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Circular on remuneration systems

Explanatory report

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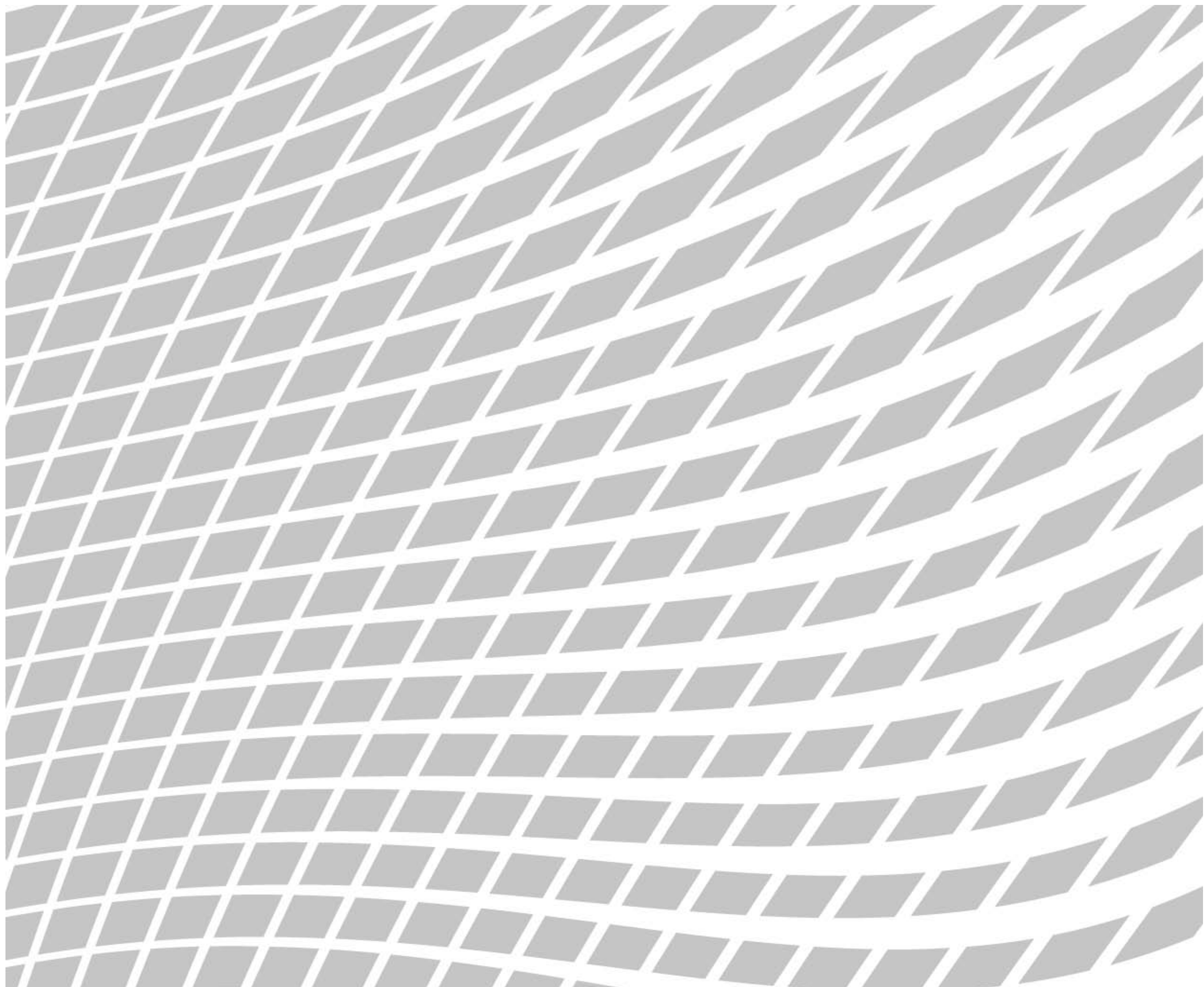

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Abbreviations

BA	Swiss Federal Act on Banks and Savings Banks (Banking Act, SR 952.0)
BO	Swiss Federal Ordinance on Banks and Savings Banks (Banking Ordinance, SR 952.02)
CEBS	Committee of European Banking Supervisors
CISA	Swiss Federal Act on Collective Investment Schemes (Collective Investment Schemes Act, SR 951.31)
CISO	Swiss Federal Ordinance on Collective Investment Schemes (Collective Investment Schemes Ordinance, SR 951.311)
CO	Swiss Federal Act on the amendments to the Swiss Code of Obligations (Fifth part: Code of Obligations) (Code of Obligations, SR 220)
FINMA	Swiss Financial Market Supervisory Authority
FINMASA	Federal Act on the Swiss Financial Market Supervisory Authority (Financial Market Supervision Act, SR 956.1)
FSA	Financial Services Authority
FSB	Financial Stability Board (previously Financial Stability Forum, FSF)
IIF	Institute of International Finance
ISA	Swiss Federal Act on the Supervision of Insurance Companies (Insurance Supervision Act, SR 961.01)
ISO	Swiss Federal Ordinance on the Supervision of Private Insurance Companies of 9 November 2005 (Insurance Supervision Ordinance, SR 961.011)
SESTA	Swiss Federal Act on Stock Exchanges and Securities Trading (Stock Exchange Act, SR 954.1)

SESTO	Swiss Federal Ordinance on Stock Exchanges and Securities Trading (Stock Exchange Ordinance, SR 954.11)
SO	Ordinance on the Supervision of Private Insurance Companies (Supervision Ordinance SR 961.011)

Key points

FINMA is opening the consultation period for the Circular on remuneration systems, which will enter into force on 1 January 2010. The Circular will have a direct impact on the remuneration systems of the financial institutions concerned. The Circular will aim to ensure that remuneration systems do not provide incentives to take inappropriate risks that could threaten the stability of financial institutions. As a result, financial institutions will have to structure their variable remuneration packages (bonuses) on a sustainable and long-term basis in line with economic profit while taking into account the costs related to all risks entered into. Furthermore, Boards of Directors will have to discharge their duties more carefully. They are responsible for the remuneration policy of the entire company and will have to disclose the remuneration policy in a remuneration report. The consultation period for the Circular will run until 14 August 2009.

Increasing risk awareness

Inappropriate risks and false incentives can threaten the stability and profitability of a financial institution. Remuneration systems can also set false incentives, leading to inappropriate risk taking. Recent events have shown that remuneration systems play a key role in risk management at financial companies.

In accord with international committees such as the Financial Stability Board and financial market supervisory authorities abroad, FINMA is proposing that, based on the organisational requirements of effective financial market legislation, the remuneration policy of financial institutions be made subject to supervisory regulation. In contrast to comparable international regulations, the Circular will apply not only to large, systemically relevant banks, but to all financial institutions supervised by FINMA.

Remuneration systems should increase employees' risk awareness. This not only includes financial risks, such as credit defaults, losses from trading positions or liquidity problems, but also operational risks, for example legal and compliance risks, which can severely damage a financial institution and must therefore be included in a risk assessment. High risk must result in lower variable remuneration then low risk. This applies at the level of the entire company, at business unit level, and all the way down to individual employees. This provides all employees at a financial institution with an incentive to act in a risk-aware manner.

Variable remuneration as a contribution to success

FINMA believes that steep restrictions or a blanket ban on variable remuneration would not be a sensible option. Variable remuneration provides an incentive for employees to pursue the goals and interests of the company and enables them to share in its success. It also allows institutions a degree of cost flexibility. Provided the interests of the company owners are taken into account and there is no inducement to assume inappropriate risks, variable remuneration can benefit all stakeholders of an institution.

However, FINMA expects remuneration systems to place an emphasis on sustainable business conduct. It views variable remuneration as the employees' stake in the success of the company and requires that all variable remuneration paid out must actually have been earned by the company over the long term. By contrast, variable remuneration is not paid if a company does not perform well.

FINMA defines success based on economic profit. In contrast to an accounting assessment, economic profit considers a company's full cost of capital, and thus also the risk cost to investors/shareholders. As a result, a company only creates value added if an excess remains after deducting the full risk-adjusted cost of capital. The larger an institution's risk, the smaller this excess. This concept does not directly limit the amount of variable remuneration. However, it prevents high variable remuneration being paid when large risks are entered into.

When setting variable remuneration, institutions must take into account the long-term trend in economic profit. This prevents disproportionately inflated variable remuneration being paid during boom phases; however, it also enables companies to limit variable remuneration during brief downturns in business. Both encourage companies to look at the long-term picture. The more sustainable a company's positive performance, the more employees can benefit from variable remuneration.

Long-term-oriented award criteria

FINMA requires that the criteria used to award variable remuneration are not based on the short-term performance of individual company units and employees. This is to prevent employees pursuing targets that have little to do with the long-term success of the company or that do not take into account the risks entered into. FINMA does not consider targets such as turnover, net new money, sales volumes or profits for a given period to be suitable as the sole criteria for awarding variable remuneration.

Nowadays, remuneration packages at many financial institutions include a deferred remuneration component. Examples of this include restricted shares or options. FINMA also encourages "clawback"

and "malus" provisions, as they allow for a withdrawal of variable compensation upon negative events. Furthermore, individual clawbacks can be more directly linked to risks in an employee's area of responsibility.

Employees can access deferred compensation only after the holding period has expired. By deferring payment, remuneration can be subject to a risk even after it has been awarded. The duration of the holding period is based on the time horizon of the risks and must be at least three years. Both employees at higher hierarchy levels receiving comparatively large overall remuneration packages and employees that can pose significant risks should receive a deferred remuneration component.

Deferred remuneration components must be subject to fluctuations in value during the holding period so as to further increase risk awareness and the incentive for sustainable business. Employees benefit from their company performing well, for example, if the company's share price rises. They are also impacted by the risk of negative performance, for example, if the share price falls or risks arise, such as credit defaults or losses from trading positions. A key factor is striking the correct balance between the company's success, risks and the value of the deferred remuneration component, in addition to ensuring that employees are appropriately impacted by the company's performance, whether negative or positive. If the company performs negatively, deferred remuneration should make up the majority of the variable remuneration, as it is linked to the company's success and only increases in value once the economic situation of the company has improved.

Increased transparency

From a legal perspective, FINMA is not authorised to restrict the remuneration paid to employees. Indeed, this would not be a sensible option. Given the large differences within the Swiss financial sector, it would be almost impossible to determine a single appropriate regulation for all areas. However, FINMA is aware that market mechanisms have not functioned properly in recent years. This may have contributed to the significant rise in remuneration levels in recent years. As a result, FINMA is to increase market discipline by introducing new transparency and reporting obligations.

However, FINMA does not intend to insist that individuals' names be disclosed with the remuneration received; indeed, there would be no legal basis for such a requirement. Instead, financial institutions are to be required to disclose their remuneration policies to the market in a remuneration report. Third parties, such as shareholders and analysts, should be able to assess the structure of the remuneration system, allowing them to compare the variable remuneration with the performance of the company. The proposed provisions with regard to transparency go beyond specific initiatives on an international level and the current requirements under Swiss law. While the current company and stock market disclosure legislation only requires disclosure of the remuneration received by senior management, FINMA is calling for summary disclosure of the remuneration structure for all employees.

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Employment and tax legislation: a balancing act

In regulating remuneration systems, FINMA has to perform a balancing act to ensure that regulation is both appropriate and effective.

The concept of performance and success-related variable remuneration came from the English-speaking business world. In the financial sector in particular, the relationship between fixed salaries and bonuses had tended to favour the latter, meaning that nowadays variable remuneration makes up a significant part of employees' total remuneration. However, Swiss employment law has not kept pace with this trend. The lack of clear statutory regulations on bonuses may be one reason why, in the past, Swiss courts have judged claims from employees for variable remuneration to be a component of salary to which they are entitled. The framework of Swiss employment law makes it difficult to defer variable remuneration in line with circumstances, or to reduce it as a result of economic conditions. In this instance, legislators must amend employment legislation in line with the current conditions, thus taking into account the nature of variable remuneration and the interests of employers and employees in a balanced manner.

There is a similar problem with regard to tax legislation. The deferred remuneration components being promoted by FINMA and which are prevalent across the sector must in some cases be taxed before employees can have access to them. As a large proportion of remuneration for employees in upper hierarchy levels is paid on a deferred basis, these employees may face a large tax bill in excess of the remuneration they receive in cash. Furthermore, in certain circumstances the employee may be taxed on income that he or she may never receive as a result of the deferred remuneration falling in value before the end of the holding period. In this respect, it should be considered whether it would it would be sensible to defer the tax burden on the deferred remuneration component until the employee has access to the remuneration without any restrictions.

Keeping competition balanced

Remuneration regulation initiatives abroad mostly address large banking institutions. FINMA however believes that remuneration systems should not only be regulated for systemically relevant firms. The increasing complexity of risks is placing the same strain on the risk management and risk control functions in all financial institutions. To ensure a level competitive playing field within Switzerland in this respect, the Circular should apply equally to all financial institutions. The Circular is not intended to distort competition within the Swiss financial market in any way.

The market for highly qualified specialists for certain key positions has a global dimension. Companies have to fight hard to recruit and retain such employees, part of which often revolves around the remuneration offered. Every additional regulation governing remuneration places yet another

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competitive limitation on financial institutions. If one company has to comply with stricter regulations than its competitors, it will be disadvantaged in the competition for qualified staff and will be weaker over the medium term, not only with regard to the job market. FINMA is going further with its proposals than any other initiatives yet seen outside of Switzerland. However, it must consider the impact its remuneration regulations will have abroad; otherwise these regulations may result in only Swiss financial institutions being disadvantaged, which in turn would threaten the Swiss financial centre as a whole.

Public consultations to run until 14 August 2009

FINMA has opened the public consultation phase and is inviting all supervised entities and other interested parties to submit suggestions to FINMA. **These suggestions must be received by 14 August 2009**. FINMA will continue with its international dialogue throughout the consultation phase. It plans to set out the definitive provisions in September 2009, with the Circular entering into force as of 1 January 2010. This will give financial institutions a transitional period during which they can bring their remuneration systems into line with the new requirements. FINMA expects the remuneration systems of all financial institutions concerned to comply with the principles set out in the Circular from 1 January 2011 onwards.

