Corporate Governance in Germany –
after three years' experience with the Code

Presentation by

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Check against delivery.

Ladies and Gentleman,

Having not made any changes to the German Corporate Governance Code in 2004, the Government Commission introduced and amended a number of points in its meeting on June 2, 2005. In the current version, the Code contains a total of 82 recommendations and an unchanged number of 19 suggestions.

For both we have been in the public spotlight – in 2004 for the fact that we changed nothing, and now in 2005 for the fact that we have changed some things but in the view of some observers not enough. Let me state at the outset that I expressly welcome the public debate on the Code and its further development because what this is all about is creating transparency for business decisions and providing a benchmark for assessment.

It is self-evident that our Code will be used not just to judge companies but also to judge the Commission itself. We are willing to face up to this debate and I will be dealing today with the aspects on which the Code Commission did not make any decision at the beginning of June, namely the question of management board compensation.

The main thrust of this year's Code changes came about as a result of the following considerations:

- Firstly, we looked very closely this year at the subject of the supervisory board and made three material changes:

- o the first change relates to the question of the independence of supervisory board members. Here we had to respond above all to recommendations of the EU Commission, which has put forward criteria for the independence of non-executive directors.
- o the second change deals with the direct switch of management board members to the chair of the supervisory board or a supervisory board committee. Here we recommend that such a switch should not be the rule. Where it is planned, however, the special reasons for it should be presented to the annual general meeting.
- o regarding the qualifications of supervisory board members, we made a recommendation – clarifying and adding to our previous statements – that the chairman of the audit committee should have special knowledge and experience in the application of accounting principles and internal control methods.

- Secondly, in addition to these supervisory board issues we also looked at the changes resulting from legislation which has already come into effect – for example the Investor Protection Improvement Act, the Accounting Law Reform Act and the Balance Sheet Monitoring Act.

Due to the changed political situation after the announcement of early elections to the German Bundestag, it was not possible to say reliably at the time of the plenary meeting of the Code Commission which legislative projects would still be passed into law and which would be picked up again in the new legislative period. In the meantime we have a little more clarity on this, as reported yesterday by Undersecretary of State Geiger. The Act on Corporate Integrity and Modernization of the Right of Avoidance – UMAG for short – was passed by the Bundestag on June 16; it has not yet been finally debated in the Bundesrat. The Management Board Compensation Disclosure Act is expected to be debated and passed in the Bundestag next week – that at least is the declared intention of the Federal Government and the governing coalition. In the Code we made no changes in areas where we expect repercussions from these legislative projects, whose final wording we do not yet know.

I would like to structure my remarks today as follows:

1. After a brief introduction

2. I will first be dealing with the results of our Commission meeting on June 2 and explaining to you our reasons for changing the Code.

3. Then I would like to make a few brief remarks about developments in Europe having regard to the specific situation in Germany.

4. Finally I will be dealing with outstanding issues in connection with corporate governance.

1. Introduction

Ladies and Gentlemen,

Many of the changes that we made to the Code three weeks ago can be attributed from the point of view of the Government Commission to developments in the European Union: the corporate governance action plan of May 2003 has now been implemented in two further areas by the recommendations resolved by the EU Commission in fall 2004:

- On board compensation – i.e. in Germany on compensation of the management board and supervisory board, and
- on the role of non-executive directors – i.e. in Germany on the question of the independence of supervisory board members.

Naturally the Government Commission addressed these changes. Speaking here a year ago, I said that we would be carefully analyzing the new legal framework conditions in Europe and where appropriate incorporating them in the Code. We want the German Corporate Governance Code to remain what the Government Commission feels it has been for the last three years: a voluntary, flexible code for German business which creates transparency for shareholders and other stakeholders of the company and also makes our two-tier governance system understandable to international investors in Europe and the USA.

I think that there is no doubt that we have achieved these aims. The Code is a major success, as illustrated by the renewed increase in acceptance levels found in this year's survey by the Berlin Center for Corporate Governance. By the end of 2005, 97.3% or 70 of the 72 recommendations of the May 2003 version of the Code will be followed by the DAX companies, which set the trend.

I say this precisely in view of the current legislative procedure regarding the management board compensation disclosure law and I would like to make the following remark at this point: the current acceptance study of the Berlin Center for Corporate Governance shows that 20 of the 30 DAX companies already disclose management salaries individually; three further companies do this at least for their chairman.

The Government Commission believes that this is a major success – especially in view of the previous year when it was only nine out of the 30 DAX companies. Voluntary acceptance of this one Code recommendation has increased significantly and is now at “two thirds plus”. The glass is certainly more than half full, to use a familiar analogy. I would like to thank those companies expressly on behalf of the Government Commission.

Nevertheless, using this voluntary approach we have failed to achieve the 80 to 90% target set by the government. It was for this reason that I described the law announced by the Federal Justice Minister as “only consistent and logical”. I would have preferred a voluntary solution. Laws can only ever set the framework in which best practice rules can be translated into corresponding Code recommendations and suggestions. That also applies to the management board compensation disclosure law – especially as it anyway puts into legal form the recommendations of the Code on the individual disclosure of managers' salaries.

Perhaps the government could have waited a little longer before implementing the legal solution, because changes to corporate practice need time, as we know from our experience so far with implementation of the Code. On the other hand, there are companies who have publicly admitted to being strictly opposed to voluntary disclosure and will find it difficult to change their minds.

