

REGIERUNGSKOMMISSION

Deutscher Corporate Governance Kodex

Proposals for a Code Reform 2019

Media conference call

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Prof. Dr Rolf Nonnenmacher, Chairman of the Government Commission
German Corporate Governance Code

Strengthen relevance and acceptance – for a strong and modern Code

- ❑ The objective of the Code is to present accepted standards of good and responsible governance. The goal is for these standards to be seen as the relevant set of rules by as many institutional investors as possible.
- ❑ **Key topics covered**
 - ❑ "Apply and explain" – supplementing the concept of "comply or explain"
 - ❑ Remuneration of the Management Board
 - ❑ Independence of Supervisory Board members
- ❑ **Focus on essential issues**
 - ❑ General principles instead of highly detailed legal rules
 - ❑ Easier to understand
 - ❑ Preservation of the obligation to provide information
 - ❑ Clarification of guidelines and recommendations
 - ❑ Clearer rules
 - ❑ More extensive explanations
 - ❑ Functional structure of the Code
 - ❑ Focus on duties
 - ❑ Enhanced readability

Strengthen relevance and acceptance, through intensive dialogue with stakeholders

- ▣ Draft Code prepared in seven Commission meetings and eight workgroup meetings
- ▣ In-depth dialogue already maintained during the discussion phase – especially with members of Supervisory Boards and Management Boards, domestic and international investors, as well as other stakeholders
 - ▣ Discussions were actively invited – in one-to-one meetings and at numerous events
 - ▣ Good response to the call for dialogue, sent out by e-mail in the spring of 2018

Guidelines for the 2019 Code reform

- ▣ A Code that reflects the status quo of discussions at an international level
- ▣ A stronger Code – not a weaker one
- ▣ High degree of relevance for all stakeholders of the Code: Supervisory Boards, Management Boards, investors, companies
- ▣ Best possible assessment of specific corporate governance practice, through sensible yet comprehensive transparency
- ▣ Establish transparency for the German corporate governance system
- ▣ Focus on essential issues: word count reduced by a third
- ▣ Comprehensible
- ▣ Long period of validity
- ▣ Inclusion of amendments pursuant to the German Act Implementing the Second Shareholder Rights Directive ("ARUG II")

Modern, clear, compact and relevant draft Code

Code reform 2019: "Comply or explain" plus "apply and explain"

- Important corporate governance codes of other countries have supplemented the tried-and-tested “comply or explain” approach with an “apply and explain” approach. In this context, "provisions" or "practices" are preceded by "principles" – the application of which is mandatory, and has to be explained.
- The explanation regarding the application of the principles in the enterprise is intended to enable shareholders and other stakeholders to assess the corporate governance structure within the enterprise. The use of standardised texts would not give proper consideration to this intention.
- The new category of the principles and the “apply and explain” approach are introduced in the Foreword. The recommendation to explain how the principles are applied can be found in recommendation A.19 of the draft Code.

Foreword: "The principles reflect both significant legal requirements and fundamental standards of good and responsible governance. The explanation in which way the principles are applied (the concept of “apply and explain”) is in accordance with good corporate governance."

Recommendation A.19: "Supervisory Board and Management Board shall explain in which way they apply the principles of the Code (“apply and explain”)."

Code reform 2019: Specification of the independence requirements regarding shareholder representatives on the Supervisory Board

- The Supervisory Board shall include what it considers to be an appropriate number of independent members (section 5.4.2 of the GCGC 2017), whose names should be published (section 5.4.1 (4) of the GCGC 2017).
- Independence is only an issue for the shareholder representatives, since only the shareholder representatives are elected by the General Meeting upon the proposal of the Supervisory Board. Therefore, recommendation B.7 of the GCGC draft, which corresponds to section 5.4.2 of the GCGC 2017, only applies to shareholder representatives.
- It is common practice internationally to link the definition of independence with a catalogue of specific circumstances which rule out independence, that represent a rebuttable presumption or that merely represent indicators for the lack of independence which are subject to a due consideration.
- The Code Commission prefers the indicator-based solution, since evaluation of the independence of Supervisory Board members necessarily is a subjective assessment which requires an overall view.
- The catalogue criteria in recommendation B.8 of the GCGC draft may help in this context, but cannot replace exercising due discretion.

Code reform 2019: Specification of the independence requirements regarding shareholder representatives on the Supervisory Board

- ▣ Recommendation B.8: Indicators
 - ▣ Member of the company's Management Board in the two years prior to appointment
 - ▣ Material business relationships (supplier, customer, lender, advisor, etc.)
 - ▣ Other material variable remuneration from the company (NEW)
 - ▣ Close family relationship with a member of the Management Board
 - ▣ Controlling shareholder
 - ▣ More than twelve years' membership of the Supervisory Board (New)

Recommendation B.9: "If one or more of the indicators set out above are met and the Supervisory Board member concerned is still considered independent, the reasons for this shall be given in the Corporate Governance Statement."