Principles

Principle 1

The Board of Directors is responsible for the design and implementation of the financial institution's remuneration policy and issues remuneration regulations.

Principle 2

The remuneration system is simple, transparent, and enforceable as well as oriented towards the long term.

Principle 3

In designing and applying the remuneration system human resources and control functions are involved.

Principle 4

The structure and level of total remuneration are aligned with the financial institution's risk policy and enhance risk awareness.

Principle 5

Variable remuneration depends on the long-term economic performance of the financial institution.

Principle 6

Variable remuneration is granted according to sustainable criteria.

Principle 7

Deferred remuneration gives the employees a symmetric participation in the financial institution's future development and its risks.

Principle 8

The remuneration of the control functions does not give rise to conflicts of interest.

Principle 9

The Board of Directors reports annually on the implementation of the remuneration policy.

Principle 10

Deviations from these principles are possible only in well-founded exceptional circumstances and must be disclosed.

1 Introduction

Inappropriate risks and false incentives can threaten the substance and profitability of a financial institution, and thus its stability. Since remuneration systems set incentives, they also can lead to inappropriate risks being taken. Experience has shown that remuneration systems play a key role in risk management at financial institutions. FINMA is proposing that, based on the organisational provisions of the financial market legislation, the remuneration policy of all financial institutions be made subject to supervisory regulation. In contrast to comparable initiatives abroad, FINMA regulations will apply not only to large, system-relevant banks, but to all financial institutions supervised by FINMA.

In recent years, institutions have developed complex remuneration systems. However, these systems mostly contain deficiencies and loopholes. Each of these loopholes generates false incentives, which in a worst-case scenario, could corrupt the entire system. Even though there is no empirical evidence[1], people nowadays assume that remuneration systems with false incentives played a part in the financial crisis. These remuneration systems rewarded employees for short-term success, but did not consider that decisions that were beneficial over the short term could result in huge losses further down the line, at the level of the individual institution or even the system as a whole. While it would be an exaggeration to accuse institutions and their employees of deliberately exploiting these loopholes, it is clear that at the very least, these remuneration systems did not contain any incentive to consider the long-term effects of current behaviour or avoid excessive risk-taking.

On a global level, financial market supervisory authorities, international committees and representatives of private investors, for example, the International Finance Forum (IFF), have broadly discussed the matter. Since December 2008, FINMA has held a number of consultation meetings with financial institutions in Switzerland, including banks, insurance companies, asset managers and other companies that are authorised and supervised by FINMA. These meetings have also involved foreign institutions that are domiciled in Switzerland. Furthermore, FINMA carried out two supervisory reviews which, *inter alia*, investigated how incentives in remuneration systems impact the conduct of business and what risks they may induce. In accordance with a mandate issued by the Federal Council, FINMA also approved the variable remuneration payments of UBS for 2008. Hence, FINMA gained a real insight into and background knowledge on the way remuneration systems function and the job market in the financial sector.

[1] There are many more examples to the contrary: many employees at Bear Stearns and Lehman Brothers held large amounts of their private assets in shares of their employers; when these banks went bankrupt, they lost billions.

In its proposed regulations for remuneration systems, FINMA adopts a principle-based approach. This takes into account the fact that remuneration systems depend heavily on the business model and are thus a core element of an institute's strategy. For this reason, there are often many different remuneration models applied even within a single larger institute. To a certain extent, institutions must also structure their remuneration in line with market practices, which differ by region. It is a reality that in many sectors, global competition for qualified staff ultimately revolves around the compensation packages offered.

Nevertheless, FINMA requires that the remuneration systems of the institutes it supervises comply with the regulations that it considers necessary for supervisory purposes. By contrast, FINMA does not address issues outside its supervisory remit. It will propose neither the introduction of a salary cap nor a ban on variable remuneration/bonuses. There would be no room within the legal framework of the Financial Market Supervision Act to regulate these issues.

1.1 Problematic aspects of existing remuneration systems

Remuneration systems play an integral role in the way a financial institution is managed. They provide incentives that directly impact daily business and the decisions taken by the employees. As a result, remuneration systems must be compatible with an institution's strategy, and are therefore also a matter for the board of directors. Many remuneration models were too short-sighted. Employees were encouraged to pursue short-term goals; as a result, they often lost sight of the need for sustainability. Significant risks were overlooked and were not considered in the remuneration models. This meant, for example, that traders making short-term trading gains were able to achieve high variable remuneration payments. By contrast, subsequent losses resulting from the same transactions were not taken into account when awarding compensation. In addition, there was a significant imbalance in the relationship between the opportunity to make profits and the need to take responsibility for losses; in turn, this further reduced risk awareness.

The structure of the remuneration systems and the amount of remuneration in certain areas of the financial sector were largely known even before the issue was picked up on by market participants, supervisory authorities, politicians and the general public. The question must be asked why these problems were not acknowledged and dealt with at an earlier stage. The main reason can be found in the high returns and growth potential of the financial sector before the crisis broke. Most institutions saw their sales, profits, returns and headcount consistently increase. With a shortage of qualified staff on the job market, employees were in a position to demand an increasingly large share of the profits made by companies. In some areas of the financial sector, over 50% of profits were distributed to employees as variable remuneration. The financial institutions were more than happy with this arrangement given the high returns they were generating even after deducting compensation expenditures. Their strategy focused on growth; as a result, companies structured their remuneration models in a way that rewarded employees for achieving short-term volume and earnings targets. This overlooked the fact that staff were having to take significant risks to achieve these targets, both at an institution and system level, which ultimately led to huge losses.

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After the financial crisis broke, the lack of flexibility of the current remuneration systems caused another problem. Despite posting huge losses, financial institutions were forced to continue paying variable remuneration, both out of legal considerations and because of a job market that continued to allow key personnel to receive large remuneration packages. While many members of top management had to bear substantial pay cuts or high value corrections on deferred remuneration, some middle-management staff and employees with client contact continue to receive high compensation packages despite significant losses. It became apparent that this remuneration policy was unsustainable and that variable remuneration had moved away from its original purpose – to act as motivation to share in a company's success.

1.2 International efforts

On a global level, representatives of the financial industry and financial market supervisory bodies have spent recent months analysing the relationship between the financial crisis and the incentive/remuneration systems employed by financial institutions. They largely agreed that the remuneration models of financial institutions provided wrong incentives by rewarding short-term gains and largely ignoring any longer-term risks associated with the transactions. On the part of the private industry, the Institute of International Finance (IIF) in particular addressed the problem, producing an initial code of conduct for the financial sector.

Textbox 1: Private initiative of the Institute of International Finance

In July 2008 the Institute of International Finance (IIF) published a response of the financial industry to the financial market turbulence.[2] Among other things, it concluded that significant market growth linked to the "originate-to-distribute" model and the increase in structured products had led to some companies introducing incentive systems that contributed to the financial crisis. The IIF formulated seven *Principles of Conduct on Incentive Compensation* that are to serve as guidelines for financial institutions to realign their incentive systems. However, compliance with these principles of conduct is on a voluntary basis.

In March 2009 the IIF produced a detailed report containing new findings on remuneration systems in the private sector.[3] The IIF identified that lasting changes to structures and governance of remuneration systems will help prevent a repeat of the financial crisis and will drive the rightsizing of remuneration. The IIF also discussed with financial institutions the question of whether intervention by the regulator would help in changing remuneration systems. The industry fears that such regulatory action could erode some of the positive aspects of certain remuneration practices, particularly if there is a lack of uniformity across countries and regions. Despite these concerns, some companies believe that support from the regulator could be useful in the following three areas:

[2] Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations

[3] Compensation in Financial Services Industry Progress and the Agenda for Change

1.	The adjustment of legal constraints to allow for greater flexibility in remuneration practices, in particular ensuring that employment legislation in various jurisdictions does not restrict the introduction of new remuneration practices.[4]
2.	The regulation of the percentage of remuneration that is deferred.
3.	Increased disclosure requirements.

A number of initiatives have been launched and principles published at a global level, some by bodies on which national authorities are represented. Further details on some of these can be found below, including the principles of the Financial Stability Board (previously Financial Stability Forum) in section 1.2.1, the initiatives of the European Commission and the Committee of European Banking Supervisors (CEBS) in section 1.2.2 and the initiatives of national supervisory authorities in section 1.2.3.

The approaches established to date place the emphasis on principle-based, risk-oriented regulation. Generally they refrain from prescribing remuneration models, setting specific limits or stipulating any salary caps.

1.2.1 Principles of the Financial Stability Board

The Financial Stability Forum (FSF), which has been re-established as the Financial Stability Board (FSB), issued in April 2008 a number of recommendations following the financial market turbulence. One of these stated that regulatory and supervisory authorities should work together with market participants to mitigate the risks arising from remuneration systems.[5] At the end of 2008 the FSF put together a working group that drew up the principles for sound remuneration systems. These principles were formally adopted on 2 April 2009 at the G20 meeting of heads of states and governments.

In the Principles for Sound Compensation Practices[6], the FSB identified the remuneration practices of large financial institutions as being one of many factors that contributed to the financial crisis. The FSB determined that in the past, financial institutions' management bodies have paid too little attention to the link between remuneration systems, risk management and risk governance. It views the global supervisory and regulatory structure as a suitable vehicle for introducing sound remuneration practices. The FSB believes that the benefits of sound remuneration practices will be achieved only if there is determined and coordinated action by national regulators, facilitated if necessary by suitable legislative powers and supported by national governments. However, the principles of the FSB do not establish any specific binding obligations for the financial institutions.

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[4] As detailed below, this need likely applies to Swiss employment law, as well. Given the lack of clear statutory regulations and in view of the jurisdiction of the Swiss courts, employers in Switzerland are subject to a number of uncertainties and legal risks with regard to the (non-)payment of bonuses (see section 3.2 below).

[5] Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience of 7 April 2008, sect. II.19

[6] http://www.financialstabilityboard.org/publications/r_0904b.pdf

The nine FSB principles are intended to reduce incentives towards excessive risk taking that may arise from the structure of compensation systems. The FSB requires that remuneration systems must be adjusted for risks that have not yet materialised. Furthermore, remuneration should be sensitive to risk outcomes by linking the bonus pool to the performance, on the one hand, and paying deferred bonuses in relation to the longer-term risks, on the other, with the forms of remuneration being structured accordingly. The principles are aimed at significant financial institutions, but they are especially critical for large, systemically important firms. They apply to all employees at all levels of the financial institution.

Textbox 2: Principles for Sound Compensation Practices of the Financial Stability Board

1. Effective Governance of Compensation

1. The firm's board of directors must actively oversee the compensation system's design and operation.
2. The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended.
3. Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.

2. Effective Alignment of Compensation with Prudent Risk Taking

4. Compensation must be adjusted for all types of risk.
5. Compensation outcomes must be symmetric with risk outcomes.
6. Compensation payout schemes must be sensitive to the time horizon of risks.
7. The mix of cash, equity and other forms of compensation must be consistent with risk alignment.

3. Effective Supervisory Oversight and Engagement by Stakeholders

8. Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.
9. Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.

According to the principles of the FSB, bonuses should diminish or disappear in the event of poor firm, divisional or business unit performance. The FSB believes that sign on payments that reimburse a new employee for unvested compensation foregone at the employee's predecessor firm as a result of

moving to a competitor reduces the incentive effects of the principles. The FSB is therefore proposing a possible approach whereby the new employee is paid a deferred remuneration, on terms similar to the lost bonus claim. It admits at the same time that this practice must be widely adopted to be effective. According to the FSB, multi-year guaranteed bonuses and severance payments that are not sensitive to risk or performance do not comply with the principles.

1.2.2 Initiatives at European level

At the end of April 2009, the European Commission revised its 2004 recommendation on directors' remuneration in listed companies and issued a new recommendation on remuneration specific to the financial sector. The scope of this recommendation extends across the entire financial services sector, including banks, insurance companies and collective investment schemes. The remuneration policy described therein is to apply to any employee whose professional activities have a material impact on the risk profile of the financial institution. According to the general principle, the remuneration policy must be consistent with a solid and effective risk management. Financial institutions should strike a balance between the fixed salaries and the bonus payments. The payment of a major part of the bonuses should be deferred; the underlying performance for bonus payments must take into account risk, capital costs and liquidity. Further measures relate to the areas of corporate governance, disclosure and supervision by supervisory authorities. Payments related to the early termination of the contract which are awarded on a contractual basis should not reward failure. In its revised recommendation on directors' remuneration in listed companies, member states are asked to set a cap on severance pay, which should usually be no more than two years' basic salary.

The Commission's recommendations are not legally binding regulatory instruments. As the Commission explained, this approach enabled it to adopt general principles applicable to the entire financial services industry and thus for financial institutions with different goals, activities and culture. The measures to be taken by member states following the recommendation can be tailored to each particular sector of activities. The Commission invites member states to inform it by end of 2009 of the measures they have taken. The recommendation will be followed by legislative proposals namely introducing supervisory sanctions in the form of higher capital requirements. The remuneration policies at banks and investment firms are to be addressed as part of the revision of the Capital Requirements Directive in June 2009.

Furthermore, at a European level, the Committee of European Banking Supervisors (CEBS) published its principles on remuneration systems in April 2009.[7] The CEBS paper contains five principles for remuneration policies in financial institutions. Where remuneration is performance related, both individual and collective performance are to be considered; the respective measurement of performance should include an adjustment for risks and cost of capital. Remuneration policies must also ensure that there is an appropriate balance between the fixed and variable salary components

[7] High-level Principles of Remuneration Policies, see http://www.c-ebs.org/; the representatives of the insurance supervisors, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), address with their own principles the same goals as the CEBS principles.

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and that any significant bonuses contain a deferred component that is linked to future performance. The CEBS clearly addressed the issue of severance pay and remuneration in relation to scenarios such as mergers and acquisitions; it determined that these payments should be related to achieved performance over time and designed in such a way as to not be a reward for failure.

