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Public Consultation on the Proposed Amendments to the German Corporate Governance Code

Response by Allianz Global Investors

Allianz Global Investors (AllianzGI) welcomes the opportunity to respond to the public consultation to the German Corporate Governance Code (the Code). The views expressed in this document represent our position as an investment manager and do not reflect the formal position of Allianz SE as a listed issuer.

Allianz Global Investors is a diversified active investment manager, managing EUR 535 billion[1] in assets for individuals, families and institutions around the world. We invest for the long term across a range of different investment strategies, and pay close attention to growth prospects, return on capital, good governance, market positioning and quality of franchises. Furthermore, we believe that material environmental and social considerations are crucial to the success of a company looking for long-term outperformance.

Consistent with our investment philosophy, we routinely engage in dialogue with investee companies. Our investment views are influenced by the outcomes of these engagements and are linked organically to the proxy voting process, forming a consistent stewardship approach.

General Comments

We consider many of the proposed amendments to the Code as a significant step towards the alignment of the Code's recommendations with internationally accepted standards of good and responsible governance. We commend the Government Commission on the German Corporate Governance Code (the Commission) for their efforts in reviewing the current Code, and for incorporating the comments we made back in 2016 into the current review of the Code.

At the same time, we believe that there is further scope for improvements of corporate governance standards in Germany that would both reflect the specificities of the co-determination system and be beneficial for companies, investors and other stakeholders and would contribute to long-term sustainable value creation by German issuers.

[1] As at 30 September 2018.

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AllianzGI believes, that the practical role of the Code should be to:

1. Help establishing and encouraging robust governance structures and practices by German issuers that would be largely consistent with international best practice standards as applicable in the local legal and regulatory context; and
2. Provide a reliable reference point for German issuers, who should be confident that complying with the Code's recommendations or providing meaningful explanations of any departures, would help them gain support of their shareholders, as well as confidence of customers, employees and general public.

Many positive amendments notwithstanding, the remaining gap between general expectations of international investors and the Code's recommendations could undermine both the Code itself and the confidence in the governance and supervision at listed German issuers. We would, therefore, encourage further revision and enhancement of the Code as set out below.

Where Code's recommendations encourage companies to go beyond the legal requirements to enhance governance practices and protection of minority shareholders via, for example, introducing changes to companies' articles of incorporation or reviewing the composition of their supervisory boards, a longer implementation period and the "comply or explain" system should be allowed.

AllianzGI welcomes and supports the following enhancements to the Code:

1. **Setting clear independence criteria** for Supervisory Board members:
   - We agree that clear independence criteria and guidance on their application in the Code will provide a useful reference point for both issuers and investors.
   - It is important to note, however, that while we welcome the proposed amendments, we believe the independence criteria can and should be enhanced to align with international standards and general investor expectations (please see further comments below).
2. **Clear guidance on what constitutes an appropriate balance of independence** on the Supervisory Board (**B.10**). We would suggest that the Recommendation make it clear that "more than half independent shareholder representatives" is a minimum expectation and a higher standard is encouraged.
3. The proposal under **B.2** that a Supervisory Board shall specify its **target composition and skills/expertise profile** and make director nominations to meet these requirements, while reporting to shareholders.
4. **Guidance on the maximum number of board mandates** that a Supervisory Board member, a Supervisory Board Chairman, and a Management Board member can hold to ensure they can fulfil their responsibilities to the high standard expected by investors (**Principle 21**; Recommendations **B.5** and **B.6**).

   While we would prefer to see stricter limits (e.g. limit of two simultaneous Supervisory Board Chairmanships with no additional non-executive roles, and no more than one Supervisory Board directorships for a full-time executive), we believe the proposal is a big step in the right direction to account for the increasing workload, responsibilities (and potentially liabilities) associated with non-executive roles and to ensure that Supervisory Board members have enough time to fulfil their duties under both normal and extraordinary circumstances when significant additional time commitment may be required.
5. The proposal under **B.1** to **limit the Supervisory Board term to 3 years** to encourage a more frequent review of Supervisory Board composition, mix of experience, skills and diversity.

   As an investor we welcome this recommendation and see it as a good compromise between the existing practice of 4-5 year terms in Germany and the international standard of annual director re-election. At the same time, we understand that existing AGM regulations in Germany are creating unnecessary complexity and impeding companies' ability to hold more frequent director elections. We would encourage the Commission to supplement the new recommendation with a call for simplifying local AGM regulations and making it easier for companies to put Supervisory Board members forward for more frequent re-elections.

6. The recommendations for the Supervisory Board to meet on the regular basis without the Management Board, and to disclose board and committee meeting attendance on an individual basis (**A.13** and **A.14**). We note, however, that a comply or explain approach is critical here to make sure that such meetings are adding real value rather than being held purely for compliance purposes.