Code reform 2019: Re-statement of the rules regarding Management Board remuneration

- Objectives:
 - "Pay for Performance"
 - Incentive to promote especially the business strategy (section 87a (1) sentence 2 no. 1 of the draft AktG, under ARUG II)
 - Social acceptance
 - Transparency and comprehensibility
 - Recommendations concerning the remuneration report as well as sample tables will become obsolete in the course of ARUG II

Code reform 2019: Re-statement of the rules regarding Management Board remuneration

- In a first step, the Supervisory Board shall determine total target remuneration for the Management Board.
- The target total remuneration comprises all remuneration components and represents the amount granted in case of full target achievement.
- The target total remuneration largely depends on what is necessary to attract or retain the Management Board member concerned. The target total remuneration is supplemented by a maximum remuneration (cap).
- Total target remuneration and maximum remuneration must be communicable overall in comparison to the remuneration of other senior managers and the employees, and must be explainable to the general public.
- Every total remuneration package comprises fixed and variable performance-related components. The fixed components include the fixed salary, the pension contributions and non-operational fringe benefits. The performance-related components comprise short-term (bonus) programmes and long-term variable remuneration.

Code reform 2019: Re-statement of the rules regarding Management Board remuneration

- ▣ Variable remuneration is the key material incentive for pursuing the objectives of business policy.
- ▣ Short-term variable remuneration
 - ▣ ... is based predominantly on operative metrics. These can include financial (e.g. EBITDA, margins, productivity) as well as non-financial parameters (e.g. net-promoter score, employee commitment).
 - ▣ The amounts granted on the basis of target achievement shall be disbursed in cash at the end of the period.
- ▣ Long-term variable remuneration
 - ▣ ... focuses on the corporate strategy as well as on the strategic milestones and initiatives provided for the year under review.
 - ▣ Implementation of these strategic initiatives and measures shall determine remuneration levels. Given that evidence of success in performance will only emerge much later, the amounts granted shall therefore be disbursed in the form of company shares, which are then valued by the market:
 - ▣ a restriction of at least four years should be imposed on the sale of the shares.

Code reform 2019: Selected amendments to enhance transparency and clarity

- Recommendation A.14: disclose meeting attendance
 - Section 5.4.7 of the GCGC 2017 recommended that the report of the Supervisory Board disclose when a Supervisory Board member attended less than half of its respective meetings.
 - For the purpose of providing information to shareholders in particular, a comprehensive disclosure of individual meeting attendance is more suitable than the use of a transparency threshold.
- Recommendation A.15: extensive self-assessment of the effectiveness of Supervisory Board work is recommended
 - The ambiguous concept of an "efficiency review" (section 5.6 of the GCGC 2017) has been replaced by the self-assessment of how effectively the Supervisory Board fulfils its tasks
 - This self-assessment expressly includes the work of Supervisory Board committees
 - Self-assessment shall be supported externally in intervals of three years.

Code reform 2019: Selected amendments to enhance transparency and clarity

- Recommendation B.1: international best practice for the term of office of Supervisory Board members
 - Pursuant to section 102 (1) of the AktG, the maximum length of term of office for Supervisory Board members is five years.
 - Internationally, Germany is at the high end of the range in this respect. The recommendation to appoint Supervisory Board members representing shareholders for terms of no longer than three years takes into account international developments. Of course, re-appointment is possible.

- Recommendations B.5 & B.6: reduction of mandates instead of a self-assessment regarding the time required
 - It is proposed to remove the existing recommendation (in accordance with section 5.4.1 (5) of the GCGC 2017), according to which when making its proposals concerning the election of new members to the Supervisory Board, the Supervisory Board should satisfy itself that the respective candidates are able to devote the expected amount of time required.
 - Leaving aside the administrative efforts involved, practical experience has shown that this recommendation did not succeed in providing a convincing protection against so-called “overboarding”.
 - Instead, the Code now recommends to impose a restriction to five Supervisory Board mandates for members who are not a member of a governing body, and to two mandates for members of a governing body, respectively.
 - An appointment to the Chair of a Supervisory Board shall count twice.

Code reform 2019: Selected amendments to enhance transparency and clarity

- Recommendation C.2 incorporates international best practice for the term of office of Management Board members
 - According to section 5.1.2 (2) no. 1 of the GCGC 2017, for first-time appointments of Management Board members, the maximum permissible appointment period of five years should not be applied as a rule.
 - In accordance with established practice, the Code now recommends to limit first-time appointments to three years.

