Status and Development of Corporate Governance in Germany

by

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Ladies and Gentlemen,
In recent years, a great deal has been done for modern corporate governance here in Germany, and the Code has played a major part in this. This is the finding of an objective analysis of corporate governance in Germany in mid-2004. Nevertheless we have no reason to sit back and relax, for there remains a great deal to be done.

We are gathered here in Berlin for the third time today to explore some basic points of the corporate governance debate in a critical and constructive way. These are:

- the status of implementation of the German Corporate Governance Code
- current national and international developments in this area and
- unresolved or even contentious issues concerning the theme of corporate governance.

Corporate governance is a key building block of a modern capital market and business structure for Germany. As far as the framework for this is concerned, a great deal is happening at the present time. As a result of new laws in Germany as well as new directives and recommendations at the level of the European Union, we will shortly be seeing a greatly changed legal environment for corporate governance. This was is also the main reason why the Government

Commission left the Code unchanged after its meeting on June 8. I will return to this point later.

My report today on corporate governance in Germany is structured as follows:

- First I would like to give you an overview of today's program.
- Then I will turn to the current status of implementation of the Code.
- This will be followed by remarks on the integration of corporate governance in the legal environment I mentioned earlier.
- Finally I will address some of the points in the current debate.

1. Overview of the conference

Ladies and Gentlemen,
The main aims of the 3rd German Corporate Governance Code Conference are to promote the Code, spell out its main points, discuss these with you and thus enhance the further acceptance of the Code.

Yesterday evening we heard the Federal Minister of Economics and Labor, Wolfgang Clement, and this morning the Federal Minister of Justice, Brigitte Zypries. I would like to thank both of them once again for their contributions. The agenda for today after my report is as follows:

- Since the introduction of the Code, the supervisory board audit committee has taken on much greater importance. I am therefore pleased that the supervisory board chairman of Siemens AG and chairman of the audit committees of several major German companies, Dr. Karl-Hermann Baumann, will be exploring the theme from a practical perspective. After that, Professor Harald Wiedmann, chief executive of KPMG, will open the

discussion with a statement. We look forward to receiving active contributions from the floor on this multifaceted subject.

- This year too we want to look at the bigger picture outside Germany. Frits Bolkestein, the EU Internal Market Commissioner, will explain to us the status of the debate in the European Union. For the OECD, Richard Hecklinger, Deputy Secretary-General, will be speaking to us.
- The question of judicial reviews of business decisions, particularly in terms of utilizing the latitude for discretion, is another highly topical subject – and not just since the Mannesmann trial. This afternoon, Professor Erich Samson and attorney Dr. Martin Peltzer will look at this subject from the point of view of criminal and civil law.
- Holger Steltzner, publisher of Frankfurter Allgemeine Zeitung, who welcomed us here this morning, has kindly agreed to moderate the entire event.

As you can see, Ladies and Gentlemen, we have again put together a varied and topical agenda for you this year. This underlines once more the importance of and interest in corporate governance in Germany.

2. High acceptance for the Code

Ladies and Gentlemen,
The German Corporate Governance Code has existed since February 2002. The Transparency and Disclosure Act of July 2002 integrated the Code with the Stock Corporation Act. The newly introduced Section 161 of the Stock Corporation Act requires the management and supervisory boards of all listed companies to make a declaration of compliance with the Code's recommendations once a year, the so-called comply-or-explain rule. In its first two years, the Code has already brought about some massive changes of behavior among businesses, in a way which is voluntary in its use, transparent in its presentation and flexible in its implementation.

Unfortunately, in the public criticism of corporate governance in Germany, this highly complex subject is usually reduced to a question of faith regarding the individualized publication of management salaries. However, this question is only one aspect. Do not misunderstand me: I urge greater transparency on this point, as I have emphasized this repeatedly in recent months. But corporate governance is far more than disclosing management pay. If we remember this, we can say that businesses' efforts to organize themselves voluntarily as far as corporate governance is concerned have on the whole been very successful:

- In Germany, the Code is used by companies as well as by interested third parties as a benchmark for good corporate governance. In addition it promotes further improvements in business practice in this area.
- Outside Germany, understanding is growing for our two-tier board system, precisely because the Code has made our system transparent and brought about necessary changes.

  However, in the public debate the differences between the one-tier and the two-tier system are often neglected. Corporate government principles from legal systems that use the one-tier system cannot be transferred into German practice without reflection. This has to be given much greater recognition for example in the debate on the independence of supervisory board members – I will return to this point later.