The CEBS principles are intended to be implemented appropriately both at the level of the individual company and the group level. Within a financial institution, the principles apply to the entirety of the remuneration policy and to all employees, in particular management staff and other risk takers and risk managers. The remuneration policy should include all levels of the organisation and all categories of employees. The principles should be implemented by the end of the third quarter of 2009, with a transitional period allowed in order to make the necessary changes to existing contracts. These principles will be integrated into the CEBS Guidelines on Internal Governance. These aim at supervisory authorities and the financial companies regulated by these authorities. CEBS will further consider the integration of the principles under pillar 2 and any possible sanction mechanisms in more detail over the coming months.

Like the FSB principles, the initiatives at European level discussed above are in this form ultimately of a non-binding nature and do not constitute any specific compulsory obligations for financial institutions. They are merely requests that the recommendations be implemented into national law.

1.2.3 Initiatives by national supervisory authorities

The UK Financial Services Authority (FSA) and the supervisory authorities in the Netherlands (De Nederlandsche Bank together with the Netherlands Authority for the Financial Markets) in particular have published first principles for remuneration systems at a national level.

In March 2009, the FSA published a draft code on remuneration practices (the Code) with an accompanying consultation paper. The FSA expects to publish the definitive version of its Code after termination of the consultation period at the end of July/beginning of August 2009, with the Code coming into effect in November 2009. In deciding how to implement its plans, the FSA apparently will consider how the supervisory authorities for other major financial centres address the issue of regulation and integrate the international recommendations in their local supervisory legislation.

The FSA draft constitutes a framework for the remuneration policies of financial institutions and contains a general requirement [8] and ten related remuneration principles. The FSA intends to incorporate the general requirement as a rule into its Handbook. The FSA would in this case be authorized to directly enforce respective requirements against the financial institutions subject to its supervision. The FSA proposes to further integrate the ten remuneration principles as “evidential provisions”. An evidential provision is a type of rule that has evidential value in showing that another rule (in this case, the Code’s general requirement) has been breached or complied with.

[8] “A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.”

With regard to the scope, the FSA identifies two options in its consultation paper. The Code should in either case be applied to large banks, building societies and broker dealers whereupon the amount of regulatory capital, and therefore the systemic relevance is relevant. On this basis, 45 institutions would be covered by the principles. Foreign-controlled financial institutions domiciled in the UK as well as foreign subsidiaries of UK institutions supervised by the FSA would also be covered by the principles. Depending on the feedback received within the consultation phase, the FSA will decide on a second option regarding the scope; according to this, the scope would be extended to all other FSA-authorized firms, including smaller financial institutions and insurance companies. The FSA further announced that it will increase its focus within the supervisory programmes on the potential risks posed by inappropriate remuneration practices in all FSA-authorised firms (irrespective of any limitations to the scope of the Code).

The FSA explained that while it is competent for remuneration systems and practices, the levels of remuneration however are a matter for firm's board of directors and shareholders. They are responsible for introducing structures in their company that would ensure appropriate salaries throughout the entire company. The Code aims to promote awareness of the link between incentive systems and risks and to urge companies to introduce better practices. However, the Code will not prevent companies from providing large remuneration packages to employees so long as the company's performance justifies such payments and the payments are adjusted appropriately for risk. Special payments, such as sign on payments and severance pay, will not be banned by the FSA, but will be expressly subject to the Code.

1.3 Special situations for government-supported institutions

Financial institutions that have received government assistance during the financial crisis have come under a lot of pressure with respect to their remuneration policies. Politicians and the general public expect companies that have received government funding to keep a tight rein on their budgets and have little understanding if these financial institutions pay out large bonuses. Furthermore, the state funding, which was granted to strengthen companies' capital bases and liquidity, would not be serving its purpose if it were used for “voluntary” remuneration payments. The huge losses, which caused institutions to seek government funding in the first place, cannot justify any “profit-sharing” for employees in the form of large bonuses.

Almost all of the recent government support packages contain restrictions with regard to the remuneration policies of the financial institutions. These range from the deferral of bonus payments and overall salary caps for each employee to a blanket ban on any variable remuneration or other payments for the duration of the government assistance. Most of these restrictions were agreed between the state body providing the assistance (usually the ministry of finance or a special fund set up by the ministry of finance) and the institution receiving the support. Supervisory bodies had no part in this process.

The effectiveness of these measures is the subject of some debate. As a rule, they only tend to place restrictions on remuneration payments for board of directors and senior management. This overlooks the fact that at many companies the majority of variable remuneration is paid out to employees on levels below board and senior management and in the past, some of these employees have received significantly higher remuneration payments than the directors themselves.

The Swiss government has adopted an extended policy. It instructed UBS to review the variable remuneration paid to all employees of UBS for 2008, irrespective of rank and ordered UBS to get state approval for variable remuneration awards for 2008. The Swiss government delegated the implementation of the approval and supervision process to FINMA. Eventually, FINMA approved the size, composition and allocation of the UBS pool for variable remuneration in advance.

2 Mandate and objective of FINMA

The steps taken by FINMA and the proposed rules are based on the aims of the financial market supervision and the legal mandate conferred upon FINMA: the financial market supervision has the objectives of protecting creditors, investors, and insured persons as well as ensuring the proper functioning of the financial market.[9] FINMA protects the stability of its supervised financial institutions and of the entire financial system. Remuneration and incentive systems of financial institutions as well as the risks arising out of compensation practices must be in line with an appropriate and effective risk management framework. Just as much as unsustainable and short-sighted business conduct, inappropriate risks can threaten the capital and profitability of a financial institution, and therefore its stability. Remuneration systems and the incentives they induce should be part of corporate strategy and, as such, should not encourage inappropriate risk-taking but encourage sustainable business conduct. FINMA sees the promotion of sustainability and risk-aware behaviour as the core elements of solid remuneration systems. Solid remuneration systems, however, are only one element in the stability of a financial institution and the financial system. Good remuneration systems are not enough in themselves to prevent negative events. After all they were not the main cause of the current financial crisis. The proposed regulations are therefore just one building block of the financial market regulation and supervisory structure.

FINMA is now formulating regulations for remuneration systems. However, it is deliberately refraining from prescribing specific remuneration models. The actual structuring and application of remuneration systems is in the responsibility of the institution itself, as such systems should be part of the company's specific strategy and business model. FINMA will issue its principles in the form of a Circular. The provisions in the FINMA Circular are ultimately binding on the institutions, as they give FINMA's interpretation of the duties stated in the supervisory laws. There are supervisory procedures

[9] Art. 5 FINMASA

for responding to violations which ultimately can result in the withdrawal of the offending institution's licence.

FINMA does not intend to restrict pay levels. Given the large differences within the Swiss financial sector and also internationally, it would be almost impossible to set any universal ruling on pay. FINMA leaves this up to the market. At the same time, FINMA is aware that market mechanisms have fallen short in recent years. That is why FINMA wants to strengthen market discipline by enforcing transparency and disclosure provisions.

FINMA does not consider massive cuts of, or even a total ban on variable remuneration, which have been advocated in some quarters, as sensible. Variable remuneration can set incentives for employees to pursue the objectives and interests of the institution and enables them to share in the institution's success. If this works in both directions – i.e. employees share in the upside, but also in the downside –, variable remuneration can provide institutions with a degree of financial flexibility, they pay less when profits fall. Provided variable remuneration properly considers the interests of the company's owners and does not encourage inappropriate risk taking, it can serve its purpose for all the stakeholder groups of the institution.

FINMA considers discussions and best practice on the international level for its own regulatory activity.[10] FINMA takes part in international committees and has close bilateral contacts with other national supervisory authorities. Compensation is still a new regulatory field and largely unregulated within and outside Switzerland. Supervisory authorities have yet to form a consensus on how to develop a regulatory approach. Such a consensus is necessary however, due to the increasingly global nature of the financial system, large institutions and the labour market. FINMA actively contributes its perspective in international committees and bilateral discussions.

3 Regulation of remuneration under Swiss law

3.1 Corporate law and listing regulations: a balancing act

3.1.1 Effective provisions

Applicable Swiss law contains provisions regarding corporate governance mainly in the Code of Obligations (CO). Remuneration as an aspect of corporate governance is currently only regulated with regard to listed companies and their reporting obligations. The applicable regulations (Art 663b^{bis} CO) entered into force on 1 January 2007. These oblige listed companies to disclose details about remuneration of directors as part of their annual reporting. Listed companies must, amongst other things, disclose individually the remuneration packages of any member of the board of directors. With respect to the members of the executive committee, it is sufficient to disclose the remuneration in toto

[10] Art. 7 para 2 lit. d FINMASA

except for the highest compensation paid to a member of the executive committee, which must be fully disclosed. Remuneration is broadly defined and includes in particular fees, salaries, bonuses, credits, royalties, non-cash benefits, the allocation of holdings as well as conversion and option rights, severance payments, cancellation of debt and expenditures that constitute or increase claims to pension benefits and payments made for extra work.[11]

The stock exchange regulations include further rules for corporate governance and remuneration for listed companies. The SIX Swiss Exchange requires via its Directive on Information relating to Corporate Governance (the Corporate Governance Directive) that issuers meet certain criteria regarding disclosure of remuneration details. According to section 5 of the Annex to the Corporate Governance Directive, details need to be provided about the content and method of determining the remuneration paid to members of the issuer's board of directors as well as for its executive committee. Foreign issuers with primary listing at the SIX Swiss Exchange must apply Art. 663b^{bis} CO analogously. The Corporate Governance Directive applies the principle "comply or explain" for all information prescribed in the Annex. The issuer may opt not to disclose certain information, provided the annual report contains an individual, substantiated justification for each instance of such nondisclosure.[12]

The Swiss Code of Best Practice for Corporate Governance (the Swiss Code) issued by economiesuisse, the association of Swiss businesses from all sectors of the economy, also addresses remuneration. The Swiss Code is a self-regulation guide consisting of recommendations for Swiss publicly listed companies. Non-listed economically significant companies or organizations are encouraged to develop appropriate guidelines with guidance from the Swiss Code.[13] The Swiss Code was issued in 2002 and an Appendix was added in 2007 containing detailed recommendations on board of directors and executive board remuneration. These recommendations particularly require companies to structure their remuneration systems so as to reward conduct aimed at medium- and long-term success with compensation elements available at a later date.[14] The Swiss Code is merely designed to provide guidance, it has no legal authority.

3.1.2 Revision of company law

Corporate governance regulations in Swiss law are sometimes criticised as being incomplete and fragmentary. Since 2001 there have been many parliamentary initiatives designed to address this problem. As a result, the Federal Council published an announcement on revising company and accounting law in December 2007.[15] An extensive overhaul would improve the corporate governance,

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[11] Art. 663b^{bis} para. 2 CO

[12] Art. 7 Corporate Governance Directive

[13] Section 2.1 para. 3 Swiss Code

[14] Section 4 Appendix 1 of the Swiss Code

[15] Botschaft zur Änderung des Obligationenrechts (Aktienrecht und Rechnungslegungsrecht sowie Anpassungen im Recht der Kollektiv- und der Kommanditgesellschaft, im GmbH-Recht, Genossenschafts-, Handelsregister- sowie Firmenrecht) vom 21. December 2007, BBl 2008 1589 (Announcement for the amendment of the Code of Obligations (company and accounting law and amendments to the legal status of partnerships in limited liability

introduce new regulations governing capital structures and accounting law and update the rules governing annual general meetings.[16] In respect of private listed companies there would be also a right to know about the remuneration paid to top management, as these companies, unlike public companies, are not obliged to disclose compensation details in the appendix to the annual financial statements.[17] Shareholders as owners of the company would be entitled to influence the remuneration of the top management if they choose so. By being recorded in the articles of association, the General Meeting would make the corresponding competences binding.[18]

In February 2008, the popular initiative (i.e. a propose referendum) "Against fat-cat salaries" was submitted. This aims to improve corporate governance in order to cap excessive remuneration for executive managers in publicly listed companies. Board or management members of a company, for example, would be able not receive severance payments, “sign on payments” or bonuses in connection with corporate acquisitions or sales. Contraventions of the provisions outlined in the initiative would be treated as a criminal offence.

As a counterproposal to this initiative, the Federal Council announced a bill in December 2008[19] designed to complement the bill on company law drafted the year before. In view of the financial crisis and the problems with remuneration policies at a number of large corporations, the Federal Council integrated additional provisions in the draft law, aimed at strengthening protection of shareholders and in particular covering remuneration at publicly listed companies. The legal commission of the Council of States further tightened the Federal Council's counterproposal with regard to remuneration in spring 2009. It followed the proposal of the popular initiative by aiming to abolish severance payments, sign on payments and bonuses for corporate acquisitions and sales paid to members of the body of a company. The Council of States will discuss the draft in its 2009 summer session.

The draft bills passed by the Federal Council as part of its revision of company law are based on the corporate governance guidelines and the accompanying comments by the SIX Swiss Exchange. They contain provisions which would affect the provisions of the FINMA Circular.

In particular, boards of directors at listed companies would have to issue a policy on the remuneration of board members, the executive management and any committee members (remuneration

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law, public register of cooperatives, commercial register and company law) of 21 December 2007, FG 2008 1589.

[16] The provisions mentioned under Section 3.1.1 about transparency in remuneration at public companies were originally also part of this revision of company law and were enacted earlier on 1 January 2007.

[17] Art 697^{quinquies} draft CO. Transparency is also being reinforced in cooperative law: as per Art. 857 para. 2bis draft CO company law applies analogously for disclosure and provision of information regarding remuneration for the board of directors. The provisions applicable to public companies with listed equities apply to cooperatives with more than 2,000 members.

[18] Art. 627 clause 4 draft CO; these competences contain in particular the approval of compensation paid to members of the board of directors and stock option plans for staff and were forwarded from the Federal Council with an additional message in December 2008 about approval of compensation for the executive management.

