Fidelity International
25 Cannon Street
London EC4M 5TA
United Kingdom

Regierungskommission Deutscher Corporate Governance Kodex
c/o Deutsches Aktieninstitut e.V.
Senckenberganlage 28
60325 Frankfurt am Main
Germany

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Dear Prof. Nonnenmacher,

We are pleased to have this opportunity to respond to your consultation on proposed revisions to the German Corporate Governance Code ("the Code"). Fidelity International ("Fidelity") has US$ 414.8 billion in assets under management, with approximately US$ 13.6 billion invested in German listed equities and with almost all of these funds being under active rather than passive investment mandates.

Introduction

We believe the new structure of the Code is sensible and highly readable, and with regard to the recommendations themselves we are generally pleased with the direction of travel.

Regarding the decision to move to an 'apply and explain' framework: we are supportive of this in principle so long as the disclosures that result from this are genuinely meaningful for investors seeking to understand how companies are applying the German corporate governance framework.

We understand that part of the impetus for this revision was the series of significant votes against management remuneration at DAX companies during the 2017 annual meeting season and the resulting recognition that there was a disconnect between investor expectations on governance matters and the standards set by the Code. Your statements in the article *Corporate Governance im Spannungsfeld von Investorenerwartungen und Kodexreform* express the hope that the proposed revisions will contribute to a greater level of trust and understanding between German companies and their shareholders and a reduction in dissent at German shareholder meetings. While we share your belief that the Code can play an important role here, we would emphasise that the adherence to the Code should not be seen by market participants as a substitute for direct dialogue between supervisory boards and shareholders. Furthermore, we support a flexible, principle-based governance framework that is adaptable to individual company circumstances, and we believe this is only achievable with open and effective dialogue.

In our response we have not endeavoured to comment on all sections of the code, but only those on which we believe there is a particular need for improvement, giving due consideration to current German market practice, the direction proposed in the draft Code, and the wider context of corporate governance best practices internationally.

Comments

Engagement with the Chairman of the Board (Suggestion A.2)

The proposed version of A.2 states that the supervisory board chair should be available - within reasonable limits - to discuss supervisory board-related issues with investors.

For the reasons mentioned above, we believe that direct engagement between shareholders and the supervisory board chairman should be strongly supported in the Code and that A.2 should be elevated to a “shall” recommendation.

We would also suggest that A.2 provide the flexibility for direct engagement with other supervisory board members, as there may be instances where shareholders wish to engage in dialogue with other directors on matters pertaining to their specific mandates, for example with the chair of the Audit Committee on audit-related matters.

Material Transactions with Related Parties (Principle 11)

The proposed version of Principle 11 states that material transactions with related parties are subject to prior approval of the Supervisory Board.

We would generally prefer material related party transactions to require approval by a majority of non-affiliated shareholders, but acknowledge that the proposed principle reflects the intended implementation of the EU Shareholder Rights Directive in Germany. We would therefore suggest the following recommendations be added in order to better protect the interests of minority shareholders:

- That all material related party transactions shall be subject to review and approval by a committee of independent supervisory board members, without inclusion of interested parties, and

- That any such committee resolutions shall be reported on in the Annual Report, including any dissenting votes and the reasons for such dissent.

Self-Assessment of the Supervisory Board (Recommendation A.15)

We welcome the inclusion of Recommendation A.15, which states that the Supervisory Board shall assess, at regular intervals, how effective the Supervisory Board as a whole and its committees fulfil their tasks.

We would suggest that the recommendation be strengthened to state that the supervisory board shall report on the significant findings of the assessment and any steps taken in response to these findings in the annual report.

Independence of the Supervisory Board (Principle 20 and related recommendations)

We welcome the proposed changes regarding the diversity and independence of the supervisory board. However, we would suggest the following changes to the list of criteria for considering director independence in Recommendation B.8:

- Whereas the proposed version states that a controlling shareholder or related party may be considered non-independent, we would suggest expanding this to any shareholder or related person who holds more than 10% of the share capital or voting rights. In the proposed draft code, a shareholder with 10% of the voting rights is considered to have a material interest in the company (Recommendation B.14) but the list of independence criteria only refers to controlling shareholders. In our experience, a shareholder does not need to hold a controlling interest in a company in order to be in position to exert significant influence over its supervisory board and management. In practice we generally support the presence of significant shareholders or their representatives on supervisory boards, but we are cognisant of the fact that there may be instances where their interests are not aligned to ours or other minority shareholders, for example due to differences in investment strategy, time horizon, or other business or investment interests (and any potential conflicts arising from these interests).

