

## German Corporate Governance Code – PIRC comments

There are mostly positive changes in the amended German Corporate Governance Code, as of 13 October 2016 (hereafter, the Code).

In addition to the call “legitimacy of behaviour and decisions and thus [...] responsibility (concept of the Honourable Business Person)” in ensuring the existence of the enterprise and its sustainable creation of value<sup>1</sup>, the Code appears to have learnt some lessons from recent corporate issues in Germany. In addition, the rationale behind most of the amendments seems to be to aim to enhance disclosure and engagement from management. Although the Code contains only recommendations and not legally-binding provisions, companies that adopt them should be seen as first movers in this market, where disclosure of directors and candidates’ biography and competences is limited, and where there has not been, at this time mandatory rotation for audit firms.

Although the amendments remove the recommendation for the Chair of the Audit Committee to be knowledgeable on auditing and internal controls, most of the amendments move towards incorporating EU directives and regulations, as well as increase disclosure of the board’s competences, which is expected to have a positive impact on board composition. Supervisory boards, in turn, should become readier to engage with shareholders.

### Responsible ownership

First, the Code contains a call for institutional investors (as well as the management), to **exercise ownership responsibly**, actively and in accordance with a transparent framework<sup>2</sup>. This call for action is welcome, although it looks mostly aesthetic. There are a number of obstacles to the participation of institutional shareholders: one above all, counter-motions are not available on the ballot prior to the voting deadline for institutional investors, and would require hiring a proxy to attend at the meeting. On the other hand, there are certain recommendations for the Company to engage with investors<sup>3</sup>.

### Setup of a Compliance Management System

Among the recommendations of the Management Board, there will be the setup of “a proportionate Compliance Management System **corresponding to the level of risk that the company is exposed** to and shall publish the basic features of this system in the annual corporate governance report. Employees as well as third parties shall be

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<sup>1</sup> German Corporate Governance Code as of 13 October 2016, p. 1, Foreword

<sup>2</sup> Ibid, p. 3, Section 2.1.3

<sup>3</sup> “The Chairman of the Supervisory Board shall be prepared to engage into discussions with investors on Supervisory Board-related topics.”, *ibid.*, p. 10, section 5.3

given the opportunity of anonymously reporting misconduct within the company in a protected manner.”<sup>4</sup> The presence of a whistleblowing hotline is seen as a good change: VolksWagen did not have a whistleblowing hotline and this can be seen one of the reasons why the scandal erupted publicly. On the other hand, publishing the basic features of the compliance management system: this is somehow backward-looking for companies with a high risk appetite. A higher appetite for risk should also require higher disclosure of advanced features of such system. Nevertheless, the CMS should be proportionate to the risk appetite and should be published by all companies. On balance, it is reasonable to expect enhanced disclosure or risk governance by all companies in this market.

### **Incorporation of EU Audit Directive Provisions**

Auditing is another issue on which key amendments have been inserted. The Audit Committee should propose at least two auditors for election as external auditors<sup>5</sup>: the current auditor may be re-appointed, but this recommendation eventually incorporates rotation as one of the key elements of sound corporate governance in Germany. In addition, the Code transposes provisions by the EU Audit Directive, by recommending that the “Audit Committee supervises the independence of the auditor and furthermore considers the additional services rendered by the auditor, the issuing of the audit mandate to the auditor, the determination of auditing focal points and the fee agreement”<sup>6</sup>. On the other hand, these amendments remove the recommendation for specialist knowledge and experience in the application of accounting principles and internal control processes by the Chair of the Audit Committee, which nevertheless appears to be against the EU Audit Directive<sup>7</sup>.

### **Composition of the Supervisory Board**

Lastly, the Code recommends that companies should incorporate criteria of board quality in selecting and reporting on the composition of supervisory boards, their independence and their competences to be disclosed prior to election (section 5.4.1). Lack of disclosure regarding the Company’s independent assessment and limited biographical disclosure have been weak points in the reporting of German companies. As per the new amendments, the supervisory board should “set up a profile of competencies for all of the Supervisory Board” and should “inform about the appropriate numbers of independent members of the capital-side of the Supervisory Board and the names of these persons”. In addition, “the candidates’ proposal shall be accompanied by a brief curriculum vitae and an abstract about the respective candidate’s essential activities further to the Supervisory Board Mandate; these information shall be published updated annually on the company’s webpage.”

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<sup>4</sup> Ibid, p. 6, Section 4.1.3

<sup>5</sup> Ibid, Page 10, section 5.3.2

<sup>6</sup> Ibid, page 11, Section 5.3.2

<sup>7</sup> Ibid, page 10, removed from section 5.3.2. The EU Directive prescribes that all of the members of the Audit Committee should have sector knowledge and at least one should have financial experience.