[19] Notice about the popular initiative "Against fat-cat salaries" and to change the CO (company law) of 5 December 2008, FG 2990 299.

regulation).[20] This remuneration policy would set forth the responsibilities and procedures for determining remuneration, the foundation on which the remuneration is based and the specific elements of remuneration (especially employee participation programmes). The board of directors would provide the shareholders and, if they can demonstrate a protectable interest, the company's creditors with the remuneration policy on demand. The board must distinguish between basic remuneration and any additional compensation in the remuneration regulations.[21] This distinction is relevant insofar as the draft law states that the annual general meeting for listed companies is charged with approving the entire amount of the basic remuneration for the board over the coming term, as well as the additional compensation for the board for the past year. The Federal Council said in its announcement on basic remuneration that basic remuneration can contain fixed as well as success- and performance-related components. The general meeting must, however, be able to decide on a maximum amount. When establishing a fixed part of the basic remuneration package, the board would pay particular attention to the potential functional workload of each individual (e.g. Chairman, Vice-Chair, delegated duties, participation in a committee or similar body).[22] In contrast, the additional compensation comprises success- and performance-related components. As a result of the requirement for approval by the general meeting, the contractual agreements between the members of the board of directors and the company would need to make additional remuneration contingent on gaining shareholder approval.[23] The general meeting would also vote on the total remuneration pot for the executive board and advisory committee members for the past financial year via a consultative vote.[24]

The basis for the general meeting vote on remuneration would be the written remuneration report produced by the board of directors. The board would give its position on adherence to the remuneration regulations and, if applicable, articles of association.[25] The rules governing publication of the annual report would also apply to the remuneration report.

The additional draft on company law also contains provisions, which are not restricted to listed public companies. It aims to improve the mechanisms used by all public companies to allow shareholders to proceed against excessive remuneration. In addition to making it easier to claim for the return of unjustified payments, the duty of care incumbent on the board of directors and executive board as regards fixing compensation is mentioned and specified. The members of the board of directors and third parties involved with the executive management must ensure that the remuneration they approve is aligned to the business situation and the sustainable welfare of the company. The legally stipulated duty of care relates to remuneration which is or would have to be determined by board members and

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[20] Art. 731c draft CO

[21] Art. 731c para. 3 draft CO

[22] FG 2009 324.

[23] FG 2009 325.

[24] Art. 731f draft CO.

[25] Art. 731d draft CO.

third parties involved in the executive management of the company.[26] The business situation criterion demands that remuneration be in line with the company's performance at that time. The company's sustainable welfare criterion states that the remuneration policy should target sustainable earnings conducive to the company's long-term interests.[27] The Federal Council would grant a certain degree of flexibility to individuals at a company responsible for fixing the remuneration in this respect: high salaries can be permitted, despite a negative business situation, if it can be demonstrated that such salaries are required to attract or retain well qualified managers and specialists.[28]

3.1.3 Integrating the FINMA Circular with the other measures

It is one of FINMA's concerns to uphold good corporate governance as a requirement of good corporate organisation. However, FINMA's main priority is not shareholders' interests. FINMA therefore refrains from introducing directives designed primarily to strengthen proprietary rights, such as the owners of a financial institution approving remuneration packages. Instead the FINMA directives aim to make financial institutions structure their remuneration in a way that does not award incentives for taking inappropriate risks and which uses variable remuneration to promote, not impede, the institution's sustainable development. FINMA is thus going in the same direction as the proposal in the revision of company law, whereby the business situation and sustainable development of the financial institution are taken into account when deciding on remuneration. The new provisions in the company law are, however, not far-reaching enough by themselves to achieve FINMA's goals.

The FINMA Circular is in its scope more extensive than the current law, including its proposed amendments. The Circular is not restricted to publicly listed companies (and cooperatives where applicable). The Circular applies to all financial institutions under FINMA supervision, which employ a certain number of staff or whose remuneration systems allow large total or variable remunerations. The legal form of the financial institution or whether it is publicly listed is immaterial in the FINMA proposal. The Circular is not restricted to remuneration for the top management, it applies to all employees.

While the FINMA Circular sets additional remuneration requirements beyond those in the current or prospective CO provisions, it does not replace what is the CO. Where the CO contains different provisions or stricter ones, they will remain binding on the applicable companies. The Circular is designed to act in harmony with company law. Of course, the new company law provisions are not yet finalised.

As indicated above, some aspects of the proposed FINMA regulations exceed the CO regulations. FINMA proposes that companies use a comprehensive risk review when structuring and implementing remuneration systems, including variable remuneration. The Circular also contains guidance on what

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[26] According to statements made by the Federal Council this means remuneration for members of the board of directors, any committees, the executive board and top-tier management, see FG 2009 318.

[27] FG 2009 318 f.

[28] FG 2009 319.

to avoid in compensating risk-control functions and on how to incorporate control functions in the design and operation of the remuneration policy. The financial institutions are charged with reporting on their compensation. Such report is to be divided between the board of directors, executive board and employees and must distinguish between the different forms of remuneration. Special payments (sign on payments, severance payments) must be documented and justified as well. The disclosure of remuneration follows the provisions applicable to the publication of the annual report. The remuneration report does not have to be included in the audited annual financial statements.

In other areas, however, the Circular is less stringent than the CO. For example, the Circular allows a financial institution to deviate from the Circular's rules in specific instances and subject to sufficient justification, provided it discloses such deviation and, obviously, provided such deviation does not contravene applicable law.

The term “total remuneration” in the Circular covers all payments made to an employee, including those listed in Art 663b^{bis} CO.[29] The Circular does not, however, distinguish between basic and additional remuneration like the revised draft company law. Instead it refers to total and variable remuneration as well as special payments. According to FINMA, the basic remuneration mentioned in the Federal Council draft can include variable remuneration as referred to in the Circular. The categorisation of specific remuneration types as basic or additional remuneration is a matter for interpretation by Federal law. According to the message from the Federal Council severance payments in any case count as additional remuneration.[30]

3.2 Employment legislation: a balancing act

There is a degree of uncertainty in Swiss employment law regarding specific agreements on variable remuneration. As an employer a financial institution could have a problem if desired elements of its remuneration policy, e.g. discretionary bonuses, are not necessarily seen as such by the Swiss courts. Financial institutions are nevertheless obliged to observe private employment law when forming their remuneration systems.

Textbox 3: Need for action on Swiss employment legislation

In the Code of Obligations (CO) there are many provisions on salary as a component of the working relationship starting with Art. 322 CO. However, there is no mention of the word "bonus" anywhere in Swiss employment law.[31] A bonus can be defined as a *gratuity* as per Art. 322d CO or as a *salary component* as per Art. 322 CO. A salary component is when, for example, the bonus agreement

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[29] Article 697^{quater} draft CO basically corresponds to the present Article 663b^{bis} CO.

[30] FG 2009 325.

[31] One reason for this may be that variable remuneration, which is normal in the financial sector, has been taken over from the English-speaking business world where the legal regime allows employers to make entirely discretionary payments.

entitles the employee to share in the profit, turnover or other part of the business result (Art. 322a CO). A gratuity, on the other hand, is legally defined as an extraordinary bonus, over and above the salary and paid at specific times.

The distinction between gratuity or salary component is relevant, because gratuities allow for much more flexibility than salaries. If a bonus counts as salary, this means that its payment cannot be made contingent on other conditions, such as the employee not having given/received notice. The employee is entitled to receive a form of remuneration classified as a salary component. The jurisdiction of the Federal Supreme Court means that care must be taken not to have a bonus supposed to be payable at the employer's discretion (i.e. which the employer reserves the right not to pay) counted as a salary component in the event of a dispute.

Swiss courts are delivering more and more verdicts on the nature of bonus agreements. Legal precedents work on the basis that an objectively definable (predetermined and agreed sum) amount counts as salary[32] not as a gratuity. The payment of a gratuity is entirely at the employer's discretion, for example if the bonus (and its amount) depends on the business result and the employee's personal performance. However, there are additional criteria the courts take into account. The longstanding, regular and unconditional payment of a gratuity qualifies it as a salary component. For this reason employers regularly add a discretionary proviso to the bonus payment and the employment contract for the bonus payments part. As the Federal Supreme Court recently ruled, however, this proviso may be invalid if it is applied randomly and without sufficient intent and the employer demonstrably shows that it feels obliged to pay a gratuity.[33]

To protect the character of a special remuneration, the gratuity can only be of secondary importance according to the Federal Supreme Court. If the gratification is regularly worth more than the salary, it loses credibility as an add-on according to the Federal Supreme Court.[34] This likely applies to members of management too as the Federal Supreme Court has ruled (albeit in another context) that Swiss employment law does not distinguish between employees according to their hierarchical position. The provisions on employment contracts apply to all hierarchical levels; the key issue is whether someone qualifies as an employee or whether his/her contract qualifies as some other category of contract.[35] This ruling means in effect that high bonuses qualify as a salary component, meaning the employee is contractually entitled to them. The upshot of this is that large or perhaps even excessive bonuses may be supported by law. There is thus need for action. The challenge facing the legislature is to move away from the precedent established over years by the Federal Supreme Court. In discussions held between FINMA and market participants various representatives of HR

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[32] The Federal Supreme Court refers to this as "variable salary component" (BGer 4A_115/2007, ruling of 13.7.2007, E. 4.3.4) or "variable salary" (BGer 4A_511/2008, ruling of 3.2.2009, E.4.2), not to be confused with the term used in the Circular "variable remuneration".

[33] Federal Supreme Court ruling of 3 February 2009, 4A_511/2008 and 4A_509/2008.

[34] Rulings by the Federal Supreme Court of 3 February 2009, 4A_511/2008, E.4.1, and 4A_509/2008, E. 4.1, and 13 July 2007, 4A_115/2007, E.4.3.5.

[35] Ruling of the Federal Supreme Court of 1 October 2004, 4C.237/2004, E. 3.3 and BGE 130 III 213, E. 2.1.

departments have expressed a wish for clearer guidance about bonuses in employment law. The current legal regime is also restricting the supervisory authority of FINMA.

Compensating employees through employee participation programmes is also a sensitive issue from a contractual angle. Giving shares or options as part of a contractually agreed salary can be equivalent to a contractual obligation of the employee to use their salary in the interests of their employer.[36] Such an agreement in an employment contract would also be unenforceable according to Art. 323b para. 3 CO[37] (known as the "truck prohibition“) for management[38] and could lead to the agreement becoming void. Complex legal issues are also raised by deferred remuneration.

The lack of a clear legal framework and the employee-friendly rulings of the Swiss courts complicate the organisation and implementation of bonus agreements. Furthermore, depending on the geographic scope of a financial institution's activities these questions may not be restricted to Swiss law; they may also apply to other locations and jurisdictions outside Switzerland.

3.3 Tax legislation: a balancing act

Remuneration is taxed as income earned by the employee, while the employer lists it as an expenditure. The organisation and implementation of a company's remuneration system is thus also influenced by taxation considerations. The tax treatment of remuneration components is a complex subject which is approached differently by the different authorities in Switzerland and, as a result, is dogged by various legal uncertainties. One complicated area is tax treatment of employee participation programmes.

Textbox No. 4: Taxation of employee equity-based compensation: legislative process adjourned

Art. 17 of the Federal Law on Direct Taxation provides the legal basis for taxing the financial value of remuneration paid by means of equity-based instruments. However, this legal basis does not cover a situation where employee shares and options are deferred. The question is whether the income is earned when the equity-based compensation is allocated or when it actually becomes available to the employee. As for employee options the question is whether they count as income when they are allocated, when they are irrevocably transferred or when they are exercised. These issues have partly been assessed very differently by the various tax authorities. That is why a clear legal basis is needed to restore certainty to taxing the financial value of these compensation components.

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[36] Ruling by the High Court of Lucerne of 3 March 2004, LGVE 2004 I S. 48 ff, in which the awarding of options whose monetary value would not be made immediately available to the employee and which would be void in the event of notice being given or received as being an infringement of the truck prohibition (the Federal Supreme Court rejected the appeal against this ruling).

[37] According to Art. 323b para. 3 CO agreements about use of salaries to benefit the employer are invalid.

[38] BGE 4C.237/2004 from 1 October 2004, E. 3.3.

In November 2004 the Federal Council submitted to Parliament the draft of a federal law on taxing employee equity-based compensation.[39] The idea was that employee shares be taxed when they are received by the employee (that is when they are transferred according to civil law and the respective dividend rights are granted), as per the practice at that time. The deferral of the employee shares is taken into consideration by reducing the taxable value of the share to reflect the duration of its deferral. Listed employee options, which are freely disposable or exercisable, are also taxed when they are acquired. Non-listed or blocked employee options, on the other hand, are only taxed when they are exercised. The previous practice of taxing employee options when they are allocated should now be discontinued. Any taxable profit made by exercising options is reduced by a certain percentage per year of deferral. These new provisions are to be included in the Federal Law on Direct Taxation and in the Federal Law on Harmonisation of the Direct Taxes of the Cantons and Municipalities.

In the summer session of 2008, the Council of States upheld its different stance vis à vis the National Council in respect of the extent of the reduction for deferred employee options. The Committee for Economic Affairs and Taxation of the National Council subsequently decided to resume its activities when the National Council and Council of States will have passed the revised Family Taxation Act. The Committee delayed giving its opinion on the grounds that priorities have to be set in taxation policy. The administration, alleged the Committee, also needed more time for a closer analysis of the effects of remunerating staff with options, not just from a taxation angle but also in general business terms.[40]

Taxation law places certain constraints on financial institutions in structuring remuneration programmes. Below are some examples of issues to provide an insight into some of the problem areas:

- In forming remuneration plans and considering the relationship between equity-based remuneration and cash payment, it should be taken into account that the employee needs liquid assets to pay the tax charged against his/her income. If the employee or organ of a company working at a financial institution only receives blocked equities, they may not have the means of paying the total tax charged against the financial value of their assets. This is an argument in favour of a cash bonus.

- Employees may be obliged to declare something which they do not ultimately receive, depending on the structure of the remuneration system, e.g. if they pay taxes on the financial value of their assets, but a subsequent fall in the share price means they actually receive less than they declare.

[39] Message pertaining to the Federal law on taxation of equity-based compensation for staff of 17 November 2004, FF 2005 464 ff.

[40] Fact sheet issued by the Federal Department of Finance for taxing equity-based compensation, see http://www.efd.admin.ch/documentation/zahlen/00579/00608/00638/index.html?lang=de

This can happen, for example, when options are taxed when they are awarded instead of when they are exercised. However, this may be exploited as an incentive in remuneration policy as well.