  This also applies to the not insignificant impact that the Sarbanes-Oxley Act has had on the work of the audit committees, including in companies which are not listed in the USA. For example, the requirements which the Sarbanes-Oxley Act place on the Financial Expert cannot be used to specify the specialist qualifications of all members of the German audit committee required by the Code.

  The Commission will now look at these issues in more detail and try to provide companies with concrete assistance – for example by specifying the Code's qualification criteria.

Ladies and Gentlemen,
My introduction today, like last year, includes a look at the status of Code implementation, which has again been investigated by the Berlin Center of Corporate Governance under the leadership of Professor Axel von Werder. The report is available in the foyer. The results of this year's empirical survey can be summarized as follows:

- The German Corporate Governance Code continues to enjoy growing approval and is contributing to the dynamization of corporate governance in Germany.
- Approval for the various criteria increases tendentially with the size of the companies. In the DAX segment, it is generally higher than in the M-DAX and S-DAX.
- Let us begin with the DAX, the trend setter for the German capital market. At the end of 2004, i.e. at the end of this year's AGM season, DAX companies will on average have implemented 96% of all recommendations – that's 69 of the Code's 72 total recommendations.
- By the end of the year, on average 90% of the recommendations will have implemented by companies in the new M-DAX, and 87% by companies in the S-DAX. In absolute terms, that's 65 and 63 of the 72 recommendations.

These results are not fully comparable with last year's figures. First, the total number of Code recommendations has increased from 62 to 72 since the change of May 2003. At that time, several recommendations on management pay were added, including those on individualized disclosure of management compensation. Last year's survey found that based on the first version of the Code around 90% of DAX companies had implemented 95% of all recommendations at the end of 2003. In the "old" M-DAX of 70 companies, the rates were slightly lower, as expected, but satisfactory. On the whole, we can therefore observe a generally positive trend of acceptance.

Naturally, the Commission would have wished for higher implementation rates for some of its recommendations, including, but not limited to, the much-discussed question of individualized disclosure of management compensation. This recommendation is currently being followed by 11 DAX companies, although two merely disclose the compensation of the management board chairman. That is not enough and more companies will have to disclose in the future if a statutory solution is to be avoided. Ms. Zypries was clear on this subject this morning, and the EU Commission has also submitted wide-reaching proposals on this point.

In addition to the individualized disclosure of management compensation, the Berlin Center of Corporate Governance classifies a further six of the Code's 72 recommendations as "sensitive issues" because the percentage of companies which have adopted them – while still being a very big majority – is not quite 90%.

One such recommendation is the individualized disclosure of supervisory board compensation. Supervisory board compensation is determined by the company's articles of association or the resolutions of the annual general meeting; the amounts for each individual supervisory board member can therefore be calculated. However, many companies make a connection between the individualized disclosure of supervisory board remuneration recommended by the Code and the recommended individualized disclosure of management compensation, with the result that opposition to the latter recommendation extends to the former.

Several deviations can be explained by the fact that the Code has entered uncharted territory with its recommendations and the companies need time to get used to these standards. This relates in particular to the discussion of the structure of the management compensation system by the full supervisory

board, the introduction of an age limit for management board members and the consideration given to internationality, conflicts of interest and an age limit for supervisory board members. In practice the pros and cons of an appropriate deductible for D&O insurance are still under discussion. The insurance companies only pass on the deductible to their customers in part – if at all – in the form of reduced premiums.

We therefore have empirical evidence to support the view that we are on the right track with a modern system of corporate governance also with the implementation of the Code at Germany companies. And I am very confident that over the next few years corporate practice will continually change in line with the Code's recommendations.

3. Legal environment of the Code

Ladies and Gentlemen,
I already said at the beginning that the Code is to remain unchanged for the time being. While the Government Commission was set up as a standing commission, this does not mean that we are always compelled to modify the Code. We had good reason for leaving the German Corporate Governance Code unchanged in our meeting on June 8, 2004.
A whole series of draft bills and initiatives are currently under discussion which will have far-reaching effects on corporate governance practice, for example

- The draft bill on corporate integrity and modernization of the right of avoidance (UMAG) aims to enhance the efficiency of annual general meetings and specify the liability of governing bodies by applying the so-called "business judgment rule".
- At balance-sheet level, two bills are under preparation:

  - Firstly, the government's draft of the accounting law reform bill, which incorporates the IAS standards in law and addresses questions relating to auditing and the independence of auditors.
  - Secondly, the draft bill on the control of companies' financial statements, the balance-sheet monitoring bill (BilKoG), dealing among other things with the establishment of an independent, private-sector enforcement body. This will help improve investor protection.
- Similar ends are pursued by the draft bill to improve investor protection (AnsvG), which strengthens insider trading law and introduces better measures against market malpractices.
- Finally, the German government has initiated the bill on test cases for investors' compensation claims (KapMuG) which creates the legal framework for a test case to eliminate the need for a large number of individual cases.