- Directors representing shareholders who are appointed to the supervisory board rather than elected by the AGM should in principle be considered non-independent.
- Founders of the company or members of the founding family should also be considered non-independent even if the founders/founding family no longer hold a significant shareholding stake.

Remuneration of the Management Board (Principles 26-28 and related recommendations)

We commend the Code Commission for its efforts to address the topic of management board remuneration, which has been an area of particular investor focus since the 2007-08 financial crisis. The level of shareholder dissent expressed on management pay during the 2017 annual meeting season clearly shows that a greater understanding of investor expectations vis-à-vis executive remuneration is desirable, and we believe the Code can serve a valuable role in establishing basic standards upon which German companies, shareholders, and other stakeholders can agree.

That said, we are concerned that the recommendations on management board remuneration set forth in the new Code establish a remuneration framework which is - as far as we are aware - not yet used by any German company, or at the very least is not widely used, and would establish a rather rigid set of constraints on German supervisory boards when designing management board pay. We also believe there are some recommendations on management board pay that should be enhanced. Our specific comments are as follows:

- For short and long-term variable remuneration, we believe that the supervisory board should have the flexibility to design incentives which it believes are appropriate for motivating management and providing alignment with shareholders given the individual circumstances of the company. Whilst we would agree that long-term incentives should be determined under due consideration of strategic planning, we believe this may appropriately take the form of financial metrics aligned to the business plan. Supervisory boards should also feel they have the freedom to set strategic targets as part of the short-term incentive if they believe this is appropriate. We also do not see why the short-term incentive should be paid out solely in cash rather than, for example, a combination of cash and shares if the supervisory board so determines.
- We believe it is important that the supervisory board should have the flexibility to apply appropriate discretionary adjustment to incentive pay outcomes from time to time, in order to ensure that such outcomes fairly reflect management performance and the shareholder experience and serve as a bona fide incentive. Any such adjustments should be clearly disclosed and explained to shareholders in detail. We believe this is a reasonable way to address potential concerns about the efficacy of multi-year performance targets, and therefore do not agree with the recommendation D.11 that subsequent changes to targets should be excluded in all cases.

- We would encourage the Code to place a stronger emphasis on the importance of share exposure/retention periods. Recommendation D.7 currently states that shares granted for long-term variable remuneration must not be sold for a period of at least four years. We think it is worth highlighting that many investors - ourselves included - believe that the retention period should be longer than this. In our view, a guaranteed retention period of five years on a weighted-average basis is appropriate at minimum, and ideally at least a of portion of shares awarded to executives should be in the form of career shares which must be retained until termination of employment with the company. By retention period we mean the total time that elapses between the grant of share awards and the time at which any sales restriction is lifted, including the vesting period and any additional post-vesting holding period which may apply. We would not be opposed to a greater emphasis on management shareholding guidelines, which is common practice now in many markets, though we are of the view that this approach can have drawbacks in practice. In our experience, shareholding guidelines are sometimes set at a rather low level relative to annual equity award grants, which means that once the threshold is reached, there may be no holding restriction on future awards beyond the vesting period. For this reason, we have tended to favour placing emphasis on the share retention period instead.

- We were happy to see that that the revised Code now contains a recommendation against benefits in case of early termination upon a change of control (suggestion D.15). However, we consider the standard severance cap of two times' annual remuneration to be excessive, as it is calculated based on both fixed and variable elements and means that executives terminated prior to the end of their contract can effectively receive 'unearned' bonuses, including in cases where the executive is terminated due to poor personal performance. We consider this to be the very definition of "pay for failure" and would therefore recommend that D.14 be changed so that the recommended severance cap is calculated based only on contractually obliged fixed remuneration.

Supervisory board remuneration (Principle 29)

The draft revision of the Code continues to take a neutral stance on the subject of performance-related remuneration for supervisory board members, with recommendation D.20 stating that any performance-related remuneration to members of the supervisory board should be linked to sustainable growth of the enterprise.

We believe that the provision of performance-based pay conflicts with supervisory board members' responsibility for independent oversight of management and should therefore be avoided. This view is widely shared among investors internationally and Europe in particular. Several years ago, the Code recommendation on supervisory board remuneration was softened from an explicit endorsement of performance-based pay to the rather more neutral current version. In response to this, many German companies took the positive step of revising their articles to eliminate performance pay for supervisory board members, which we have welcomed. We would now encourage the Code Commission to consider revising its recommendation further to an explicit recommendation against performance-based remuneration in line with international best practice.

Conclusion

We hope that this submission will make a positive contribution to your deliberations but please feel free to contact us if you have any questions.

Yours sincerely,

Matthew Roberts
Corporate Governance Analyst