- Managers working for a global financial institution usually change their residence and place of work more than once during their term of employment with that institution. It is therefore possible that an employee is remunerated (with deferred equity-based assets) in one country and moves to another one before he/she actually gets access to the remuneration. Different income tax systems by the countries involved are therefore also relevant when forming remuneration systems.

Different foreign tax regimes pose major challenges to global financial institutions, where employee participation programmes are implemented worldwide, which requires extensive research into local taxation regimes. There are thus various aspects and questions raised by tax law which go beyond FINMA's remit and which influence the precise nature of remuneration systems.

4 Regulatory approach adopted by FINMA

4.1 Regulation based on principles

The remuneration system is a major aspect of the governance of a company and must be comprehensively aligned to the company's specific requirements and situation. While the basic features of remuneration systems may appear similar, the details vary substantially. Factors such as strategy, business lines, regional focus and competitive environment all influence the way a remuneration system is structured and implemented. There is therefore no single remuneration system that yields good results for *all* institutes. If a supervisory authority were to prescribe a particular remuneration system, it would be forcing the majority of firms to introduce a system that is less than ideal for their specific needs.

The same applies to the level of remuneration. Remuneration levels vary from business to business and from country to country. Salaries in retail banking are generally lower than in investment banking. Employers in New York are forced to pay higher salaries than in Zurich because of the higher cost of living there. There are also variations within Switzerland. Salary levels in the Canton of Jura, for example, are substantially lower than in the Canton of Zurich. These issues must be taken into consideration when setting upper limits for remuneration, requiring a salary cap to be defined specifically for each “submarket”, and this must also be updated regularly. Defining a single cap for all markets would be counter-productive as this could even push up salary levels in lower market segments.

However, it is possible to define principles that would apply to all remuneration awarded. Such principles would still allow institutions and the market to design the structure of remuneration systems

and to determine remuneration levels. However, FINMA believes it is also necessary to set out certain implementation rules explaining how FINMA expects these principles to be implemented in practice.

This principles-based method of regulation also focuses on those aspects of remuneration systems which are of primary concern from a regulatory perspective. The aim is to achieve risk-based regulation that deals with the relevant issues clearly and effectively, while leaving all other aspects unaffected as far as possible. Any other approach would run the risk of creating undesirable side effects, thus undermining the effectiveness of the regulatory measures adopted. The same applies to any approach to regulation that is overly specific. This can rapidly lead companies to find ways to get around the rules and could result in efforts at “forum shopping” and “regulatory arbitrage”.

In regulating remuneration systems, FINMA therefore proposes to adopt a risk-oriented approach based on principles. These principles and the implementation rules are formulated in such a way that they can be applied to all financial institutions irrespective of size or the type of business operations engaged in.

4.2 Comply or explain

Although the principles-based approach permits a certain amount of discretion, it may not be possible for institutions to apply specific principles in whole or in part. This may be for institutional reasons or due to the conditions prevailing in specific business areas and regions. The “comply or explain” principle proposed by FINMA allows institutions some latitude in compliance, while requiring them to explain any departure from the rules. FINMA will only accept non-compliance with the rules in exceptional circumstances. Institutions are required to disclose to FINMA and to the recipients of their annual reports the specific reasons for any departure from the rules laid down in the Circular and the types of remuneration affected. A general reference to market practices would be regarded insufficient in this context. The institution must explain how any such variation in practice relates to FINMA’s core requirements, i.e. governance and the alignment of remuneration systems with performance, sustainability and risks, and how it will deal with potential risks and adverse effects.

4.3 Legal foundation

Banks, insurance companies, securities dealers and licence holders under the Collective Investment Schemes Act must have organisational structures in place that can capture, limit and monitor all significant risks.[41] In line with the organisational rules of the company, each financial institution is therefore required to implement a system of risk management that is comprehensive and designed to capture all risks. There are inherent risks in incentive and remuneration systems, which financial institutions also need to incorporate into their risk management processes. Risk management and relevant internal control mechanisms ensure the early identification and assessment of potential risks and the early adoption of measures to prevent or at least protect against the emergence of substantial

[41] Art. 22 (1) ISA, Art. 3 (2) (a) BA; Art. 10 (2) (a) SESTA; Art. 14 (1) (c) CISA

risks or risk accumulations.[42] Financial institutions are further required to set up an effective system of internal controls covering all business operations.[43] Groups and conglomerates subject to consolidated supervision by FINMA must also satisfy these requirements in relation to organisational structure and risk management.[44]

Furthermore, a reasonable system of remuneration is an element of effective risk management and appropriate organisational structures within financial institutions. It also forms a key component of effective corporate governance within a company. Appropriate remuneration and incentive schemes, which serve the long-term interests of the company, help to achieve long-term corporate objectives and promote ethical practices, help ensure standards of integrity, ethical behaviour and a culture of responsibility as core features of corporate governance. This is explicitly set out in Circular 2008/32 "Corporate governance - insurers", which applies to insurance companies, insurance groups and conglomerates.[45] Various provisions applying to the remuneration systems of banks and securities dealers are already set out in FINMA Circular 2008/24 "Supervision and internal control". Margin number (Mn) 13 of FINMA-Circular 2008/24 provides that the board of directors shall ensure that control mechanisms are not circumvented as a result of pressure placed on staff to achieve targets at any level in the hierarchy. The board of directors is also required to ensure that compensation systems do not provide any incentives to disregard internal control mechanisms. The Circular also specifically provides that remuneration systems for staff employed within internal audit, compliance and risk control may not offer any incentives that would lead to conflicts of interest. In particular, the remuneration of staff employed in these functions must not be dependent on the performance of individual products and transactions.[46]

4.4 General application of the Circular to all supervised financial institutions

The organisational requirements laid down in financial market legislation require that all supervised financial institutions have appropriate, comprehensive risk management systems in place. Accordingly, remuneration systems should not merely be regulated in relation to financial institutions of systemic importance or institutions that have adversely affected the financial market in the past. There is also evidence of remuneration practices in other financial institutions creating false incentives, which could have a detrimental impact on the financial institution, its stakeholders and the Swiss financial market in future. At the same time, the increasing complexity of risks poses a challenge to both the risk management and risk control functions within financial institutions. One response to these challenges is an appropriate remuneration system. Proper pay-related incentives help to prevent misconduct on the part of staff employed within financial institutions and thus any future adverse affects on the Swiss financial market. The Circular is therefore intended to apply in principle to all financial institutions

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[42] cf. Art. 96 (1) SO

[43] Art. 27 (1) ISA, Art. 9 (4) BO, Art. 20 (1) SESTO, Art. 12 (3) CISO

[44] Arts. 67, 68, 75 and 76 ISA, Art. 3f BA, Art. 14 SESTA

[45] Mn 9 FINMA-Circ. 2008/32

[46] Mn 68, 103 and 117 FINMA-Circ. 2008/24

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supervised by FINMA, including financial groups and conglomerates and insurance groups and conglomerates subject to consolidated supervision by FINMA.[47]

4.5 Exemption from implementation requirements

The Circular is thus intended to encompass a wide target group. FINMA goes further in this respect than most of the international initiatives (cf. 1.2 above). However, the Circular sets out a range of mechanisms that may result in exemption from implementation requirements.[48]

Nevertheless, FINMA also recommends that exempt financial institutions review the remuneration systems implemented by them to ensure that these are adequate and appropriate. The rules laid down in the Circular may be used as guidance for such purposes.

4.5.1 Remaining below specific thresholds

The Circular provides that financial institutions must structure their remuneration models and incentive systems in such a way as to promote adequate risk management rather than creating additional risks for the institution, its stakeholders and the Swiss financial system. The potential expense incurred by financial institutions in making any adjustments required under the rules should not be underestimated and as a result any such adjustments should also serve the Circular's intended purpose. Companies which in the circumstances appear to have adequate remuneration systems are therefore exempted from the implementation requirement. In certain circumstances, regulation may therefore be dispensed with.

The Circular provides that financial institutions must remain below at least *two* of the *three* thresholds described below:

- *No person may receive a total remuneration which consists of more than 20% of variable remuneration and special payments.*[49]

  Remuneration systems with a smaller variable component should generally permit fewer incentives and pose fewer risks than systems where staff may be paid a substantial variable component on top of their base salaries under their contracts of employment. As a result, wrong incentives essentially arise from additional remuneration components that staff are in a position to influence. In particular, where these additional remuneration components constitute a significant proportion of the total remuneration, they are likely to induce staff to act in a self-interested manner. FINMA accepts that these types of incentive are immaterial if the employee's base salary can be increased by no more than one quarter and where the variable remuneration may not exceed 20% of the total remuneration payable respectively. In calculating the threshold, the

[47] Mn 5

[48] Mn 6 to 11

[49] Mn 8

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amount of variable remuneration actually or potentially paid to staff, thus creating specific incentives, is determinative. The threshold need not actually be exceeded and also applies to the remuneration awarded to the board of directors and individuals appointed to manage the business.

- *No person may receive total remuneration exceeding CHF 800,000 or the equivalent in a year.*[50]

  The cost incurred by a financial institution in making any adjustments required for implementation purposes is justified where a high threshold value applies to the variable remuneration component as well as to remuneration in general. High threshold values may be recognised, for example, where the variable remuneration component constitutes a major cost item relative to the total remuneration payable, or total personnel expenses are relatively high. This may be the case, for example, where the financial institution pays employees high salaries. Companies may deliberately align high total remuneration levels, as well as high variable components, with corporate strategy and strategy implementation. However, where remuneration levels are high, there is even more justification and need for the regulator to set limits to clearly address related risk management issues, and to lay down corresponding transparency rules to ensure that relevant information is disclosed to the institution's stakeholders.

- *The financial institution employs not more than 100 people on annual average.*[51]

  There is a reduced need for regulation in respect of companies which, due to their size and organisational structure, are able to ensure the operation of adequate remuneration systems through suitable mechanisms. Where no more than 100 staff are employed (including the board of directors and individuals appointed to manage the business) it may be assumed that the company's management and organisational structure are suitably transparent so that sufficient priority is afforded to remuneration systems and to staff incentives created under such systems and that appropriate self-regulation is in operation. Moreover, financial institutions with a smaller workforce are presumed to pose less risk to the stability of the financial market. With regard to groups and conglomerates falling within the scope of the Circular, the number of staff employed across the group is relevant. In the case of branch offices of foreign financial institutions, the staff employed by the branch must be summed up.

Any exemption from implementation requirements must be disclosed to FINMA and other recipients of the annual report as part of the year-end reporting process. In addition to the fact that the financial

[50] Mn 9

[51] Mn 10

institution is exempt from implementation requirements, the circumstances resulting in such exemption must also be disclosed.[52]

4.5.2 Foreign branch offices and subsidiaries

The Circular also applies in principle to subsidiaries and branch offices outside Switzerland that are supervised by FINMA on a consolidated basis. Certain remuneration practices outside Switzerland are evident which may pose potential risks to supervised financial institutions within Switzerland. FINMA recognises that implementation of the Circular across an entire group may be problematic. In some cases, for example, the provisions of applicable foreign law (e.g. employment law) may conflict with the provisions of the Circular. It is also possible that a financial institution may be significantly disadvantaged on foreign labour markets as a result of requirements laid down in the Circular. In such circumstances, the Circular provides that financial institutions should inform FINMA accordingly. FINMA will assess the situation and consult where necessary with the relevant foreign supervisory authority. Having regard to the overall circumstances in any given case, FINMA may decide to exempt the financial institution from the obligation to implement the Swiss rules for its staff employed at foreign locations.[53]

4.5.3 Branch offices of foreign companies

The Circular must be implemented mutatis mutandis at Swiss branches of foreign financial institutions. This would mean, for instance, that the remuneration of staff employed at the branch office would be governed by the rules laid down in the Circular. However, remuneration systems and employee share ownership plans in particular are usually applied across groups. The Circular is not intended to prevent the use of such remuneration models for Swiss employees, although such models comply with general minimum standards for adequate remuneration systems. Such entities of foreign companies may therefore be exempted from the rules laid down in the Circular. However, such exemptions are only permitted if the companies concerned are subject to equivalent regulation in the foreign location in which the head office is based, and the head office is also required to implement such rules in Switzerland.[54]

4.6 Implementation requirement in respect of exempt financial institutions

If remuneration structures and levels or the number of employees in a company are below the thresholds set out in 4.5.1 above, it could be assumed that a financial institution's remuneration system does not give rise to any significant risks for the various stakeholders or the financial market. However, such an assumption could be mistaken: even if the variable component of the total

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[52] Mn 11

[53] Mn 6

[54] Mn 7

remuneration is less than 20% or the salaries do not exceed CHF 800,000, wrong incentives may have the cumulative effect of encouraging employees to incur risks for the financial institution. It is also possible that a financial institution employing less than 100 staff may still be, or become, significant or even systemically important, e.g. owing to its total assets. Similarly, a financial institution may reasonably be subject to the rules laid down in the Circular on the grounds of its risk profile and the nature of its business activities.

As a result of such considerations, FINMA explicitly reserves the right in the Circular to require the partial or complete implementation of these rules by financial institutions that would not otherwise be obliged to implement them.[55] This right is also enforceable against branch offices of foreign financial institutions.

4.7 Inclusion of all forms of remuneration

Employers compensate staff in many different ways. In addition to cash payments such as the base salary, employees are often entitled to pension and insurance benefits (under state or private sector schemes or otherwise). Capital market instruments such as shares or synthetic products such as options are also employed. Some staff receive payments in kind or other fringe benefits. The composition of a remuneration package is ultimately a strategic decision of the company, also based on prevailing market conditions and regional variables. FINMA therefore needs to take into consideration all remuneration paid by financial institutions to individuals under employment or executive service contracts, irrespective of the actual form of remuneration. All remuneration payments are therefore subject to the proposed rules.