- Recommendation D.15: clarification regarding a cap for benefit commitments made in connection with the early termination of a Management Board member's activity as a result of a change of control
 - The recommendation of a cap on benefit commitments made in connection with the early termination of a Management Board member's activity as a result of a change of control in accordance with section 4.2.3 (5) of the GCGC 2017 was widely mistaken for the recommendation to promise such benefits. In fact, this was never the purpose.
 - In suggestion D.15 of the Code, the Government Commission supports the view that such benefits should not be agreed upon. Accordingly, there is no recommendation regarding the maximum amount.

- Recommendation D.17: Management Board members shall not chair supervisory bodies of non-group entities.

Code reform 2019: Focus on essential issues: selected items removed

- Section 2.2.4 (2) of the GCGC 2017: "In this context, the Chair should take into account that the Annual General Meeting be completed after four to six hours."
 - This suggestion has not turned out to be a suitable instrument to achieve a swift execution of the General Meeting.

- Section 3.7 (3) of the GCGC 2017: "In the event of a takeover offer, the Management Board should convene an Extraordinary General Meeting at which shareholders will discuss the takeover offer and, if appropriate, decide on corporate actions."
 - The suggestion has been met with criticism in terms of legal practice and legal politics.

- Section 3.8 (3) of the GCGC 2017: "A similar deductible shall be agreed in any D&O policy for the Supervisory Board."
 - There is widespread deviation from the recommendation of a deductible in any D&O policy for Supervisory Board members, since a deductible (of at least 1.5x of fixed remuneration, cf. section 93 (2) sentence 3 of the AktG for Management Board members) does not represent a suitable instrument to increase the sense of responsibility and the motivation of the Supervisory Board members. The Government Commission responds to the criticism and deletes the recommendation.

Code reform 2019: Focus on essential issues: selected items removed

- Section 5.4.3 (3) of the GCGC 2017: "Proposed candidates for the Supervisory Board Chair shall be announced to the shareholders."
 - Maintaining the existing recommendation is contradicted by the fact that this is a decision by the newly-constituted Supervisory Board, whereby publication of a proposal for a candidate by the previous Supervisory Board might prejudice the new Supervisory Board.
- Section 5.4.4 (2) of the GCGC 2017: "In the latter case, appointment as Chair of the Supervisory Board shall be an exception that has to be justified to the General Meeting."
 - The changeover to the Chairmanship of the Supervisory Board within the waiting period of two years requires a proposal of shareholders combining more than 25% of voting rights (section 100 (2) sentence 1 no. 4 of the AktG). There is no need for giving additional reasons beyond this proposal and a rationale of the proposal for election by the Supervisory Board following the recommendation B.2 of the draft GCGC.
- Section 7.1.3 of the GCGC 2017: "The Corporate Governance Report shall contain specific information on stock option programmes and similar securities-based incentive systems of the company, unless this information is already provided in the annual financial statements, the consolidated financial statements or the remuneration report."
 - Specific information on stock option programmes and similar securities-based incentive systems for the benefit of members of the governing bodies shall be disclosed in the remuneration report. Corresponding disclosures on employee programmes are not within the scope of corporate governance.

Code reform 2019: Consultation procedure – transparent process and active discourse

- ▣ Consultation procedure ensures transparency and participation
- ▣ Target groups for the consultation procedure
 - ▣ Members of Management Boards and Supervisory Boards
 - ▣ National and international investors
 - ▣ Solicitors, external auditors, and other advisors
 - ▣ Academia
 - ▣ Associations and other interested parties
- ▣ The amendments proposed by the Commission have been published on the Government Commission's website, upon commencement of the consultation procedure on 6 November 2018.
- ▣ In principle, comments are set to be published on the Code website.
- ▣ Additional round-table meetings for members of Supervisory Boards and Management Boards, investors, scientific experts, legal and other experts are scheduled for November and December 2018
- ▣ End of the consultation procedure: 31 January 2019
- ▣ New Code to be submitted to the German Federal Ministry of Justice and Consumer Protection in April 2019
- ▣ The new wording of the Code will come into force upon publication in the electronic Federal Gazette

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Contacts

▣ Media

Peter Dietlmaier
CCounselors
Königsallee 6
40212 Dusseldorf, Germany
Telephone: +49 211 210738 0
Facsimile: +49 211 210738 22
E-mail peter.dietlmaier@ccounselors.com

▣ Code users and other stakeholders

Dr Cordula Heldt
Head of the Secretariat
Government Commission
German Corporate Governance Code
c/o Deutsches Aktieninstitut e.V.
Deutsches Aktieninstitut e.V.
Senckenberganlage 28
60325 Frankfurt/Main, Germany
Telephone: +49 69 92915-0
Facsimile: +49 69 92915-12
E-mail: regierungskommission@dcgk.de