With these legal initiatives and draft bills, the requirements of the Baums Commission have largely been fulfilled. The German government has meanwhile announced the next stage of implementation under which board members bear increased liability for issuing false capital-market information on the company.

We must remember that alongside the legal initiatives and proceedings in Germany, the EU Commission is also working on the implementation of its corporate governance action plan of May 21, 2003. This action plan is based largely on the deliberations of the high level group headed by Jaap Winter, who was our guest last year and reported on these questions in detail. Many of the action plan's themes and especially the basic decision against having a European corporate governance code have met with widespread approval in Germany. A positive view is also taken of the proposed introduction of the right to choose between a one-tier and two-tier system in Europe; this is a good example of the spirit of flexibility which is so important for Europe. Under the EU action plan the member states will receive recommendations and directives from Europe on, for example, questions of independent non-executive directors and

supervisory board members, improving the quality of auditing, and management compensation, and these will have to be reflected in our work, too.

Unfortunately, in respect of the independence of non-executive directors and supervisory board members the EU has presented very extensive and detailed individual criteria which do not allow the national codes any rule-making latitude. However, the hallmark of the German Corporate Governance Code is that it strengthens individual responsibility and takes into consideration individual particularities by establishing transparency and using legal terms which leave room for interpretation. Under the EU plans this strength would be lost. This will be difficult to reconcile with the EU Commission's fundamental decision not to prepare a European corporate governance code and to allow instead the member states to develop their own codes taking due account of their legal and cultural particularities. The EU Commission has therefore moved away from its original principle-based viewpoint and distanced itself considerably from the proposals of the high level group headed by Jaap Winter. Against this background the discussion with EU Commissioner Bolkestein this afternoon promises to be very interesting.

Let me now come back to the independence criteria of the EU Commission mentioned earlier. In this discussion the question repeatedly asked is who exactly the supervisory board members should be independent of. It is generally agreed that supervisory board members should be independent of management. Despite the general consensus on this point it should nevertheless be possible to use valuable expertise for the company by appointing customers or suppliers to the supervisory board. A more critical aspect – especially from the viewpoint of German stock corporation law – is the EU's requirement that supervisory board members should be independent of the controlling shareholder. In Germany it is common practice for listed subsidiaries to be managed via the supervisory board, whose members are then of course determined by the parent company. Under the EU proposals on independence,

this tried and trusted management system would no longer constitute good corporate governance. So the question can well be asked whether the EU Commission has perhaps overshot the target.

Many of the new laws will lead to improved corporate governance in Germany and thereby enhance the country's standing as a business location. For this reason alone it would serve little purpose to adapt the code now on the basis of the latest updates on the legislative procedures and initiatives. On the contrary, this would be counter-productive.

4. Outstanding questions in the corporate governance discussion

Ladies and Gentlemen,
I have deliberately chosen to face public criticism here. From my viewpoint, there are five dominating aspects:

- management compensation, especially the individualized disclosure thereof, and supervisory board compensation in the form of stock options – especially after the latest ruling of the federal court of justice;
- the question of a management board chairman being appointed supervisory board chairman;
- the current status of annual general meetings in Germany;
- the concern that corporate governance is creating more bureaucracy and thus increasing formalism for companies, and
- questions of co-determination in a corporate governance context.

4.1 Criticism regarding compensation

In presenting the results of the von Werder study, I stated that only around a third of the DAX companies comply with the recommendation that management

remuneration be disclosed on an individualized basis. This is not enough. In the earlier part of this year I said on several occasions that the "objectors" must understand that voluntary disclosure is the only way to avoid the need for a statutory obligation. And it should also be borne in mind that statutory provisions are generally much more rigid and far-reaching than voluntary practices.