7. The amendments to **A.15** with regard to the regular **self- and external assessments of the effectiveness** of the Supervisory Board.

This is not an exhaustive list, but only some examples of the amendments to the Code that we believe will help enhance corporate governance standards and practices in Germany to the benefit of issuers, investors and society as a whole.

AllianzGI would welcome further improvements to the Code as set out below:

1. **Protection of minority shareholders:**

   - **Material transactions:** Minority shareholders in German companies have limited rights to decide on transactions of fundamental importance for the business and of profound implications for their investments. This stands in sharp contrast with normal practices in other markets, and can have dire consequences for both companies and investors.

     In this context, we are **extremely concerned over the proposal to remove para 3.7** of the Code, which suggests that, in the event of a takeover offer, the Management and Supervisory Boards of the target company ask for shareholder approval of the transaction via an extraordinary general meeting. By contract, AllianzGI considers that not only this **recommendation should be preserved and strengthened**, but a similar recommendation should be made in respect of the acquiring company in the event of a material acquisition.

   - **Principle 11 (Related Party Transactions):** this principle is not sufficient to protect minority shareholders from inappropriate RPTs that can negatively impact our investments. To provide more robust protections to investors in the absence of corresponding regulation, the Code should recommend that all RPTs outside of the company's ordinary course of business (as defined under the Shareholder Rights Directive) should be subject to the approval of the Audit Committee or a specially appointed Board committee comprised of independent shareholder representatives. All such transactions should be disclosed to shareholders notwithstanding the size of the transaction. Furthermore, we would advocate for an enhanced recommendation that material related party transactions (definition can be elaborated based on existing practices in the EU member states), should be put to shareholder approval thus protecting minority shareholders from decisions that could be detrimental to their investments.

   - **Differential ownership and control structures:** Some companies in Germany maintain capital structures that lead to differential ownership and control. These are cases where ordinary shares with voting rights are concentrated with so called "anchor investors", and non-voting preferred shares are being widely available in the market. We encourage the Commission to make it an **explicit recommendation in the Code** that capital structures of listed issuers should be designed and managed to offer equal opportunity for all shareholders to invest in ordinary shares with voting rights. This way the requirement of "one share one vote" would be upheld in practice.

2. **Supervisory Board dialogue with investors**

   - We welcome suggestion **A.2** that the Supervisory Board Chair should be available to discuss Supervisory Board related issues with investors. However, we believe that this **suggestion should be elevated to the Recommendation level** and the language changed to "shall be available".

     Having had direct experience of engagement with Supervisory Board Chairs of many DAX 30, as well as mid- and small-cap issuers, we confirm that these interactions are extremely valuable to investors and help us understand governance structures and practices of companies we invest in, assess the quality of the company's leadership, and enhance our ability to exercise our ownership rights actively and responsibly.

     The positive impact such a dialogue can have on all market participants is underscored in the "Guiding principles for the dialogue between investors and German supervisory boards" published

in July 2016 by a group of German institutional investors, companies, associations and academics. Having tested this framework for over two years now, we believe that it is both feasible and has worked well for companies and their investors.

- We also suggest that **an opportunity to have a dialogue with investors should be open to all Supervisory Board members and especially the chairmen of the Remuneration, Nomination and Audit Committees**. This would also help address instances where a dialogue with the Supervisory Board Chairman may not be appropriate (e.g. where investors have concerns about the Chair, or where the Chair is considered to be non-independent, or has been non-receptive to investor engagement).
- Engagement with investors can be undertaken in many different ways, from one-on-one meetings with individual directors to group meetings with either the entire Supervisory Board or a combination of Supervisory and Management Board members. It is therefore important that companies have flexibility in finding the best solution to engage in a dialogue with their investors.

3. **Supervisory Board composition and effectiveness:**

- AllianzGI places great importance on having a critical mass of unquestionably independent directors on the board to ensure that minority interests are protected and conflicts of interests are managed effectively. However, we also appreciate that directors, who are deemed to be non-independent, can add a lot of value to the board and all company's stakeholders. We would recommend that the Code highlights that **non-independence should not been seen negatively** or preclude a director from being elected to the board; but rather that **all boards should ensure there is a critical mass of unquestionably independent directors at all times**.
- In the context of the previous statement, AllianzGI believes that the **independence criteria proposed under B.8 should be amended/enhanced** to create a closer alignment between the Code's recommendations and general expectations of international investors:

  i. AllianzGI sees a great benefit in having a former executive with deep inside knowledge of the company to serve on the Supervisory Board given Germany's co-determination system. However, we **do not believe it is appropriate or justifiable to designate a former Management Board member as independent after only a 2-year cooling off period.** By comparison, international best practice standards recommend a cooling-off period of at least 5 years, while in some markets a former executive would never be considered independent.