4.8 Valuation: accounting and management perspectives

Remuneration must be valued, both for the purpose of preparing income statements and quantifying remuneration at institutional level or at the level of individual staff members. In the case of cash payments that are transferred to and immediately available to employees, this is straightforward. Such payments are valued at their nominal value. One example of this would be the monthly base salary. Such remuneration payments are also charged to the institution's income statement at nominal value.

The issue is more complex in the case of deferred forms of remuneration, where employees do not receive the cash payment until a later date, e.g. compensation in the form of shares. These may fluctuate in value until the employee sells them. The net realisable value of share compensation cannot be predetermined, just like the future share price. Institutions often intentionally expose remuneration to such fluctuations in value,[56] by transferring ownership of shares to employees but prohibiting the sale of those shares for a period that may often extend to several years. If the ownership of these compensation instruments is immediately transferred to the employees, value

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[55] Mn 12

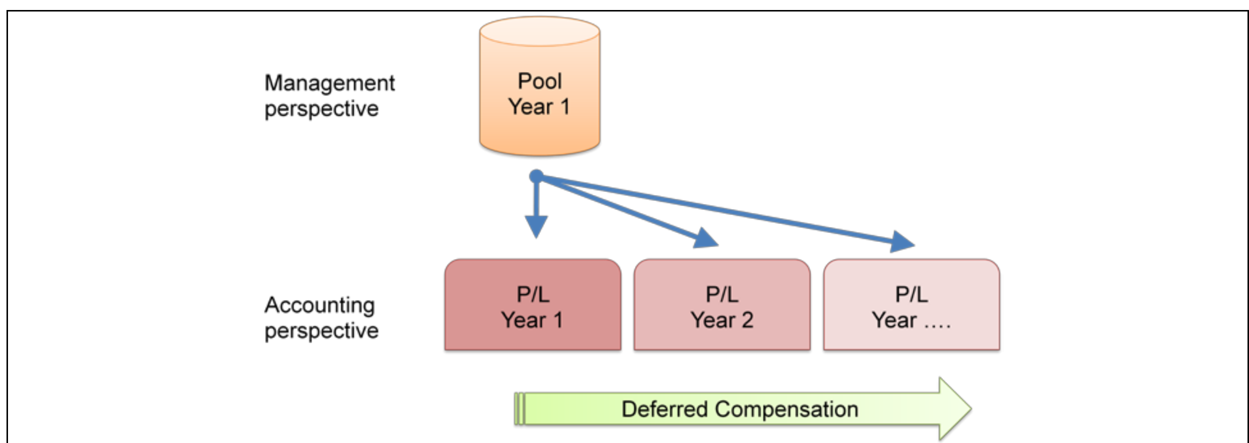
[56] Tax requirements are also relevant in this respect.

fluctuations are borne by the market, rather than by the institution itself. In contrast, synthetic compensation instruments may impact directly on the institution's annual results if it is acting as counterparty (e.g. in the case of options).

Even cash compensation may be subject to fluctuations in value, if the institution retains the ability to adjust the level of payments. An example of this would be the "bonus bank", where remuneration is deposited but only made available to the employee after a certain holding period. During the holding period, the institution may, upon the occurrence of certain predefined events, take back all or some of the remuneration deposited in the "bonus bank" ("clawback" or "malus" mechanisms). Upward adjustments are also possible e.g. where the final value is contingent upon performance factors (e.g. in the case of "performance units").

From an accounting standpoint, deferred remuneration payments constitute future liabilities and must be valued at regular intervals based on a "true and fair view". Any changes in valuation are reflected in the income statement. Deferred remuneration payments therefore have an impact on an institution's income statement (in the form of debits or credits) until ownership is irrevocably transferred.

However, institutions must assign a value to the remuneration at the time of allocation. Where the remuneration corresponds to past results and performance (e.g. the overall pool of variable remunerations is set for a given year), the value of remuneration must be linked to profit and performance factors. The institution must be aware of the future cost of deferred remuneration, even if this is not yet reflected in the annual results.



Institutions therefore view remuneration from two perspectives:

- ***Accounting perspective***
  The accounting perspective is based on the income statement and is published in the annual report. It conforms to applicable accounting standards and includes all remuneration expenditures

debited or credited in the relevant financial year. However, deferred remuneration is only fully charged to the income statement in future years. Also, annual results do not just include charges for remuneration paid in the relevant year, but also those relating to deferred remuneration awarded for previous years. Where deferred remuneration is employed, the remuneration awarded for a given year will not be properly reflected in the income statement.

- ***Management perspective***
  Like the accounting perspective, the management perspective relates to a particular period (e.g. a year). However, it does not look at the remuneration expenditures accruing *in this period*, but at the remuneration *awarded for this period.* The management perspective is thus oriented forwards as well as backwards. The retrospective component links the level of remuneration allocated in the period with profit, performance and risk figures for that period. The forward-looking component ensures that all charges arising under this remuneration are taken into consideration, irrespective of the time at which they are actually payable and recognised in profit and loss. FINMA expects a valuation to be made at present value (from the institution's perspective) at the time of allocation, unless the accounting standards require a higher valuation. Fluctuations in market prices will result in value adjustments, so the actual charge may be higher or lower than originally reflected under the management perspective.

In a stable market environment, the accounting and management perspectives are more closely aligned, because charges arising from remuneration in previous years are offset by future charges accruing from remuneration payable in later years. In boom phases, the accounting perspective tends to produce lower charges, as any increase in current remuneration is only reflected in results for later years. This applies in particular to charges arising from remuneration instruments for which increases in value must be borne by the institution (e.g. option schemes).

Financial institutions currently use the management perspective as the basis for accumulations and distributions of variable remuneration as well as for the disclosure of remuneration paid to senior management under corporate governance rules. FINMA's considerations are similarly based on the management perspective, and it also expects institutions to disclose elements of the management perspective in future.

5 Principles for sound remuneration systems

5.1 Comprehensive governance by the board of directors

Principle 1: The Board of Directors is responsible for design and implementation of the financial institution's remuneration policy and issues the remuneration regulations.

The remuneration policy is a core element of corporate strategy. This is especially true for financial institutions, where personnel costs and variable remuneration often account for a large proportion of

operating costs, thus impacting the institution's capital and liquidity position. Variable remuneration also affects risk-taking by the financial institution. As a result, the board of directors must be responsible for remuneration policy across the institution as a whole. The involvement of the board of directors needs to be formalised to a certain extent in the interests of stressing its global responsibilities. For this purpose, FINMA requires boards of directors to issue remuneration regulations.[57] As part of this process, boards of directors must ensure that the remuneration systems and the implementation of such systems satisfy the requirements of the proposed Circular.

Provided the board of directors retains its overall responsibility and management role, it may delegate aspects of the remuneration policy to a committee or individual members.[58] The appointment of a remuneration committee is usual and is also consistent with applicable corporate governance recommendations.[59]

For reasons of practicality, the details of remuneration policy below executive board level and the specific implementation of policy are not directly determined by the board of directors. Such matters are usually dealt with by the executive board or delegated within the firm's hierarchy. Insofar as boards of directors are still required to determine the remuneration of senior management and the overall level of variable remuneration or the size of the overall pool,[60] they retain control over the core elements of the firm's remuneration policy. Special payments such as severance or "sign on" packages should also remain firmly under the control of the board of directors: if the financial institution decides to continue making such payments, the remuneration regulations must assign responsibility to the board of directors for approving any such payments above a given level. To enable the board of directors to discharge its responsibilities in respect of any delegated duties, the executive board must report to the board of directors on a regular basis with regard to all key remuneration issues.[61]

Principle 2: The remuneration system is simple, transparent and enforceable, as well as oriented towards the long term.

Remuneration systems must be set up in such a way as to be comprehensible to affected employees and all levels of authority involved. Effective governance can only be achieved if the attributes and effects of the remuneration system are readily understood. Simple and transparent structures are therefore a quality criterion for remuneration systems.[62] This also means that the number of remuneration models used by institutions should be kept to a minimum and these should be broadly applicable. If the long-term incentive effect of these models is to be achieved, they need to generate

[57] Mn 21
[58] Mn 23
[59] cf. section 4.1
[60] Mn 22
[61] Mn 24
[62] Mn 25

acceptable results irrespective of business performance. Accordingly, remuneration models must be designed to ensure that they are sustainable even if the financial institution performs poorly.[63] The remuneration system should only be adjusted if the adjustments would result in long-term improvements to the system.[64]

Accordingly, employment contracts must provide for variable remuneration that is flexible in practice and also specify that such remuneration may not be payable if business performance is poor. FINMA expects financial institutions to ensure not only that the provisions of their employment contracts are in line with the Circular and with remuneration regulations, but also that the terms of the contract would be legally enforceable where necessary.[65] This applies in particular to clauses providing for variable remuneration to be revised downwards (e.g. in the event of poor business performance or where malus or clawbacks apply).[66]

Principle 3: In designing and applying the remuneration system human resources and control functions are involved.

In the interests of effective governance throughout the company, checks and balances must also be established at an operational level. It is important to prevent individual business units within the institution from defining or implementing their remuneration policies without consulting equal or higher-level functional units. Risk management, compliance and legal departments should ensure that the approach to risk described below is appropriate and consistent with the institution's risk strategy and is reflected in its remuneration policy.[67] Human resources departments should ensure that the remuneration policy for the institution as a whole is coherent and corresponds to its human resources strategy and best practices for human resources management.

It is essential that compensation matters are assessed from an institution-wide perspective at all times. To this end, it is advisable for large and highly diversified institutions to set up centralised control functions and human resource departments for the institution as a whole, which will be responsible for coordinating and monitoring the work performed by the relevant officers within divisions. It is important to ensure that these centralised functions and departments are not too closely aligned with or embedded within operational units, so that remuneration policy within individual units can be properly managed and monitored.[68]

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[63] Mn 27

[64] Mn 26

[65] Mn 28

[66] cf. section 3.2above on problems in relation to bonus arrangements under Swiss employment law and the need for new legislation.

[67] Mn 30

[68] Mn 30

However, even control functions are not entirely independent, as they ultimately report to the executive board. It is therefore important to involve the internal auditors, who report directly to the board of directors. The internal auditors must also be consulted on all remuneration issues. The remuneration system and its implementation should be incorporated into the audit plan at appropriate intervals.[69]

5.2 Capturing all risks

Principle 4: The structure and level of total remuneration are aligned with the financial institution's risk policy and enhance risk awareness.

There will always be risks associated with financial intermediation. It is neither possible nor desirable to eliminate risk entirely. Moreover, prudent risk-taking is ultimately a key value driver for financial institutions. Providing employees with incentives to generate revenue also provides them with implicit incentives to take risks. At the same time, the institutions' appetite and tolerance for risk is limited. Staff should not be offered any incentives to exceed these limits.

All risk-taking must therefore be consciously managed and controlled. Remuneration policies that adequately capture risks can assist in this process. In theory, this can be achieved simply by ensuring that anyone who incurs a risk is also liable for any loss that may be suffered as a result. As the risk taker knows what risks he is willing and able to incur, he can decide on that basis which risks to take or not to take. However, employment contracts do not operate in this way. Most employees of financial institutions work mainly with third party capital. Any losses are allocated unevenly. The maximum loss that may be suffered would be the sum of an institution's total assets and off-balance sheet items. This would vastly exceed the financial capacity of any employee. In addition, the sharing of loss is incompatible with the basic concept of a contract of employment. The unequal distribution of loss also results in diverging attitudes to risk on the part of employees, the institution, investors and the public.

This asymmetry will be even more pronounced if, despite the absence of loss sharing, employees share directly in any profits generated by their decisions in the form of performance-related pay. The problem cannot be resolved conclusively. However, creating an adequate link between employee remuneration and risk can raise the employee's awareness of risk and go some way towards redressing the balance between the employee's attitude to risk and that of the institution and its stakeholders.

The risks and incentives for risk-taking among employees will vary between different business models. However, FINMA expects attention to be paid to risk in relation to all key elements of a remuneration system. Firstly, all significant risks arising in the course of business should be captured[70] and a holistic approach to risk promoted. Secondly, any assessment of risk in relation to remuneration policy should

[69] Mn 31

[70] Mn 33

be consistent with the views of the in-house risk control units and undertaken by these units.[71] Thirdly, it is essential to ensure that the remuneration policy does not promote disaggregation of the value chain or the fragmentation of risks and responsibilities.[72] Risks that are difficult to measure in advance must also be captured.[73] Finally, the extent to which each individual employee may combine risks should be made subject to the level of responsibility assigned. Increased responsibility generally corresponds to an increased ability to take risks. It is therefore advisable to ensure that a high proportion of overall remuneration is subject to the degree of risk-taking involved.[74]

In addition to the risks routinely incurred in business, there are certain risks that are entirely undesirable. Remuneration and the criteria for awarding remuneration (whether formalised or otherwise) should not create incentives to incur undesirable risks of this type.[75] This applies especially to risks that are incompatible with the financial institution's strategic and operational objectives and its tolerance for risk, or risks that cannot be adequately managed. In addition remuneration systems should not create incentives that would unduly damnify the institution's stakeholders, including its clients,[76] for example pay-related sales targets for investment products that adversely affect the outcome of investment advice provided to clients.

5.3 Variable remuneration as a participation in success

Principle 5: Variable remuneration depends on the long-term economic success of the financial institution.

Variable remuneration enables employees to participate in the success of the financial institution. This success is therefore the benchmark for measuring variable remuneration at the level of the institution as a whole. Hence, variable remuneration is distinctive, compared to other operating costs, in that it must be earned before getting paid out. In turn, this means that if a company does not perform well, it is not sensible from a business perspective to pay out variable remuneration.

