SENIOR MANAGEMENT ARRANGEMENTS, SYSTEMS AND CONTROLS (REMUNERATION CODE) INSTRUMENT 2009

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 149 (Evidential provisions);
(3) section 156 (General supplementary powers); and
(4) section 157(1) (Guidance).

B. The rule-making powers referred to above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on 1 January 2010.

Amendments to the Handbook

D. The modules of the FSA Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Glossary of definitions	Annex A
Senior Management Arrangements, Systems and Controls sourcebook (SYSC)	Annex B
General Prudential sourcebook (GENPRU)	Annex C
Supervision manual (SUP)	Annex D

Citation

E. This instrument may be cited as the Senior Management Arrangements, Systems and Controls (Remuneration Code) Instrument 2009.

By order of the Board
11 August 2009

Annex A

Amendments to the Glossary of definitions

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

Remuneration Code	*SYSC* 19 (Remuneration Code).
Remuneration Code general requirement	*SYSC* 19.2.1R.
remuneration committee	a committee or other body responsible for a *firm's remuneration policy*.
remuneration policy	the policy, procedures and practices established, implemented and maintained in accordance with the *Remuneration Code general requirement*.
third country BIPRU 730k firm	an *overseas firm* that: (a) is not an *EEA firm*; (b) has its head office outside the *EEA*; and (c) would be a *BIPRU 730k firm* if it had been a *UK domestic firm*, had carried on all its business in the *United Kingdom* and had obtained whatever authorisations for doing so as are required under the *Act*.

Annex B

Amendments to the Senior Management Arrangements, Systems and Controls sourcebook (SYSC)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

1.1A Application

1.1A.1 G The application of this sourcebook is summarised at a high level in the following table. The detailed application is cut back in *SYSC* 1 Annex 1 and in the text of each chapter.

Type of firm	Applicable chapters
…	…
Every other *firm*	Chapters 4 to 12, 18, 19

1.4 Application of SYSC 11 to SYSC ~~18~~19

What?

1.4.1 G The application of each of chapters *SYSC* 11 to *SYSC* ~~18~~19 is set out in those chapters.

Actions for damages

1.4.2 R A contravention of a *rule* in *SYSC* 11 to *SYSC* ~~18~~19 does not give rise to a right of action by a *private person* under section 150 of the *Act* (and each of those *rules* is specified under section 150(2) of the *Act* as a provision giving rise to no such right of action).

…

Remuneration policies

4.1.12 G Certain *banks*, *building societies* and *BIPRU 730k firms* will need to comply with the *Remuneration Code* requirement to establish, implement and maintain an effective *remuneration policy* that is consistent with effective risk management. See *SYSC* 19.1 for details of the application of the *Remuneration Code.*

…

6.1.4-A G In setting the method of determining the *remuneration* of *relevant persons* involved in the compliance function, certain *banks*, *building societies* and

BIPRU 730k firms will also need to comply with the *Remuneration Code*. See *SYSC* 19.1 for details of the application of the *Remuneration Code.*

…

7.1.7B G In setting the method of determining the *remuneration* of *employees* involved in the risk management function, certain *banks*, *building societies* and *BIPRU 730k firms* will also need to comply with the *Remuneration Code*. See *SYSC* 19.1 for details of the application of the *Remuneration Code.*

…

After SYSC 18, insert the following new chapter. The text is not underlined.

19 Remuneration Code

19.1 Application

Who?

19.1.1 R (1) The *Remuneration Code* applies to a *firm* that meets at least one of the conditions in this *rule*.

(2) The first condition is that the *firm* is a *UK bank* or *building society* that had *capital resources* exceeding £1 billion on its last *accounting reference date*.

(3) The second condition is that the *firm* is a *BIPRU 730k firm* that had *capital resources* exceeding £750 million on its last *accounting reference date*.

(4) The third condition is that:

(a) the *firm* is a *full credit institution*, a *BIPRU 730k firm* or a *third country BIPRU 730k firm*;

(b) the *firm* is part of a *group*; and

(c) on the *firm*'s last *accounting reference date* total *capital resources* held within the *group*:

(i) by *UK banks* or *building societies* exceeded £1 billion; or

(ii) by *BIPRU 730k firms* exceeded £750 million.

19.1.2 R The *Remuneration Code* does not apply to a *firm* to the extent that it is acting as an *incoming EEA firm*.

What? Where?

19.1.3 R (1) If the *Remuneration Code* applies to a *firm*, it applies in the same way as *SYSC* 4.1.1R (General Requirements).