  We are concerned that if included in the Code, this provision will continue to create major differences between the definition of independence as recommended by the Code and applied by major institutional investors following international best practice standards.

  ii. The **reference to a "controlling" shareholder** only is not sufficient and **should be replaced by a "major" shareholder**. The definition of a "major" shareholder should include block-holders and other investors with a significant stake in the company, who have committed a large amount of capital and may therefore be conflicted when it comes to certain proposals discussed by the Supervisory Board. We propose that 5% shareholding in a large-cap company, and 10% shareholding in a mid-/small-cap company should be considered as "major shareholding".

  iii. "Close **family** relationships" can have a narrow legal interpretation, whereas there are other types of relationships that can create conflicts of interests. We suggest using "related or associated relationship".

  We also note that, objectively speaking, we would not consider employees of the company or representatives of a specific interest group (e.g. trade unions), as independent in the context of the German supervisory board.

  Finally, we do not agree with the proposal that the Supervisory Board can declare the director independent if they fail one or more of the independence criteria stated in the Code.

- As stated above, we welcome Recommendation **B.10** that more than half of the shareholder representatives should be independent from the Company and the Management Board. However, we do not see why directors connected to major shareholders should be exempted from this requirement.

As an example, when assessing board composition and balance of independence, we look at the board as a whole, and whether individual board members have potential conflicts of interests (e.g. a major shareholder, employee or trade union representative, former executive, advisor, etc.) that may affect their independence. Our own expectation would be for at least 1/3rd of the entire Supervisory Board to comprise unquestionably independent directors.

- With regard to **Principle 9** and Recommendations **A.5**, **A.6** and **B.10**, we believe it is critical for the Code to provide guidance with regard to the level of **independence of the key board committees**.

  Due to different practices among German companies regarding the composition of board committees, we believe it is really important for the Code to provide guidance as regards the appropriate level of independence.

  As an investor, we would like to see **high level of independence on the Audit Committee** combined with appropriate qualifications, experience, skills and capacity to effectively contribute to the committee's work. Similarly to our comment above, we would encourage the Code to look at the committee as a whole, and any potential conflicts of interests present, and not at shareholder representatives only.

  Thus, we would advocate that the Code includes a Recommendation that **an Audit Committee shall comprise at least 50% (with higher aspiration) of unquestionably independent directors and have an unquestionably independent Chair.** This approach would give companies flexibility as regards the addition of non-independent directors to the Committee, be it representatives of a major shareholder, former executives, long-tenured shareholder representatives, or employee representatives.

  We also believe that the Chair of the Audit Committee must be a financial expert with strong audit and accounting expertise.

- In view of the critical role of the Supervisory Board Chair as a key liaison between the Management and Supervisory Boards, and his/her more significant involvement with the company compared to other Supervisory Board members, we believe it is important to provide further checks-and-balances on the Board, particularly where Supervisory Board Chair was not independent on appointment (e.g. former executive or major shareholder).

  We would strongly recommend that the Commission consider a suggestion to appoint an unquestionably independent Vice-Chair or a so called Lead Independent Director to assist the Chair with running the board and serve as a point of contact with investors where dialogue with the Chair is not deemed to be appropriate. We note that this practice became well established in many markets, including the US, France and the UK, and is particularly valued by investors in companies with non-independent Board chairs.

- With regard to Recommendation **B.12**, we would advocate for a no more than one former member of the Management Board to be appointed to the Supervisory Board. As highlighted above, we agree with the significant value-add offered by a former executive on the Supervisory Board; however, we consider two such members to be excessive in the context of challenges in ensuring an appropriate balance of independence and diversity of Supervisory Boards given co-determination structure.

4. **Management Board compensation (Section D)**

- Investors evaluate effectiveness of remuneration practices based on appropriateness of remuneration structures, performance KPIs and targets, performance periods, total remuneration and incentive opportunity, etc. Furthermore, many investors favour share-based long-term incentive schemes over cash and stock options and believe that management should build substantial shareholdings in the company to ensure alignment of interests with shareholders.

- We support the annual vote on the remuneration report as required under the Shareholder Rights Directive.

- We note that in markets where a vote on remuneration policy has become binding over the past few years, there generally has been a positive change in remuneration structures, and the dialogue between companies and shareholders has improved.

