
◆ Ultimately NGNNH pay is the thing that drives the divisions to ask for more compensation funding during the year-end compensation process	◆ Motivates divisions to hold onto underperformers to help pay others
◆ Prevents divisions from wholesale cuts to pay divisions	
◆ Promotes the "one Firm" culture: no +20%, - 20% situations	

Alternatives

- In defining alternatives to the current year end pay process, we need to balance pay for performance with our "one Firm" culture

- Four alternatives have been identified to the current process
  - Divisional C&B Ratios
  - Divisional Direct Contribution Margin
  - Divisions Request Compensation
  - Formula and Discretionary Pools

- Models will not work in all situations and will need to be somewhat flexible

- These alternatives would likely result in more decentralized decision making and a variable Firm C&B ratio

- Change in process will significantly impact overall planning/budgeting process across Firm/Divisions/Regions

Alternatives

1

Divisional C&B ratio

- Consistent with the Firm approach, develop divisional C&B ratios
  - C&B ratios can be defined at the overall divisional level or by type of revenue within the divisions (e.g., principal, client, M&A, origination, etc)
- Lets producers focus on revenue production and not saving NPE
- C&B ratios can be based on historical levels or targeted performance levels
- Allow divisions some flexibility to trade NPE and PE
- Could include penalties for divisions that do not achieve NPE targets

Pros	Cons
◆ Easy to implement and for divisions to understand ◆ Consistent with the overall Firm approach ◆ Eliminates incentive for keeping underperformers	◆ Does not incent business to manage allocations ◆ Likely would result in a more variable C&B ratio for the Firm ◆ Potential for large swings in staffing by division ◆ Potential desparite pay by divisions (e.g., +20%, -20%) ◆ Could slow down growth if divisions are worried about revenue production ◆ Divisions may focus on divisional revenues not Firmwide revenues (shift in culture required)

Alternatives

2

Direct Contribution Margin

- Establish Direct Contribution Margins that divisions need to achieve after paying their people
- Direct Contribution Margin would include revenue, direct compensation, NPE and dedicated allocations (before uplift)
- Margins can be based on historical or targeted levels

Pros	Cons
◆ Makes managers manage their whole P&L ◆ Additional focus on NPE and allocations ◆ Eliminates incentive for keeping underperformers ◆ Allows divisions to trade off between PE/NPE which should increase efficiency	◆ Likely would result in variable C&B ratio for the Firm ◆ Potential for large swings in staffing by division ◆ Potential desparite pay by divisions (e.g., +20%, -20%) ◆ Could slow down growth if divisions are worried about revenue production ◆ Divisions may focus on divisional revenues not Firmwide revenues (shift in culture required)

Alternatives

3

Divisional Requests

- The divisions review their performance, staffing levels and fixed spends (benefits, guaranteed bonus, etc.) to determine the amount of compensation needed to pay the division
- Would require divisions to balance pay and performance
- Monthly updates would be required to ensure that overall Firm economics were acceptable
- Robust infrastructure would be required within each division and centrally to ensure information is correct

Pros

- Eliminates Mid Year/Budget/Final pay arbitrage
- Puts the request in the hands of the people who better know their needs
- Requires managers to balance economic results with pay levels
- Eliminates incentive to keep underperformers
- Still maintains focus on NPE and allocations

Cons

- Likely would result in variable C&B ratio for the Firm
- Potential for large swings in staffing by division
- Incremental cost for infrastructure to support requests
- Managers may not pay divisions properly to deliver results and end up losing the franchise as people leave
- Need robust divisional and central process to agree to right pay level

Alternatives

4

Formula and Discretionary Pool

- There are several problems with each of the preceding alternatives. The main concerns being a variable Firm C&B ratio, loss of the 'one-Firm' culture and focus on in divisional revenues
- An alternative approach could be to follow a strict formula based model for each division and then haircut the resultant compensation (e.g. 80%)
  - Formula can be based on C&B ratio or Direct Contribution Margin
- This would allow for a discretionary pool to be established within the Firm's overall C&B ratio which could be used to equalize the pay process. This would maintain the "One Firm" culture

Pros

- Would allow us to maintain a consistent overall Firm C&B ratio
- Ability to redistribute compensation to equalize divisions' pay level
  - More in line with the 'one-Firm' approach
- Gives divisions a minimum compensation level to make decisions
- Could eliminate incentive to keep underperformers

Cons

- Feels like the current process although there is a baseline level of compensation that each divisions can spend
- Divisions may rely on discretionary pool rather then make the hard decisions required with a more strict formulaic approach
- Could slow down growth if divisions are worried about productivity
- Could result in unnecessary staffing redistribution based on a formula that would be subsequently funded by discretionary pool