FINMA has set out some general principles for measuring the level of variable remuneration using a two-step process, which is already employed by a number of institutions. The first step involves creating a pool from which all variable remuneration is taken. In the second step, the content of the pool is distributed to the individual organisational units and ultimately to the institution's employees.[77]

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[71] Mn 37

[72] Mn 35

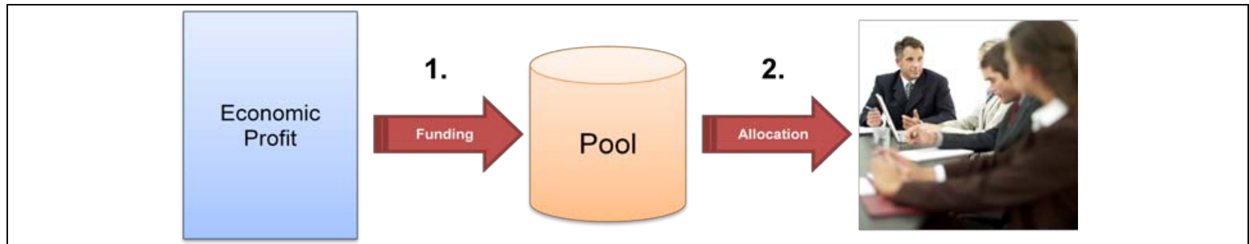
[73] Mn 36

[74] Mn 34

[75] Mn 38

[76] Mn 39

[77] Institutions frequently create sub-pools from the overall pool for individual divisions and organisational units, which are in turn further sub-divided.



5.3.1 Measuring corporate success

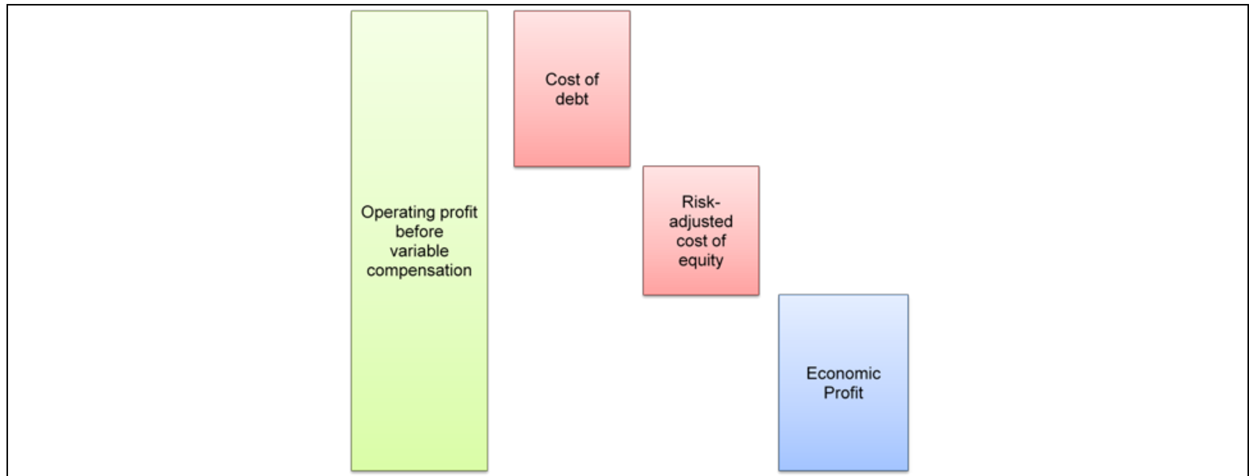
If variable remuneration is viewed as an employee's stake in the success of the company, the first question to address is how this should be quantified. Until now, many institutions calculated variable remuneration primarily on the basis of accounting figures, e.g. the net profit as recorded in the accounts before bonus payments[78], although more broadly-based approaches are becoming more common.

Taking accounting profit as the sole performance indicator is of limited usefulness, as this does not take sufficient account of the role of, and risks to, the owners and shareholders and thus only provides a limited indication of the value added generated by a company. Although equity owners normally do not have the right to get compensated for their investment and the risk of it, a risk-adjusted compensation of owners and shareholders is required from an economic point of view.

The reality from a legal and accounting standpoint does not adequately reflect the economic situation. Equity investors bear a considerable share of corporate risk. They may also lose all their investment e.g. if the company becomes insolvent. From an economic perspective, the compensation to which they are entitled is therefore appropriate and the greater the risk to the company, the higher the compensation they receive. Companies can only generate added value and therefore profits if equity investors receive a risk-adjusted return on their investment. If this does not transpire, value is lost and stability jeopardised in the medium-term, at least from a risk-adjusted perspective.

"Economic profit" represents a performance indicator that adequately reflects capital charges. Although economic profit is also based on income statement metrics, it is risk-adjusted for borrowing costs and capital charges in contrast to a purely accounting assessment of corporate profits.

[78] "Contribution before bonus"



5.3.2 Quantifying the overall pool

Although FINMA does not prescribe any specific formula to link economic profit with the overall pool, it expects that variable remuneration should not exceed economic profit over the long-term.[79] Without this requirement, variable remuneration would no longer be covered by the value added generated by the firm and would lose its profit-sharing characteristics.

Furthermore, variable remuneration must be quantified on the basis of company performance over several years.[80] This has a certain smoothing effect across business and economic cycles, so that there is a certain time lag before performance is reflected in variable remuneration, resulting in a more sustainable approach. The longer an institution performs well, the more employees can benefit from variable remuneration. However, if there is a brief downturn in business, the smoothing effect allows higher variable remuneration to be paid relative to the year under review. This affords institutions at least some continuity in their remuneration policy.

The concept does not limit the amount of variable remuneration by an absolute cap (maximum amount). It does, however, set a relative limit (economic profit). The potential for a deterioration in performance must also be factored into any distribution policy adopted during boom phases. This approach also helps to prevent short-term gains, generated by taking greater risks, from leading to high variable remuneration. If a long-term view is taken, variable remuneration must be reduced accordingly in falling markets. However, if business performance is poor over the longer-term, variable remuneration must clearly be reduced substantially, or eliminated altogether.

[79] Mn 43

[80] Mn 42

The institution's board of directors, which is accountable to the owners, must be responsible for determining the share of economic profit that may be distributed as variable remuneration.[81] Although FINMA does not intend to impose any restrictions on institutions in this respect, it does require the disclosure of remuneration policy in order to facilitate an appropriate level of owner consultation and involvement.

5.4 Distribution of variable remuneration

Principle 6: Variable remuneration is granted according to sustainable criteria.

Where financial institutions apply the aforementioned principles for determining the overall amount of variable remuneration, the overall pool is dependent on the institution's long-term performance and its risk profile.[82] However, irrespective of the size of the overall pool, the criteria for distributing the pool create incentives for organisational units and staff. This is desirable, as such incentives are a key part of business and staff management. However, incentives must be consistent with the institution's business and risk policy and should not give rise to inadequate business practices either from a strategic or risk perspective.[83]

FINMA therefore expects that any criteria for distributing the pool to individual organisational units and employees must encourage sustainability. Such criteria should not be predominantly short-term in nature. This ensures that staff are not primarily focused on key figures that are largely unconnected to the institution's long-term success or fail to take account of risks incurred. FINMA does not consider short-term targets such as turnover, net new money, sales volumes or profits for a given period to be suitable as the sole criteria for awarding variable remuneration, because they are not adequate indicators of any added value generated or the operational risks taken. In particular, such targets should not be directly linked to variable remuneration or form the basis of any entitlement to remuneration without leaving institutions some room for manoeuvre. Formula-based remuneration of this type would be decoupled not just from value added and risk, but also from the performance of the institution as a whole and would thus be at variance with any performance and long-term focus.[84]

The actual award of variable remuneration should also take account of compliance with internal and external guidelines. Any breaches of such guidelines should result in the reduction, or if appropriate the forfeiture, of variable remuneration. Such an arrangement would serve to reduce the incentive to engage in malpractice in order to generate business and rewards.[85]

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[81] The proportion of economic profit distributable as variable remuneration is also referred to as the "sharing percentage" in practice.

[82] Mn 45

[83] Mn 46

[84] Mn 47

[85] Mn 48

The Circular sets out specific provisions on special payments. Special payments such as sign on payments are not generally performance-related or sustainable. However, they reflect prevailing market practice in certain areas. FINMA has decided not to proscribe special payments.[86] However, it requires special payments to be funded from the variable remuneration pool. In addition, special payments must be disclosed and where they exceed a level determined by the institution, must also be approved by the board of directors. This places a curb on special payments and limits discretion for awarding other variable remuneration. However, it is for the board of directors and executive board to decide the extent to which the institutions wish to relinquish flexibility in awarding variable remuneration to all employees in order to benefit the contractual entitlements of a few individuals.

Principle 8: The remuneration of the control functions does not give rise to conflicts of interest.

There are fundamental conflicts of interest between the control functions (quantitative and qualitative risk management and risk control, legal, compliance, actuarial office, internal auditors or internal control systems[87]) and the units they control. Remuneration systems should not further exacerbate such conflicts of interest. FINMA expects the assessment criteria for variable remunerations to be appropriately formulated for the control functions. The remuneration of these functions should be based on the performance of the institution as a whole, and in particular should not depend on the short-term results of the individual business units being monitored.[88] In addition, the total remuneration payable must be capable of attracting qualified and experienced employees. Only in this way can the control functions be sure of building and retaining the necessary expertise.[89]

5.5 Deferred remuneration

Principle 7: Deferred remuneration gives employees a symmetric participation in the financial institution’s future development and risks.

Nowadays, remuneration packages at many financial institutions include a deferred compensation component. Examples of this include restricted shares or options, or the introduction of a malus system. In all cases, employees can access the deferred remuneration only after the holding period has expired. One of the reasons institutions use such devices is to retain staff within the company.

However, this staff retention effect is not FINMA’s primary focus. FINMA views deferred remuneration as a means of ensuring that a proportion of remuneration is subject to risk, even after awarding, and thus that realised risks, e.g. loan defaults or losses on trading positions or poor performance in general, occurring after allocation can still have a negative impact on employee remuneration. This further increases risk awareness.

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[86] cf. 6.7.2. for FINMA’s considerations

[87] Mn 59

[88] Mn 61

[89] Mn 60

The higher the total remuneration received by an employee, the greater the proportion that must be deferred. This must take into account the function and risk represented by the employee, together with the structure of the deferred remuneration instruments. Highly-paid staff, particularly at senior management level and in the upper echelons of the hierarchy, should receive a substantial proportion of their remuneration on a deferred basis. The same principle applies to staff below senior management level that are in a position to take significant risks. This “significance” should not be viewed solely from the institution’s perspective. Even staff at lower levels, who take risks within their allowed limits and whose remuneration may vary based on the profits generated from risk-taking, should receive deferred remuneration in order to encourage greater risk awareness. For example, staff responsible for trading, who work within manageable limits individually, may still incur an overall level of risk exposure collectively, which could become problematic at institutional level. For this reason, a proportion of the remuneration paid to traders should also be linked to risk, i.e. deferred.[90]

FINMA does not insist on deferred remuneration for the board of directors, although the board of directors bears a large measure of responsibility for strategic risks. In practice, directors often receive fixed expense allowances. In addition, there are already comprehensive disclosure obligations for directors’ remuneration and, in future, mandatory requirements for shareholder consultation in determining such remuneration. However, where the allowance paid to the board of directors is higher than usual, deferred remuneration should also be employed.

Deferred remuneration is subject to upward and downward fluctuations in value during the holding period. These fluctuations in value depend on the performance of the institution as a whole.[91] Employees thus benefit from their company performing well, for example, if the company’s share price rises. They are also impacted by the risk of negative performance, for example, if the share price falls. A key factor is ensuring that the balance struck between the company’s success and the value of the deferred remuneration is not unreasonable.[92] This might be the case if employees benefit disproportionately from any increases in value or if their remuneration is only marginally affected by negative performance.[93] Institutions are required to create an appropriate and proportionate relationship here.

The potential for value gain is entirely desirable, as any lack of such potential would presumably be compensated by awarding higher remuneration in the first place. Equally, the possibility of value enhancement encourages precisely the kind of long-term and entrepreneurial thinking that should be encouraged in staff having greater responsibility or higher remuneration. A ban on value gains would therefore undermine this incentive effect without having any impact on the level of remuneration. Deferred remuneration is particularly suited to value enhancement even during downturns in business. Value increases only if the institution’s economic situation improves. Deferred remuneration thus

[90] Mn 51

[91] Mn 53

[92] Mn 55

[93] In practice, option schemes are particularly unsatisfactory in this regard. However, the problem lies not in options as an instrument, but in the option parameters.

provides an additional incentive to work towards the success of the company. In the event of failure, deferral reduces the cost to the institution of variable remuneration. Accordingly, where the company performs negatively, and in particular suffers losses, FINMA prescribes that deferred remuneration should make up the majority of the variable remuneration and non-deferred payments kept to a minimum.[94]

FINMA also encourages “clawback” and “malus” provisions, since they allow for the withdrawal of variable compensation upon the occurrence of negative events. Clawbacks are used in particular to capture risks that were not taken into account at the time of the original award of remuneration. Individual clawbacks have the added advantage that they can be more directly linked to risks within an employee’s area of responsibility. They are therefore also suitable for employees at lower levels who have little influence e.g. on the institution’s share price. FINMA expects that clawback provisions should be linked to performance factors (e.g. losses, failure to achieve expected performance) and not just applied in the case of wrongful conduct.

FINMA requires a holding period of at least 3 years. In the event of longer-term risk exposure, the holding period should be increased. This holding period does not cover a complete economic cycle, but longer holding periods are unrealistic in many situations. In addition, an employee generally receives deferred remuneration components every year ensuring that a proportion of remuneration is deferred at all times.

Termination of employment should not result in early termination of the holding period. Otherwise employees could avoid the responsibility for risk implicit in the deferred remuneration by changing their place of employment. This does not apply in the event of death or the onset of disability.

Subject to these requirements, FINMA will allow financial institutions to select and structure the deferred remuneration instruments, apply instruments that are appropriate for their employees and create effective links to risk or performance. There are no plans to apply a blanket ban on particular alternatives, such as options, provided these comply with the principles laid down by FINMA.

5.6 Transparency

Principle 9: The Board of Directors reports annually on the implementation of the remuneration policy.