- We consider **Principles 23, 24, 25, 27, 28, 29 and 30 to be robust and largely aligned** with our interests and expectations as an investor in German companies.
- At the same time, we consider **many of the associated Recommendations to be overly prescriptive**, thus denying companies the flexibility to develop remuneration systems that are most appropriate for their businesses and best aligned with the interests of their shareholders and other key stakeholders. We believe that the "Guidelines for sustainable management board remuneration system[2]" developed by representatives of issuers, investors, academia and other stakeholders could serve as a good reference document to encourage best practice approach among German companies, yet provide them with flexibility to design appropriate remuneration schemes with a high degree of transparency on individual target achievement.
- Furthermore, in view of the forthcoming regular vote on the executive remuneration policy under the Shareholder Rights Directive, we expect greater level of engagement between companies and shareholders on remuneration-related issues. In this context, we believe it would be **counterproductive to create unnecessary prescription** as regards executive remuneration practices under the Code before companies and investors have had a chance to engage in a dialogue on appropriate remuneration structures.
- We have **particular concerns over the proposals regarding long-term variable remuneration** (LTI). While we agree that "implementing the corporate strategy is the focal point of long-term variable remuneration" as stated in the Code, we disagree that LTI grants should be based solely on the annual assessment of achieving strategic milestones.
- Specifically, we are concerned about the potential qualitative nature of such annual strategic milestones and the lack of both transparency and objective assessment of the management performance often associated with non-financial KPIs. We are worried that such "strategic targets" can be very arbitrary and the link to shareholder value creation too remote. An annual assessment of strategic milestones also creates the risk of short-term focus among executives and reduces accountability of the Supervisory and Management Boards to shareholders.
- We believe that **LTI awards should be linked to financial KPIs that are both transparent, GAAP aligned, and clearly signal successful implementation of the strategy**. AllianzGI will ask for high standards of transparency if LTI awards are linked to non-financial KPIs. In the case of non-GAAP compliant financial KPIs we recommend to increase transparency with reconciliation to GAAP metrics.
- Where the size of the LTI award is based on annual performance assessments, as proposed by the Code and increasingly applied by German issuers, this should be based on objective and transparent performance measures that reflect the financial health of the business and management's achievements in the year under review. However, in such cases we would like to see a secondary assessment on vesting to ensure that the management's strategy has delivered sustainable value creation it was meant to achieve.
- Overall, we would like to see less prescription in the Code and more flexibility for companies to set variable pay in the way that works for them and reflects the needs of the business. As a global investor, we have seen many different scenarios and models that have worked well for different issuers, and strongly believe that there is no need for a prescriptive approach to remuneration structures.
- With regard to proposals **D.14** and **D.15** (severance and change in control payments), it is not clear to us how non-compete provisions are going to be treated under the Code's recommendations. We agree that **any** severance payment shall be limited to a maximum of two times the annual remuneration as proposed and be inclusive of any non-compete payments. We are concerned that as the draft stands now, it may be interpreted that companies should not be enforcing non-compete clauses where these are appropriate.

[2] http://www.guidelines-executivecompensation.de/wp-content/uploads/2018/08/Leitlinien_EN_Web.pdf

5. Additional comments:

- We are supportive of the move to higher level principles, but would prefer to have an "apply **or** explain" approach in respect of the Code's Principles, which would encourage meaningful disclosures and, critically, would help avoid boiler-plate statements that are not helpful for investor understanding of the governance structures and practices of companies.
- **Principle 1**. While the definition of the "enterprise's best interests" is provided in the foreword to the Code, this definition may be seen as encouraging the management of companies to ensure continued existence of the enterprise on a standalone basis even in circumstances when this may not be in the long-term interests of the company's key stakeholders, including shareholders, creditors, employees, customers, suppliers, etc. A more nuanced definition may be needed to emphasise sustainable value creation for the company's key stakeholders. Also, we believe it would be prudent to include the reference to ethically sound and responsible behaviour in the wording of the Principle.
- **Principle 2**. It would be good to include the approval of the strategy and oversight of its implementation as a specific role of the Supervisory Board, as this would help address concerns over discussion of these matters between Supervisory Board Chairmen and investors.
- **Principle 6**: It would be helpful to include reference to material sustainability/ESG risks under this principle.
- **A.3** Recommendation and suggestion: It would be helpful to refer to the "risk and compliance management system" in the first sentence. In the second sentence, in addition to breaches of the law, employees should be able to report the breaches of the companies' codes of conduct or even general ethical principles and values.
- **Principle 8**: It would be useful to have more explicit references to the key demonstrable diversity characteristics, including professional expertise, geographic and gender diversity, etc.

  Also, the Code should recommend that Supervisory Boards set meaningful targets for increasing gender diversity on Management Boards (as well as in the levels below the Management Board). Unfortunately, we have encountered a number of companies setting management board gender diversity target at zero or single-digit percentage points, thus effectively confirming the status quo instead of putting a real effort in increasing board diversity.

  The realistic transition period should, of course, be also indicated as a part of target-setting.
- **D.20**: Our preference would be to restrict Supervisory Board remuneration to fixed fees.

We hope our comments are helpful and look forward to the publication of the new edition of the German Corporate Governance Code. In the meantime, should you have any questions or need further information, please do not hesitate to contact us.

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