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FINMA Circular 10/1 on remuneration schemes

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On 1 January 2010, the Circular 10/1 of the Swiss Financial Market Supervisory Authority (FINMA) on remuneration schemes has come into force. The Circular defines minimum standards for the design, implementation and disclosure of remuneration schemes of financial institutions, and lays down some basic principles for variable remuneration (in particular bonuses) and deferred remuneration models. The Circular must be fully complied with as of 1 January 2011. It supplements the provisions of the Swiss Code of Obligations as well as the remuneration related disclosure provisions set out in the Swiss stock exchange regulations.

Purpose of the Circular

The Circular aims at ensuring the stability of the financial markets and at addressing the criticisms raised in relation to the, in some cases exceedingly high, variable remuneration distributed to the senior management or board members of companies in the financial sector that may have contributed to triggering the worldwide economic and financial crisis in 2008. The Circular is also in keeping with international developments, as expressed notably by the European Commission and the G20, aiming at creating a framework and regulating the policy for the variable remuneration of senior management and board members of listed companies.

According to FINMA, the purpose of the Circular is to influence in the long run the remuneration practice in the financial sector. Remuneration schemes should not constitute an incentive to take inappropriate risks, which may jeopardise the stability of financial institutions (banks and insurance companies).

Scope of application

The Circular applies to the following financial institutions: (i) banks, (ii) securities dealers, (iii) financial groups and conglomerates, (iv) insurance companies and (v) insurance groups and conglomerates, which are subject to Swiss financial market supervision, as well as (vi) persons and firms authorised under article 13 paragraph 2 and 4 of the Collective Investment Schemes Act ("Financial Institutions").

The Financial Institutions' domestic and foreign subsidiaries and branches, which are mandatorily included in consolidations, are also subject to the Circular's rules. FINMA may exempt a Financial Institution, in part or in full, from implementing the Circular's relevant provisions, if the application of the Circular conflicts with mandatory foreign regulations or puts the Financial Institution at a serious disadvantage on a foreign labour market.

The implementation of the Circular's provisions is mandatory for:

- (i) banks, (ii) securities dealers, (iii) financial groups and conglomerates, which, in their capacity as individual Financial Institutions or at the level of the financial group or conglomerate, are required to maintain equity capital (in accordance with the minimum requirements set out in articles 6 et seq. and article 33 of the Capital Adequacy Ordinance) in the amount of at least **CHF 2 billion**; and
- (iv) insurance companies and (v) insurance groups and conglomerates, which, in their capacity as insurance companies or at the level of the insurance group or conglomerate, are required to hold equity capital (in accordance with the solvency margin requirements set out in article 22 paragraph 1 lit. a, article 199 and article 206 of the Insurance Supervision Ordinance) in the amount of at least **CHF 2 billion**.

What the aforementioned thresholds mean in practice is that the Circular's rules will only need to be mandatorily implemented by the seven largest banks and five largest insurance companies in Switzerland, whilst they will constitute mere recommended "best practice" guidelines for all other Financial Institutions. In justified exceptional circumstances, however, FINMA may require such other Financial Institutions to also fully comply with the rules set out in the Circular.

Alignment with the Financial Institution's risk policy and promotion of risk awareness

The structure and level of total remuneration must be in line with the Financial Institution's risk policy and must promote risk awareness. Any risk borne by the Financial Institution in the course of its business activities needs to be taken into account, namely market, credit and liquidity risks, underwriting and operational risks, including legal and compliance risks, as well as reputation risks. In addition to the Financial Institution's business risks, the individual risk profile of the beneficiaries also needs to be assessed: the higher the level of strategic and operative responsibility borne by a person, the more his/

her remuneration will need to take into account the risk he/she takes or is responsible for.

The remuneration instruments, the proportion of variable remuneration to total remuneration and the relation between immediate and deferred remuneration must be designed in compliance with these principles.

Variable and deferred remuneration

Pursuant to FINMA, variable remuneration should be granted according to sustainable criteria and should depend on the long-term economic performance of the Financial Institution, rather than on its short-term financial results. Consequently, FINMA requires that Financial Institutions defer payment of part of the variable remuneration to the extent required in light of their risk profile. As a result, the greater the risks faced by a Financial Institution, and/or the greater the responsibility and total remuneration of a beneficiary, the greater the percentage of variable remuneration that will need to be deferred.

In this respect, deferred remuneration is to be designed in such manner so as to take into account the Financial Institution's business strategy and risk policies. In particular, FINMA stresses that any changes in value of deferred compensation during the deferment period must be correlated to the development of clearly defined and objective assessment criteria, which shall take into account earnings, expenditures and capital costs or shall depend on the value of the company. Negative developments of such assessment criteria must result in a considerable reduction in value of the deferred compensation up to a total forfeiture. Also, in case of poor business performance (such as a loss recorded in the annual accounts), the payment of variable, non-deferred remuneration must be reduced to a minimum.

However, it is worth noting that the beneficiaries of the remuneration may not be forced to return, either in part or in full, any vested variable compensation, since such an obligation would infringe Swiss labour law and might therefore not be enforceable. Furthermore, the Swiss Supreme Court has held that variable remuneration, insofar as it may not be considered as mere accessory compared to the fixed portion of the salary, should also qualify as part of the salary tha-

needs to be paid unconditionally, and not as a mere discretionary bonus. In this regard, the remuneration scheme recommended by FINMA may well lead to controversies in relation to the common practice laid down by the Swiss Supreme Court.

On the other hand, FINMA abstains from setting a ceiling on variable remuneration or a time frame during which the remuneration must be deferred. However, for members of the senior management and persons with relatively high total remuneration, as well as for persons whose activities have a significant influence on the risk profile of the Financial Institution, the Circular requires that the deferment period be at least three years.

The board of directors is responsible for the design and implementation of the remuneration policy

The board of directors must design the remuneration policy and will be responsible for its implementation. It will furthermore need to issue compliant remuneration rules applying to all persons employed by the relevant Financial Institution. The remuneration scheme must be simple, transparent, capable of being implemented, and oriented towards the long-term.

The board of directors will be in charge of approving the remuneration of the senior management as well as the Financial Institution's total remuneration pool. In addition, the board of directors will need to prepare an annual remuneration report for FINMA in which it shall describe the implementation of the remuneration policy and rules.

Transitional provisions and implementation

The provisions of the Circular, in force since 1 January 2010, must be fully complied with as of 1 January 2011.

The concerned Financial Institutions will have to submit a certified report to FINMA by 30 April 2011, appraising their implementation of and compliance with the rules of the Circular.

Contacts

The content of this newsletter is for information purposes only and does not constitute a legal advice or opinion. Should you require specific advice in this matter, please get in touch with your usual contact at ALTENBURGER or with one of the below authors of this newsletter:

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