Increased transparency is another core element of the proposed regulatory standards. FINMA expects supervised institutions to ensure transparency on two fronts. Firstly, institutions should publish a remuneration report setting out the key elements of the remuneration system and its implementation.[95] Secondly, FINMA expects institutions to provide quantitative information on the institution’s variable

[94] Mn 56

[95] Mn 64

remuneration to enable the impact of the remuneration policy and significance of remuneration to be assessed by third parties.[96]

This proposal extends beyond existing requirements e.g. as prescribed for listed companies under company law, which merely requires disclosure of directors' remuneration (individually) and of the executive board (collectively and individually for the best-placed executive board member). FINMA considers these requirements to be inadequate for financial institutions. In contrast to other sectors of the economy, a large proportion of variable remuneration is paid at levels within the hierarchy outside the scope of current disclosure requirements. It is also possible for individual employees generating very high value added to be awarded compensation that may significantly exceed that received by senior management or the board of directors. This also applies to special payments, which in some cases have assumed grotesque proportions. As a result, the majority of remuneration awarded by financial institutions is not covered by disclosure requirements under company law, which moreover only applies to listed companies.

Hence, the information currently given in remuneration reports provides only a partial and distorted view of a financial institution's remuneration practices. Although the costs incurred are recorded in the institution's annual results, these do not distinguish between variable remuneration and fixed salaries. In addition, deferred remuneration is amortised over the relevant term and the charge to income distributed over several years (accounting perspective).

On the basis of current information, it is not possible for third parties to identify the total amount of variable remuneration paid in a given financial year (management perspective). An outside shareholder or regulator would be unable to determine the amount of variable remuneration payable, for example. Also, trends in performance indicators cannot be compared with trends in variable remuneration.

The current lack of transparency leads to further problems. Although market participants track the cost and earnings structures of financial institutions very closely, variable remuneration defies such examination, despite its significance.[97] This removes at least some of the pressure that market discipline might otherwise exert on an institution's cost structures and thus the variable remuneration paid. It may be assumed that this factor has impacted significantly on past trends in variable remuneration. Without greater transparency, it would also be difficult for the market or supervisory authorities to evaluate the effects of remuneration systems. In particular, the "long-term focus" that has been called for on numerous occasions, can only be assessed from the outside if third parties are able to gain a more complete picture of an institution's remuneration and relate this to economic performance indicators.

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[96] Mn 65 ff.

[97] In some divisions of large banks, over 80% of profits are paid out as staff bonuses, e.g. US brokerage business.

To this end, FINMA is only calling for the publication of summary data (by business area and remuneration instrument). The disclosure of remuneration paid to individuals is explicitly not required. However, in contrast to previous publishing requirements, publication of the “management perspective” is mandated.

The intended recipients will depend on the ownership structure of the institution. While listed companies will be required to disclose this information to the public in line with statutory disclosure requirements, privately-owned institutions (e.g. private banks) may elect not to publish the information. In such event, it is reasonable to assume that, due to their close ties with the institution, owners can obtain sufficient information and that it is also in their vital interests to discharge their governance responsibilities in full. Their obligation to disclosure information to FINMA still applies. It is still necessary to assess the extent to which transparency impacts on personnel issues for institutions that are not subject to publication requirements or market pressures. It should be considered that the freedom enjoyed by hedge funds and other unregulated investment vehicles in relation to the question of salaries has contributed to the popularity of such institutions as employers.[98]

On the Swiss market, all financial institutions with remuneration policies are subject to the same rules, ruling out distortion of competition within the sector. However, Swiss institutions may be obliged to exercise greater transparency compared to international competitors. Nevertheless, the danger that competing institutions might gain too detailed an insight into salary structures is relatively small, especially where the disclosed information is highly aggregated. Consultancy firms are already in the business of selling data to institutions. There is significant take-up of such services, which are also supported by supplies of data from the institutions themselves. To some extent, the institutions also cooperate with each other. The markets are also very close. One of the main responsibilities of human resources departments is to obtain market information and adjust its own salary policy accordingly. Transparency on the part of employers is thus in market participants’ own interests. The claim that increased transparency might lead to resentment among employees is certainly valid. Variable remuneration is distributed very unevenly across the population as a whole. In addition, salary practices vary between business segments for historical and regional reasons and these differences are not solely attributable to rank and responsibility. However, provided that summary disclosure is made and individual employees or small groups are not singled out, then any newly available data might well corroborate or refute existing speculation, without resulting in unexpected insight for employees. In addition there is nothing to support the view that transparency would lead to a general rise in salary levels. It is far more likely that an equilibrium price would be established that may vary above or below current market practice. From the standpoint of market efficiency, this would prove advantageous, because salary levels would be far more dependent on factors that are visible to both

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[98] This was also one of the reasons for the creation of Dillon Read Capital Management (DRCM). DRCM was a hedge fund established by UBS Ltd. Senior executives and other key personnel at UBS Investment Bank subsequently transferred to the newly established fund. The spin-off had two primary objectives: firstly, the fund could carry out types of trades that would not have been permitted under internal risk management. Secondly, contrary to banking remuneration models, DRCM staff could increase their remuneration significantly by means of a performance fee, which accorded them a direct share in any increases in fund value.

sides and less subject to negotiation skills or timing. This would provide additional support for FINMA's efforts to work towards remuneration that is linked to performance and profits.

5.7 Issues beyond the scope of the proposed regulatory rules

Certain issues have been analysed by FINMA, but did not get addressed within the current proposals.

5.7.1 Detailed structure of deferred remuneration instruments

Although FINMA is calling for deferred remuneration to be used it does not intend to prescribe or proscribe specific instruments such as shares or options.

Such a requirement would in our view be problematic in several respects: issuing shares and options eventually turns employees into shareholders. This is clearly desirable, as it brings the goals of employees and company owners into alignment, provided that the institution's owners are in fact prepared to accept employees as shareholders. This is not the case with private banks, for example. Other, smaller unlisted institutions will also have reservations about employee share ownership, insofar as the legal form of the institution permits the issue of shares in the first place.

For this reason, FINMA will allow institutions to define their own individual remuneration instruments in line with the principles laid down, in order to take proper account of the specific circumstances of each institution and its employees as well as FINMA's requirements.

5.7.2 Ban on retention instruments and sign on payments

Retention instruments: Deferred remuneration is often structured so as to ensure that there is a financial disadvantage to employees in leaving the company voluntarily. "Leave/lose" clauses preclude any future claims to the transfer of deferred remuneration with the aim of retaining employees within the institution. It could be in the interests of supervisory authorities to promote the organisational stability of institutions by requiring them to include such terms in their contracts. This could also prevent employees who only remain with a company for a short period from placing their own short-term interests ahead of sustainable business conduct.

However, the efficacy of retention instruments is debatable. Many market participants claim that it is counter-productive for both parties if employees only remain with a company for financial reasons. Secondly, it is precisely these high-performing and marketable employees who might be willing to move and could be bought out by a new employer (by means of sign on payments), thus negating the effect of any "leave/lose" provisions. Thirdly, any requirement for effective retention provisions would restrict employees' freedom of choice, creating an undesirable side-effect in the context of current employer-employee relations and unilaterally penalising employees.

Advance payments (sign on payments): Sign on payments are payable upon conclusion of the contract and are often unrelated to performance. As such, they are not awarded on the basis of performance or success. The fact that they are still provided is due to the widespread use of retention instruments and the negotiating strength of prospective employees. The call by some supervised institutions for FINMA to ban such payments should also be viewed in this context. Banning sign on payments would unduly restrict employees wishing to switch employers and could give rise to compensatory effects such as an increase in basic salaries. In addition, the institutions investigated by FINMA operate restrictive practices with regard to such payments. Because sign on payments have an immediate impact on results, they are approached with greater caution than is the case for promises to pay remuneration in the relatively distant future. In the case of buyouts of front office staff in particular, careful consideration is given as to whether the payment can be amortised within a reasonable timeframe. Sign on payments resemble an investment involving the inevitable risk of miscalculation. Institutions may decline to take on prospective employees who require payments that they are unable or unwilling to provide.

Retention instruments and sign on payments are interrelated. Any regulatory regime must therefore encompass both types of remuneration and give due consideration to the way they interact. Various regulatory options may be considered:

1. **No** regulation of sign on payments: FINMA considers as inappropriate the proposal put forward by supervised institutions to exclude sign on payments from regulation. Sign on payments not usually linked to profits or performance and bear no relation to risks incurred. If sign on payments were excluded, this could ultimately provide a mechanism for circumventing the principles introduced by FINMA on the basis of the remuneration regulations.

2. **Requiring the use** of retention instruments: any restriction on job market liquidity would be unacceptable to both employees and employers, so any requirement for retention instruments would promote or reinforce the practice of providing sign on payments. This is undesirable.

3. **Banning** retention instruments: this option would increase job market liquidity by reducing the opportunity costs of switching employment both for the employee and for the future employer. However, this would also remove the ability for current employers to increase staff retention through financial rewards. This is a particular problem in the case of employees whose function allows them to generate turnover regardless of the actual employer.[99] As with option 1 above, FINMA adopts a neutral stance in this respect and therefore regards any ban on retention instruments as outside the scope of its regulatory objectives.

4. **Banning** sign on payments / buyouts: the threat of high opportunity losses would promote staff retention. Prospective employers would have difficulty finding staff ready to switch jobs. In the medium term this would distort competition both in the job and financial markets, which

[99] This applies to the majority of staff with direct and close contact to clients and the market.

would not be in the interest of a supervisory authority. Financial institutions not subject to regulation by FINMA (e.g. foreign institutions or unregulated financial services providers) would not be under any such restriction. Swiss institutions would be disadvantaged in competing for qualified personnel internationally. This option is therefore problematic and should also be rejected.

5. **Transparency and governance** in relation to sign on payments: the disclosure of information to the market allows inferences to be drawn with regard to a financial institution's recruitment strategy and its general approach to recruitment. It also reveals the proportion of remuneration that an institution "invests" for future business prospects without any link to previous performance or generation of profits. Under governance requirements, such payments are subject to a defined decision-making process. Both the requirement for disclosure of sign on payments and the relevant governance requirements therefore act as a brake on the award of such payments. Discussions with supervised institutions have shown that a duty of disclosure would itself prompt a review of current practice and lead to more restrictive policies. Some major institutions have recently implemented and formalised governance requirements. The "investment character" of such payments is also emphasised by making them dependent on the overall pool so that they must be covered by economic profits.

FINMA is aware that none of these options offers an optimal solution to the issue of high special payments that are also problematic in part for both political and company-internal reasons. It thus recognises the reality of the job market and the conflicting interests of employers and staff. Disclosure will at least lead to transparency in market practice. In the light of these findings, FINMA may reconsider its position if necessary at a later date. However, the situation in other countries and markets must also be taken into consideration, insofar as this is relevant for institutions in Switzerland.

5.7.3 Restrictions on maximum remuneration (caps)

FINMA has looked into restrictions on maximum remuneration on several occasions but has ultimately rejected the idea. The remuneration paid to each member of staff is ultimately the result of a process of negotiation and is highly dependent on the relevant business sector, region and specific qualities of the employer and employee. It is not possible to define a *single* maximum level of remuneration. Instead, a separate cap would have to be defined for each market segment, giving due consideration to all the conditions prevailing in that market segment. FINMA is unable to do this as it would be outside the scope of its statutory authority. In any case, it is doubtful whether any such caps would vary significantly from the payment ranges currently observed.

Linking variable remuneration to economic profit at least limits remuneration in relation to the risk-adjusted added value generated by the institution. It is ultimately for the owners to determine what proportion of generated profit should be distributed to staff and what should be made available for capital expenditure or shareholders. From a supervisory perspective there would be no objection even to distributing all profits to staff, provided sufficient attention is paid to the issues of risk and

sustainability, as set out in FINMA's proposed Circular. The proposed transparency rules allow the owners and other stakeholders of an institution to compare remuneration with company performance and to safeguard their rights. It is the responsibility of the institution's owners – and in their own best interests – to do this.

FINMA recognises that this mechanism may lead to a level of remuneration that may be perceived as objectionable both politically and publicly. If politicians and the wider public see a need for intervention, it is for legislators to enact appropriate regulations, having fully considered the advantages and disadvantages. However, it is beyond the remit of a financial market supervisory authority to prescribe such restrictions.

6 Implementation and review

FINMA does not intend to bring compliance with the Circular as part of applicable organisational requirements within the ambit of regular supervisory audits. Instead, it proposes a different method of performing such audits, primarily on the basis of self-assessment by financial institutions. The Circular therefore requires financial institutions to assess their implementation of and compliance with the rules and to report to FINMA by 30 April 2011. FINMA will probably provide financial institutions with a standard evaluation sheet for such purpose. Companies are required to have the report for FINMA certified by an audit firm. The reports submitted by financial institutions will subsequently be evaluated by FINMA, possibly in consultation with third parties and on the basis of additional investigations resulting from a cross-comparison. FINMA will decide what further action is required on the basis of this evaluation process. FINMA recognises that the Circular, or parts of the Circular, may require subsequent amendment.

This proposed procedure is somewhat different from FINMA's standard procedure for verifying compliance with regulatory rules. There are a number of reasons for the audit procedure proposed by FINMA. Firstly, remuneration has not traditionally been the concern of financial market regulators. In practice, remuneration has generally been a matter for senior management and subsumed within management and strategy. FINMA's role must be confined to defining the regulatory requirements by formulating key principles. The actual implementation of remuneration policy within the scope of these requirements will therefore vary depending on the business operations and risk profile of each individual financial institution.

Secondly, the benefits and impact of the Circular largely depend on whether similar regulatory rules will be introduced internationally and if so, the scope of those rules. In considering whether provisions of the Circular should be amended, supplemented or even revoked, FINMA will therefore pay particular regard to whether and under what conditions foreign supervisory authorities adopt and implement similar rules for companies that are subject to financial market supervision. FINMA will keep a close eye on any relevant developments and any regulatory initiatives announced or commenced by supervisory authorities in foreign financial centres and will take these into account in

deciding on any further action to be taken. This is also consistent with Art. 7 (2) (b) FINMASA, which provides that FINMA shall take account in particular of the effect that regulation has on competition, innovative ability and the international competitiveness of Switzerland's financial centre.

The proposed procedure is intended to replace audits performed by audit firms. However, in proposing this procedure FINMA retains the power to monitor compliance by financial institutions with the requirements of the Circular either itself or in cooperation with third parties.