(2) In relation to an *overseas firm* the *Remuneration Code* applies only in relation to activities carried on from an establishment in the *United Kingdom*.

19.1.4 G Part 2 of *SYSC* 1 Annex 1 provides for the application of *SYSC* 4.1.1R (General Requirements).

19.2 Remuneration Code: General requirement

Remuneration policies must be consistent with effective risk management

19.2.1 R A *firm* must establish, implement and maintain *remuneration policies*, procedures and practices that are consistent with and promote effective risk management.

19.2.2 G (1) If a *firm's remuneration policy* is not aligned with effective risk management it is likely that *employees* will have incentives to act in ways that might undermine effective risk management.

(2) The aim of the *Remuneration Code* is to ensure that *firms* have risk-focused *remuneration policies*, which are consistent with and promote effective risk management and do not expose them to excessive risk. It expands upon the general organisational requirements in *SYSC* 4.

(3) The *Remuneration Code* covers all aspects of *remuneration* that could have a bearing on effective risk management including wages, bonus, long term-incentive plans, options, hiring bonuses, severance packages and pension arrangements. In applying the *Remuneration Code*, a *firm* should have regard to applicable good practice on *remuneration* and corporate governance, such as guidelines on executive contracts and severance produced by the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF). In considering the risks arising from its *remuneration* policies, a *firm* will also need to take into account its statutory duties in relation to equal pay and non-discrimination.

(4) As with other aspects of a *firm's* systems and controls, what a *firm* must do in order to comply with the *Remuneration Code* will vary according to the nature, scale and complexity of the *firm* and its activities. For example, while the *Remuneration Code* refers to a *firm's remuneration committee* and risk management function, it may be appropriate for the *governing body* of a small *firm* to act as the *remuneration committee*, and for the *firm* not to have a separate

risk management function.

(5) The principles in the *Remuneration Code* will be used by the *FSA* to assess the quality of a *firm's remuneration policies* and whether they encourage excessive risk-taking by a *firm's employees*.

(6) The *FSA* may also ask *remuneration committees* to provide the *FSA* with evidence of how well the *firm's remuneration policies* meet the *Remuneration Code's* principles, together with plans for improvement where there is a shortfall. The *FSA* will also expect relevant *firms* to use the principles in assessing their exposure to risks arising from their *remuneration policies* as part of the *internal capital adequacy assessment process* (*ICAAP*).

(7) The *Remuneration Code* is concerned with the risks created by the way *remuneration* arrangements are structured, not with the absolute amount of *remuneration*, which is a matter for *firms' remuneration committees*.

19.3 Remuneration Code: Remuneration principles

Remuneration Principle 1: Role of bodies responsible for remuneration policies and their members

19.3.1 E (1) A *remuneration committee* should:

(a) exercise, and be constituted in a way that enables it to exercise, independent judgment;

(b) be able to demonstrate that its decisions are consistent with a reasonable assessment of the *firm's* financial situation and future prospects;

(c) have the skills and experience to reach an independent judgment on the suitability of the policy, including its implications for risk and risk management; and

(d) be responsible for approving and periodically reviewing the *remuneration policy* and its adequacy and effectiveness.

(2) The effect of this *evidential provision* is set out in the evidential status *rule* (*SYSC* 19.3.18R).

19.3.2 G (1) *Remuneration* is usually the largest cost incurred by *firms* after funding costs. The risks arising from the way *employees* are recruited and managed, including the risks posed by *remuneration policies*, constitute some of the most important risks faced by *firms*. *Remuneration committees* should pay specific attention to these risks.

(2) While industry comparators may be relevant in setting *remuneration* they should not override the need for independent decisions that are consistent with the *firm's* financial situation and prospects.

(3) *Remuneration committees* should have a majority of *non-executive directors*, one or more of whom should have practical skills and experience of risk management, for example through being a member of a *firm's* risk committee or audit committee. *Remuneration committees* should receive regular reports directly from the *firm's* risk management function on the implications of the *remuneration policy* for risk and risk management.

(4) The *FSA* may ask a *remuneration committee* to prepare a statement on the *firm's remuneration policy*, including the implications of the policy for the *firm*. The *FSA* will expect the statement to include an assessment of the impact of the *firm's* policies on its risk profile and *employee* behaviour. In drawing up this assessment, the *remuneration committee* should exercise its own judgment and should not rely solely on the judgment or opinions of others. The *FSA* may seek a meeting with members of the *remuneration committee* to discuss the statement.

