

Remarks

by

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## Preliminary remarks on the 2008 Code Report

As well as setting out the main statutory provisions relating to corporate governance the German Corporate Governance Code in its current form as amended on June 14, 2007 contains a total of 80 recommendations and 23 suggestions on the management and supervision of exchange-listed companies. Compliance with the recommendations and suggestions is voluntary for companies. However, under Art. 161 of the German Stock Corporation Act (AktG), exchange-listed companies are required to issue an annual declaration of conformity stating which recommendations they do not observe.

Since the Code was adopted in 2002, the Berlin Center of Corporate Governance (BCCG) has been commissioned by the Code Commission to conduct a regular empirical survey to systematically record the acceptance of the Code in business practice. To this end all companies listed on the Frankfurt Stock Exchange are asked to what extent they already comply with the individual rules of the Code, intend to do so within the current year, or do not apply the rule (now or in the future). The findings of the survey are published in the annual Code Report<sup>1</sup>.

The current Code Report (Code Report 2008) is based on the analysis of altogether 195 questionnaires received from all segments of the stock exchange (see Fig. 1). Related to all (638) companies, the response rate was

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<sup>1</sup> See v. WERDER, AXEL/TALAUICAR, TILL/KOLAT, GEORG L. (2003): 2003 Code Report: The Acceptance of the Recommendations of the German Corporate Governance Code. In: *Der Betrieb*, Vol. 56, pp. 1857-1863; v. WERDER, AXEL/TALAUICAR, TILL/KOLAT, GEORG L. (2004): 2004 Code Report – The Acceptance of the Recommendations and Suggestions of the German Corporate Governance Code. In: *Der Betrieb*, Vol. 57, pp. 1377-1382; v. WERDER, AXEL/TALAUICAR, TILL (2005): 2005 Code Report: The Acceptance of the Recommendations and Suggestions of the German Corporate Governance Code. In: *Der Betrieb*, Vol. 58, pp. 841-846; v. WERDER, AXEL/TALAUICAR, TILL (2006): 2006 Code Report: The Acceptance of the Recommendations and Suggestions of the German Corporate Governance Code. In: *Der Betrieb*, Vol. 59, pp. 849-855; v. WERDER, AXEL/TALAUICAR, TILL (2007): 2007 Code Report: The Acceptance of the Recommendations and Suggestions of the German Corporate Governance Code. In: *Der Betrieb*, Vol. 60, pp. 869-875.

30.6%, ranging from 18.6% in the general standard segment to 93.3% in the DAX<sup>2</sup>.

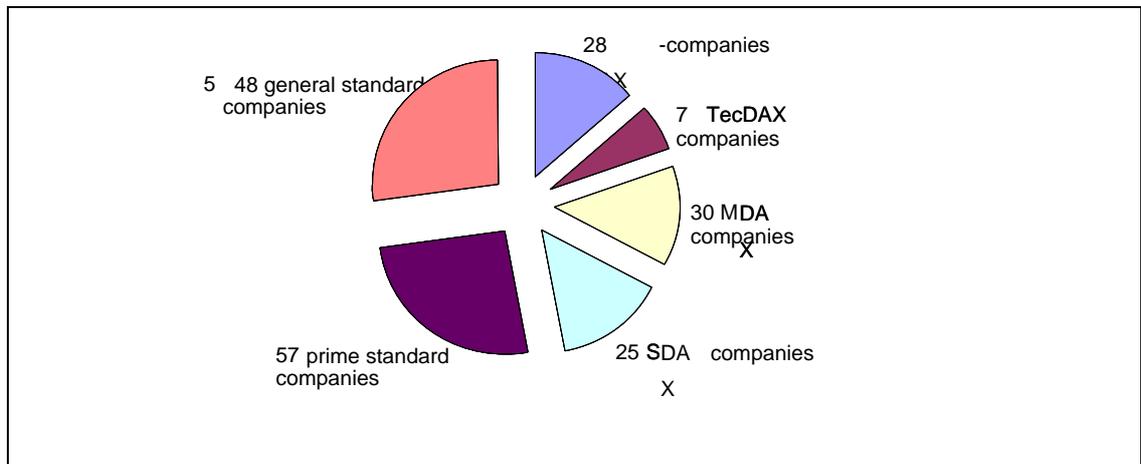


Fig. 1: Structure of sample used in 2008 Code Report

## General trends

The 2008 Code Report essentially confirms three main trends which were also identified in the previous surveys.