This issue is not about stirring up jealousy, but the fact that the appropriateness of management board pay should not be a confidential matter. If compensation is appropriate, there is no problem with informing the public and allowing the public to judge for itself. The disclosure of individual salaries can also act as a preventive measure to ensure individual salaries do not climb too high. From our point of view therefore the Code with its voluntary, flexible and transparent philosophy will achieve in the medium term what it set out to achieve: it will ensure appropriate compensation which is performance-related and competitive and at the same time socially acceptable. This is a point I can only keep repeating!

In this connection I would like to look at and clarify a further aspect – pension plans and non-cash compensation for management board members. Under legal aspects there is no doubt that both pension plans and non-cash compensation must be part of an appropriate overall management pay package. To this extent they must be dealt with in the information on the basic compensation system recommended by the Code. However, the Code's recommendation that management compensation be disclosed individually relates only to the fixed and variable components. On the subject of management board compensation we now await the proposals of the EU Commission, which will also relate to pension plans. The Code Commission will take this aspect into account in its future discussion.

Ladies and Gentlemen, I am repeatedly asked whether the Commission or I myself would like to comment on specific salary questions or other individual aspects at one company or another. This I am neither able nor willing to do. An appropriate assessment can only be made by each supervisory board or management board member individually within the latitude available on the general basis of the Code.

Since the judgment delivered by Germany's Federal Court of Justice in February this year declaring stock option programs to be inadmissible for supervisory board members, there has been considerable uncertainty surrounding the issue of supervisory board compensation. The German Corporate Governance Code is not affected by this ruling, as the Federal Court of Justice clearly stated in its reasoning. Unlike management board compensation, the Code deliberately refrains from recommending or suggesting the issue of stock options to supervisory board members. Rather, the original version of the Code contains a broadly formulated wording which remains valid. Performance-based forms of supervisory board compensation continue to be admissible.

At present, the Federal Court of Justice seems to have adopted a negative stance on any form of performance-related supervisory board compensation involving stocks or similar arrangements. However, this does not apply to performance-related cash payments and arrangements whereby part of the cash compensation is to be invested in stocks to be held for a lengthy period.

The ruling by the Federal Court of Justice that stock options are inadmissible for supervisory board members can pose significant problems in particular to young growth companies. Cash funds are usually limited at such companies, and they are thus restricted when it comes to filling supervisory board seats.

The question of how the long-term performance-related component of supervisory board compensation can be structured in the future is therefore a very difficult one which the Code Commission will continue to address. My impression is that the companies are currently developing widely varying concepts. They are displaying an eagerness to experiment which can only be welcomed. I hope that we will have been able to clarify this issue in the next two to three years.

4.2 The move from management board chairman to supervisory board chairman

Another popular topic of public debate both in Germany and elsewhere is the move from management board chairman to supervisory board chairman. There are no empirical findings on the economic advantages and disadvantages of such moves. The main worry is that a new management board chairman may have problems changing the strategy introduced by his predecessor if the latter chairs the supervisory board. Much depends on the personalities of the people involved. Ultimately the advantages of continuity and know-how must always be weighed against the disadvantage of persisting with a strategy which is seen to be wrong. In view of the different requirements of the two functions, institutionalizing such moves is rightly criticized and must not be permitted.

Various solutions have been put forward:

- The move is a question for the sole discretion of the supervisory board. Non-consideration of the previous management board chairman is no slight against that person. Ultimately it is down to the judgment of the supervisory board.
- Another option under consideration is to provide and disclose reasons for electing the previous management board chairman to the position of supervisory board chairman. This should be easy enough if the person is

suitably qualified for both positions. The task of preparing the election proposal and the reasoning behind it could be performed by a supervisory board nomination committee. The published reasons would however have to be specific to the case in question and refrain from using standardized reasons of little informative value.

- There is also much discussion of a cooling-off period aimed at minimizing the possibility of conflicts of interest between the two functions. In this solution, the Code would suggest that any newly elected chairman of the supervisory board should not have held the position of management board chairman of that company in the previous two years. Opponents of this approach argue that even during a relatively short cooling-off period of two years, the value and currency of the previous management board chairmen's knowledge could be seriously reduced. Moreover, there are doubts over whether the new management board chairman would be able to remain independent of his predecessor's influence in these two years, or whether he would orient his actions to the views of the "future" supervisory board chief.

As you can see, ladies and gentlemen, interesting solutions are also emerging to this problem. The Code Commission will continue to monitor developments and react if the need arises.