(5) It is good practice for a *firm's governing body* or the *remuneration committee* to issue a separate public document to inform its shareholders and other stakeholders about its *remuneration policy* and its implications for the *firm's* risk profile and for *employee* behaviour.

Remuneration Principle 2: Procedures and risk and compliance function input

19.3.3 E (1) Procedures for setting *remuneration* within a *firm* should be clear and documented, and should include appropriate measures to manage conflicts of interest.

(2) A *firm's* risk management and compliance functions should have appropriate input into setting the *remuneration policy* for other business areas. The procedures for setting *remuneration* should allow risk and compliance functions to have significant input into the setting of individual *remuneration* awards where those functions have concerns about the behaviour of the individuals concerned or the riskiness of the business undertaken.

(3) The effect of this *evidential provision* is set out in the evidential status *rule* (*SYSC* 19.3.18R).

19.3.4 G (1) Conflicts of interest can easily arise when *employees* are involved in the determination of *remuneration* for their own business area. Where these could arise they need to be managed by having in place independent roles for control functions (including, notably, risk management and compliance) and human resources. It is good practice to seek input from a *firm's* human resources function when setting *remuneration* for other business areas.

(2) Remuneration Principle 4 stresses the importance of risk-adjustment in measuring performance, and the importance within that process of applying judgment and common sense. It is good practice for a *remuneration committee* to ask the risk management function to validate and assess risk adjustment data, and to attend a meeting of the *remuneration committee* for this purpose.

(3) Documenting procedures for setting *remuneration* includes documenting all performance appraisal processes and decisions.

Remuneration Principle 3: Remuneration of employees in risk and compliance functions

19.3.5 E (1) *Remuneration* for *employees* in risk management and compliance functions should be determined independently of other business areas.

(2) Risk and compliance functions should have performance metrics based principally on the achievement of the objectives of those functions.

(3) The effect of this *evidential provision* is set out in the evidential status *rule* (*SYSC* 19.3.18R).

19.3.6 G (1) Remuneration Principle 3 is designed to manage the conflicts of interest which might arise if other business areas had undue influence over the *remuneration* of *employees* within control functions.

(2) The need to avoid undue influence is particularly important where *employees* from the control functions are embedded in other business areas. Remuneration Principle 3 does not prevent the views of other business areas being sought as an appropriate part of the assessment process.

(3) The *FSA* would generally expect the ratio of the potential variable component of *remuneration* to the fixed component of *remuneration* to be significantly lower for *employees* in risk management and compliance functions than for *employees* in other business areas whose potential bonus is a significant proportion of their *remuneration*. *Firms* should nevertheless ensure that the total *remuneration* package offered to those *employees* is sufficient to attract and retain staff with the skills, knowledge and expertise to discharge those functions. The requirement that the method of determining the *remuneration* of *relevant persons* involved in the compliance function must not comprise their objectivity or be likely to do so (see *SYSC* 6.1.4R(4)) also applies.

Remuneration Principle 4: Profit-based measurement and risk-adjustment

19.3.7 E (1) Assessments of financial performance used to calculate bonus pools should be based principally on profits.

(2) A bonus pool calculation should include an adjustment for current and future risk, and take into account the cost of capital employed and liquidity required.

(3) The effect of this *evidential provision* is set out in the evidential status *rule* (*SYSC* 19.3.18R).

19.3.8 G (1) Measuring performance based wholly or mainly on revenues or turnover can provide an incentive for *employees* to pay insufficient regard to the quality of business undertaken or services provided, or their appropriateness for the client.

(2) Profits are a better measure, but they should be adjusted for risk, including future risks not adequately captured by accounting profits.

(3) One of the important responsibilities of the *remuneration committee* is to determine the proportion of risk-adjusted profits that should be accrued, and paid out, in the form of variable *remuneration*.

(4) Management accounts should provide profit data at such levels within the *firm's* structure as enables a *firm* to see as accurate a picture of an *employee's* contribution to a *firm's* performance as is reasonably practicable. If revenue or turnover is used as a component in performance assessment, processes should be in place to ensure that the quality of business undertaken or services provided and their appropriateness for clients are taken into account.

(5) A number of techniques are available to adjust profits and capital for risk, and a *firm* should choose those most appropriate to its circumstances. Common techniques include those based upon a calculation of economic profit or economic capital. Whichever technique is chosen, the full range of potential risks should be covered. The *FSA* expects a *firm* to be able to provide it with information relating to the workings of the calculations. The results of risk-adjustment are not foolproof, and accordingly a *firm* should apply judgment and common sense in the final decision about the performance-related component of *remuneration*.