Firstly, the rules of the Code meet with a very positive response overall in practice.

Secondly, the acceptance level for the recommendations and suggestions increases with the size of the company and varies accordingly between the various stock exchange segments.

Thirdly, the Code with its amendments contributes to changes in the corporate governance practice of German companies.

These trends are illustrated in the following on the basis of the key indicators of the companies' average compliance rate and the acceptance level for the individual rules of the Code. The *average compliance rate* expresses what share of the Code's rules a company (from the overall sample or the individ-

<sup>2</sup> For details of the survey and the other findings, see v. WERDER, AXEL/TALAUICAR, TILL (2008): 2008 Code Report 2008: The Acceptance of the Recommendations and Suggestions of the German Corporate Governance Code. In: Der Betrieb, Vol. 61, No. 16.

ual stock exchange segments) implements on average. The *acceptance level* relates to each individual rule of the Code and thus indicates what percentage of all companies (from the overall sample or individual stock exchange segments) implement the recommendation or suggestion in question.

## **Average compliance rates**

The companies in the overall survey sample currently practice on average 67.0 of the Code's *recommendations*. With the Code containing 80 recommendations, this corresponds to an overall compliance rate of 83.8%. As expected, the corresponding figures for the DAX companies are higher. These companies comply on average with 75.9 recommendations, i.e. 94.9% of the Code's 80 recommendations.

In the previous year the corresponding compliance rates were 82.9% for all companies and 95.7% in the DAX. However, the comparison with the previous year's figures must be treated with due caution because the Code and the composition of the survey sample have since changed. According to the information provided by the companies in the questionnaires, these figures will increase further by the end of 2008 to reach 85.5% for all companies and 95.6% for the DAX.

On average, 57.5% of the (altogether 23) *suggestions* are currently followed by all companies and 75.8% by DAX companies. By the end of 2008 these figures are expected to rise to 60.7% for all companies and 78.9% for the DAX. In the previous year the compliance rates were 61.2% and 83.6%, respectively. The reduction is mainly due to the three new suggestions on severance payment caps. For the 20 pre-existing suggestions, the compliance rate is currently 61.0% for all companies and 82.0% in the DAX.

## **Level of acceptance for the Code's rules**

For a differentiated analysis of the acceptance levels for the individual recommendations and suggestions of the Code, the Code Report distinguishes between three categories of acceptance:

- *generally accepted Code rules* applied by an overwhelming majority of the companies (90% and above),
- *critical Code rules* not observed by more than 10% of companies, and
- *Code rules rejected by a majority.*

In the overall sample, 36 *recommendations* are now and 32 will in the future be *critical* under this definition. In the DAX the corresponding figures are seven today and five in the future.

The five recommendations which will continue to be critical in the DAX in the future concern

- communication of the convening of the annual general meeting including the convening documents by electronic means (acceptance in the DAX today: 82.1%; in the future: 85.7%),
- an appropriate deductible for D&O insurance for members of the management board and supervisory board (acceptance in the DAX today and in the future: 77.8%),
- discussions in full supervisory board meetings on the structure of the compensation system for the management board (acceptance in the DAX today and in the future: 85.2%),
- the restriction on the move by a former management board chairman or management board member to the supervisory board chair or chair of a supervisory board committee (acceptance in the DAX today: 71.4%; in the future: 75.0%) and
- performance-related compensation for supervisory board members (acceptance in the DAX today and in the future: 82.1%).

Even the critical recommendations already achieve a remarkably high level of acceptance in the DAX today and none of them is rejected by the majority of companies.

The rejection of critical recommendations by a majority of companies is a very rare occurrence even when all companies are included in the analysis. Overall there are only two recommendations not followed by at least half the companies (now and in the future). The first of these two is the recommendation on an appropriate deductible for D&O insurance for management board and supervisory board members, which has been included since the original

version of the Code and is accepted by 48.2% of the companies now and 48.7% in the future.