4.3 Annual general meetings

The third point of criticism concerns the way annual general meetings are run in Germany. Many of you will recall the splendid and in part highly amusing and detailed remarks made last year by Dr. Rolf-E. Breuer, one of my colleagues on the Commission and chairman of the supervisory board of Deutsche Bank, as well as the response from Claus Döring, editor-in-chief of Börsen-Zeitung.

My personal opinion from AGMs in which I participate as a supervisory board member is that the companies are now doing their homework better. The speeches by the chairmen of the supervisory and management boards are getting shorter, and the reading out of the formalities has been reduced to a minimum. That leaves more time for sensible discussion with the stockholders and their representatives. Although this trend is very welcome, on its own it is not enough to eliminate the recognized shortcomings of annual general meetings. So the Federal Justice Ministry is now right to take action with the UMAG bill and place restrictions on stockholders' right to speak and ask questions. The intention of legislators is to give legal backing to the right of the meeting chairman to set binding time limits for speeches and questions at the beginning of the AGM. If a stockholder exceeds a reasonably imposed limit, the management board is no longer obligated to provide a reply. The management board would also be relieved of its duty to reply if the requested information has already been made available to stockholders on the company's website a week before the AGM and is still accessible at the AGM. In the future, a company's articles of association or the rules of procedure for the AGM will authorize the management board to permit written questions when convening the AGM, to which written replies can also be provided on the internet. If the management board has done this, it is no longer obligated to provide replies during the AGM.

All of these measures are right. The question remains as to whether they are enough. In my opinion, a "normal" annual general meeting of a "normal" company which has performed "normally" should, when tightly chaired, last no longer than 4–6 hours. We need to work at this further, and for this we require further assistance from legislators. Of course, annual general meetings should also be allowed to last longer if there is really something out of the ordinary to discuss – be it major restructurings, critical strategic issues or problematical personnel decisions, to name just a few examples.

4.4 Accusation of formalism

A further criticism leveled against corporate governance is that the additional committees required by the Code lead to more formalism and bureaucracy in companies.

All I can say is that it always depends on how the supervisory board implements this recommendation. My personal experience is that preliminary discussions by stockholder representatives and cooperation in the committees have resulted in a completely new culture of discussion which far better satisfies the supervisory board members' need for information. Moreover, supervisory board members can contribute their experience far more effectively. In particular the intensity of discussions in the audit committee clearly leads to greater transparency and new insights, so that supervisory boards can perform their duties better, but at the same time can also be held more responsible.

However, companies should not fall for every fashionable innovation and, for example, base their corporate governance on the widely available checklists. In contrast to the practice in Anglo-Saxon countries, the Code includes no checklists prescribing how various points should be dealt with. I hope you too, ladies and gentlemen, will take the Code as a point of reference for your work, not as a rigid checklist by which your company is to be managed and overseen.

4.5 Codetermination debate

The fifth and final point of criticism relates to codetermination. We in the Code Commission do not deal explicitly with codetermination as this is not part of our mandate. However, the subject comes up repeatedly during our discussions, for example in connection with questions such as the size, composition, qualifications and independence of supervisory boards.

There is clearly a need for action here. All participants in the codetermination debate should ask themselves whether German codetermination, the conceptual roots of which date back more than thirty years, still fits in with today's environment of global structures, international constraints and strict capital market regulations. Other countries do not regard German codetermination practices in their current form as a plus point for Germany as a business location.

In the longer term, this is a subject which will have to be dealt with. With regard to good corporate governance, the upcoming recommendation of the European Union on the role of supervisory boards is bound to set off a major debate. The independence of supervisory boards is a European issue which in Germany will undoubtedly culminate in regulatory questions.

So there are numerous aspects relating to supervisory boards which also touch on the subject of codetermination. Independence, professionalism, internationality and efficiency audits of supervisory boards must be considered by stockholder and employee representatives alike.

5. Outlook

Ladies and gentlemen, that was my critical report on the status quo. What is next for corporate governance?
To start with we will await the legal changes. Our job will then be to formulate the necessary adjustments to the Code in such a way that it remains simple and understandable.

As I mentioned at the start of my speech, we have already achieved a great deal, but there is still much to be done. It is a never-ending process which the Code Commission will continue to watch and help develop. But: modern Corporate Governance in Germany is moving in the right direction – in the

interests of investors and companies and to safeguard Germany as a business location.