Remuneration Principle 5: Long-term performance measurement

19.3.9 E (1) Where the performance-related component of an *employee's remuneration* is a significant part of his total *remuneration*, the assessment process should be designed to ensure assessment is based on longer-term performance.

(2) The effect of this *evidential provision* is set out in the evidential status *rule* (*SYSC* 19.3.18R).

19.3.10 G (1) Profits from a *firm's* activities can be volatile and subject to cycles. The financial performance of *firms* and individual *employees* can be exaggerated as a result and so the performance-related component of *remuneration* should not be assessed solely on the results of the current financial year. Effective adjustment for current and future risks in line with Remuneration Principle 4 may also be relevant to compliance with Remuneration Principle 5.

(2) Performance assessment on a moving average of results can be a good way of meeting Remuneration Principle 5. However, other techniques such as good quality risk adjustment and deferment of a sufficiently large proportion of *remuneration* may also be useful (see Remuneration Principles 4 and 8).

(3) In considering whether the performance-related component of an *employee's remuneration* is a significant part of his total *remuneration*, relevant factors include:

(a) the proportion of total *remuneration* which is performance-related; and

(b) the absolute amount of *remuneration* which is performance-related.

So, for example, it may be consistent with effective risk management to pay a proportionately higher performance-related bonus to a relatively low-paid *employee* without basing the bonus on longer-term performance.

Remuneration Principle 6: Non-financial performance metrics

19.3.11 E (1) Non-financial performance metrics should form a significant part of the performance assessment process.

(2) Non-financial performance metrics should include adherence to effective risk management and compliance with the *regulatory system* and with relevant overseas regulatory requirements.

(3) The effect of this *evidential provision* is set out in the evidential status *rule* (*SYSC* 19.3.18R).

19.3.12 G (1) Poor performance in non-financial metrics such as poor risk management or other behaviours contrary to *firm* values can pose significant risks for a *firm* and should, as appropriate, override metrics of financial performance.

(2) The performance assessment process and the importance of non-financial assessment factors in the process should be clearly

explained to relevant *employees* and implemented. A 'balanced scorecard' can be a good way to do this.

Remuneration Principle 7: Measurement of performance for long-term incentive plans

19.3.13 E (1) The measurement of performance for long-term incentive plans, including those based on the performance of *shares*, should take account of future risks.

(2) The effect of this *evidential provision* is set out in the evidential status *rule* (*SYSC* 19.3.18R).

19.3.14 G Many common measures of performance for long-term incentive plans, such as earnings per *share* (EPS), are not adjusted for longer-term risk factors. Total shareholder return (TSR), another common measure, includes in its measurement dividend distributions, which can also be based on unadjusted earnings data. If incentive plans mature within a two to four year period and are based on EPS or TSR, strategies can be devised to boost EPS or TSR during the life of the plan, to the detriment of the true longer-term health of a *firm*. For example, increasing leverage is a technique which can be used to boost EPS and TSR. *Firms* should take account of these factors when developing risk-adjustment methods.

Remuneration Principle 8: Remuneration structures

19.3.15 R The *evidential provision* and *guidance* on *remuneration* structures (*SYSC* 19.3.16E and *SYSC* 19.3.17G) apply in relation to:

(1) a *person* who performs a *significant influence function* for a *firm*; and

(2) an *employee* whose activities have, or could have, a material impact on the *firm's* risk profile.

19.3.16 E (1) A *firm* should ensure that the structure of *remuneration* for a *person* to whom this *evidential provision* applies is consistent with and promotes effective risk management.

(2) The effect of this *evidential provision* is set out in the evidential status *rule* (*SYSC* 19.3.18R).

19.3.17 G (1) It is good practice for the fixed component of an *employee's remuneration* to be a sufficient proportion of their total *remuneration* to allow a *firm* to operate a fully flexible bonus policy. This means that a *firm* (or a part of it) would have the ability not to pay a bonus in a year in which the *firm* (or part of it) makes a loss. Such a practice need not prevent a *firm* from paying a bonus despite making a loss if the bonus is justified on other grounds, for example incentivising *employees* involved in new business ventures which could be loss-making in their early stages.

(2) It is good practice for a significant proportion of any bonus to be deferred with a minimum vesting period. Both the proportion of the bonus to be deferred and the vesting period should be appropriate to the nature of the business and its risks. The vesting period of the deferred element should be at least three years. In relation to the proportion to be deferred, if the bonus is significant when compared with the fixed component of an *employee's remuneration*, a reasonable starting point would be to defer at least two-thirds of the bonus.