Also rejected by a majority of companies is the recommendation on the establishment of a nomination committee which was newly included in the Code last year. The task of a nomination committee is to prepare the supervisory board's proposals on the election of supervisory board members for the annual general meeting. Here again there is evidence of the typical acceptance differences depending on company size. While 96.3% of the DAX companies will have established a nomination committee by year-end, in the overall sample only just under half (47.5%) of companies will comply with this recommendation by the end of this year. A detailed analysis shows that smaller supervisory boards more frequently dispense with the establishment of a nomination committee. However, it can be expedient for small supervisory boards subject to codetermination law to observe this recommendation by forming a nomination committee comprising all the shareholder representatives on the supervisory board. After all, 24 of the 55 companies (some subject to codetermination law, others not) with a six-man supervisory board who responded to this question have decided in favor of establishing a nomination committee.

The number of *critical suggestions* related to the overall sample is relatively high, because today and in the future only three of these rules will exceed the 90% acceptance threshold. However, among the suggestions, too, rejection by a majority of companies is the exception. At present seven rules are not implemented by the majority of companies. These include on the one hand suggestions which have been in the Code for some time

- to allow shareholders to follow the annual general meeting via modern communication media (acceptance today 26.3%, in the future 27.9%),
- to include comments on the Code's suggestions in the corporate governance report (acceptance today 41.8%, in the future 50.0%),
- to elect or re-elect members of the supervisory board at different dates and for different periods of office (acceptance today 37.1%, in the future 43.3%) and

- to specify by resolution the components of supervisory board compensation related to the long-term performance of the enterprise (acceptance today 33.5%, in the future 36.1%).

In addition, the suggestions currently rejected by a majority of companies include the three new rules on the restriction of severance payments which were likewise added to the Code last year. Specifically these are the suggestions

- that payments made to management board members on premature termination of their contracts should not exceed the value of two years' compensation (acceptance today 46.5%, in the future 54.7%),
- that this severance payment cap should be calculated on the basis of the total compensation (acceptance today 36.3%, in the future 43.8%) and
- that payments promised in change-of-control clauses should not exceed 150% of the severance payment cap (acceptance today 39.7%, in the future 48.1%).

Related to all the companies included in the survey, the basic suggestion on the agreement of a severance payment cap will be observed by around 55% of companies in the future. However, the two implementation suggestions on the calculation of the cap and on special conditions for change-of-control situations will continue to be rejected by a majority of companies in the future. In the DAX the acceptance level for the three new suggestions will be between 59% and 67% by year-end. It therefore remains to be seen to what extent compliance with the suggestions increases in the medium term. Since the suggestions in question relate to the conclusion of (new) management board contracts and do not require any amendment to existing contracts, it may take some time before these suggestions become established as standard practice.

## **Conclusions**

The current survey for the 2008 Code Report confirms that the German Corporate Governance Code continues to meet with a high level of acceptance in the business community. Of the Code's total 103 recommendations and suggestions, only one suggestion ("staggered board") will be rejected by a majority of DAX companies in the future. Even when all companies are in-

cluded in the analysis, only two recommendations and five suggestions are expected to fall short of the 50% acceptance threshold in the future. The Code is therefore without question firmly established as the standard for good corporate governance.

In detail, the findings show that compliance with the Code has reached a very high level, especially among the major companies in the DAX. By contrast, the smaller companies not belonging to any index make greater use of the Code's flexibility and are more likely to deviate from specific rules. In interpreting these differences it is important to bear in mind that a lower level of compliance with the Code does not necessarily signal poorer corporate governance, provided the company in question can produce good reasons to convincingly justify non-compliance with selected rules of the Code. Conversely, the declaration of a higher level of conformity is by no means always an expression of superior corporate governance. The deliberate rejection of individual Code rules based on a company's specific situation can signify a more thoughtful approach to corporate governance questions than the general acceptance of all recommendations and suggestions. And ultimately of course the most important thing is how the Code is actually practiced in the company - for example in exploiting the scope for interpretation.