(3) It is good practice for a significant proportion of the variable component of *remuneration* to be linked to the future performance of:

(a) the *firm* and, where practicable, the *employee's* division or business unit; or

(b) the business undertaken by the *employee*.

(4) Deferred compensation paid in *shares* can meet Remuneration Principle 8 provided that the scheme satisfies appropriate criteria, including risk-adjustment of the performance measure used to determine the initial allocation of shares.

(5) Deferred *remuneration* paid in cash should also be subject to performance criteria.

(6) Bonus pools and individual bonuses should be based on *employee*, division, business unit, or *firm* performance during the period under review. Both linkage to the future performance of the *firm* and linkage to the future performance of a division or business unit can deliver important benefits. The former promotes teamwork, while the latter assures that the risks which the *employee* had a role in assuming continue to have a bearing on his *remuneration*. It is good practice for *remuneration* awards to be based on an appropriate combination of all of these factors.

(7) 'Guaranteed minimum bonuses' which run for a period of more than one year and similar payments in addition to an *employee's* salary that are not based on performance during the performance period under review are likely to be inconsistent with Remuneration Principle 8.

Status of evidential provisions

19.3.18 R (1) Compliance with the *evidential provisions* in this section tends to show compliance with the *Remuneration Code general requirement*.

(2) Non-compliance with an *evidential provision* in this section tends to show non-compliance with the *Remuneration Code general requirement*.

Insert the following new Transitional Provisions after SYSC TP 2. The text is not underlined.

TP 3 Remuneration code

1	R	TP 3 applies to a *firm* that is unable to comply with the *Remuneration Code general requirement* because of an obligation it owes to an *employee* (the "obligation") under an agreement entered into on or before 18 March 2009 (the "agreement").
2	R	A *firm's* compliance with the obligation shall not cause it to be in breach of the *Remuneration Code general requirement* provided that the *firm* complies with 3R.
3	R	(1) Where a *firm* is entitled to amend the agreement in a way that enables it to comply with the *Remuneration Code general requirement* it must do so at the earliest opportunity and no later than 31 March 2010. (2) Otherwise, a *firm* must: (a) take reasonable steps to amend the obligation or terminate the agreement at the earliest opportunity; (b) amend the obligation or terminate the agreement no later than 31 December 2010; and (c) adopt specific and effective arrangements, processes and mechanisms to manage the risks raised by the obligation.
4	G	By 1 January 2010, a *firm* should have at least initiated a review of the extent to which the measurement of performance for any existing long term incentive plans takes account of future risks. The *FSA* may discuss the timing of that review and any remedial action with the *firm*.

Amend the following as shown.

Sch 4 Powers exercised

The following powers and related provisions in the *Act* have been exercised by the *FSA* to make *rules* in *SYSC*:	
…	…
(3A)	Section 149 (Evidential provisions)
…	…

Sch 5 Rights of action for damages

…

5.4 G

Chapter/ Appendix	**Section/ Annex**	**Paragraph**	**Right of action under section 150**		
			For private person?	**Removed?**	**For other person?**
…	…	…	…	…	…
SYSC 11 to *SYSC* ~~18~~19			No	Yes *SYSC* 1.4.2R	No

Annex C

Amendments to the General Prudential sourcebook (GENPRU)

In this Annex, underlining indicates new text.

1.2.31 R …

(4) Business risk means any risk to a *firm* arising from changes in its business, including the risk that the *firm* may not be able to carry out its business plan and its desired strategy. <u>It also includes risks arising from a *firm's remuneration policy* (see also the *Remuneration Code* which applies to certain *banks*, *building societies* and *BIPRU 730k firms* and the detailed application of which is set out in *SYSC* 19.1).</u>

…

Annex D

Amendments to the Supervision manual (SUP)

In this Annex, underlining indicates new text.

13A Annex 1 Application of the Handbook to Incoming EEA Firms

…		
(1) Module of Handbook	**(2) Potential application to an incoming EEA firm with respect to activities carried on from an establishment of the firm (or its appointed representative) in the United Kingdom**	**(3) Potential application to an incoming EEA firm with respect to activities carried on other than from an establishment of the firm (or its appointed representative) in the United Kingdom**
…	…	…
SYSC	… *SYSC* 18 applies. *SYSC* 19 does not apply to an *incoming EEA firm* when acting as such.	… *SYSC* 19 does not apply.
…	…	…