Overall, the German Corporate Governance Code remains a benchmark for the introduction of international standards of good corporate governance in Germany. The Code is about much more than the transparency of management compensation and has clearly proven itself in its totality.

2. Results of the latest meeting of the Code Commission

Ladies and Gentlemen,

At the meeting of the Government Commission in Frankfurt at the beginning of June, we made numerous changes closely affecting the subject of the supervisory board. I would like to explain to you today the main changes to the Code:

- The widest changes are those in section 5.4 on the composition and compensation of the supervisory board. In this connection, we looked at the independence of the members of the supervisory board (section 5.4.2). To allow independent counseling and monitoring of the management board by the supervisory board, the Code recommends that the supervisory board include what it feels to be an adequate number of independent members. A supervisory board member is to be regarded as independent if he or she has no business or personal relationships with the company or its management board which would establish a conflict of interest.

  In choosing this formulation we used a definition of independence along the lines of the requirements of the EU Commission for non-executive directors. We were able to dispense with a detailed list of independence criteria such as is contained for example in Annex 2 to the EU recommendation. In the German two-tier governance system of management board and supervisory board, the need to delineate non-executive directors and executive directors based on independence criteria does not exist to the same extent as in the single board system.

In Germany, the problem of independence presents itself elsewhere, namely in connection with the supervisory board representatives elected by the employees under codetermination law. In this area the EU Commission has granted Germany a special regulation: According to the definition in Annex 2 of the EU recommendation, employees of a company are in principle "dependent". However: employees of a German supervisory board subject to codetermination law who are covered by special protection against dismissal are deemed to be independent members. However, if, apart from their employee status, employee representatives meet other criteria which according to the EU catalogue constitute a dependency, they are considered to be "dependent" members of the supervisory board.

- Of key significance is also the new section 5.4.4, which states that it shall not be the rule for the management board chairman or a management board member to become supervisory board chairman or the chairman of a supervisory board committee. If this is proposed, special reasons must be presented to the annual general meeting.

  Under current stock corporation law, both the election of the supervisory board chairman and that of the chairman of a supervisory board committee are matters relating to the internal structure of the supervisory board and are the sole responsibility of the supervisory board members. And this will continue to be the case. However, in our view the shareholders should know in advance who is to be elected so that they can respond accordingly in the individual elections, which I will be coming back to later. With the wording we have selected, we wish to make clear that the election to supervisory board chairman or chairman of a supervisory board committee is a special election. It is therefore only logical that the possible election of a former management board chairman or management board member to supervisory board chairman needs to be explained separately. In the view of the Government Commission such a switch should not be the rule. There are without doubt many cases where it is appropriate, but any automatic rule would be out of place here.

The Government Commission thus also opposes a cooling-off period for former management board members. Even it is not the rule, the switch to the supervisory board should still be possible directly and without advance notice. A cooling-off period is neither necessary nor expedient for Germany with its two-tier system of governance; firstly there is no empirical evidence that a cooling-off period increases the independence of a former management board member on the supervisory board. Secondly, such a cooling-off period inevitably results in the loss of at least some of the knowledge and experience relating to the company. Finally, the introduction of a cooling-off period would mean that any supervisory board members concerned – if they have reached the age of 65 – will no longer be available for a full term of office as supervisory board chairman.

We have also included a new section, section 5.4.3: This recommends that elections to the supervisory board be made on an individual basis. In addition, an application for the judicial appointment of a supervisory board member must be limited in time, and the proposed supervisory board chairman must be announced to the annual general meeting.

- Last but not least, we have also introduced more precise recommendations in respect of the audit committee. The chairman of the audit committee must have specialist knowledge and experience in the application of accounting principles and the company's corresponding internal control processes. This recommendation is contained in section 5.3.2. In this key area, we have thus expressed in more concrete terms the requirements relating to the qualifications of the audit committee chairman along the lines of the US provisions under the Sarbanes-Oxley Act: In the USA, an audit committee member is required to have the specialist knowledge of a "financial expert".

Ladies and Gentlemen,
Beyond these complex issues relating to the supervisory board, we have amended the sections on Transparency and Audit of the Annual Financial Statements in line with the Investor Protection Improvement Act, the Balance Sheet Monitoring Act, and the Accounting Law Reform Act. One aspect of this, for example, is the enforcement powers introduced under the Balance Sheet Monitoring Act. The German Financial Reporting Enforcement Panel (Deutsche Prüfstelle für Rechnungslegung DPR e.V.) (chaired by Dr. Werner Brandt, CFO SAP) and the Federal Financial Supervisory Authority (BaFin) are authorized to check that the

consolidated financial statements comply with the applicable accounting regulations.

The Government Commission has now issued a recommendation that instead of just reporting on corporate governance, an explicit corporate governance report should be prepared (section 3.10). In this report all key aspects of a company's corporate governance should be presented contiguously.

In principle this is "merely" an editorial change, but we have specified what we expect companies to include in their annual reports in the way of a corporate governance report. Practical experience over the past three years shows that companies handle this in different ways: Some report on corporate governance separately at the beginning and thus not in the section of the annual report covered by the audit, some explain specific aspects of corporate governance in the management report or notes to the consolidated financial statements, both subject to audit, and others include a reference in the notes to the report presented at the beginning, with the result that this text can also become subject to audit. On the basis of practical experience we hope for a more uniform approach in the future.

This covers all I need to say on the latest key changes to the German Corporate Governance Code. The Government Commission is confident that we continue to have a highly effective, internationally recognized and competitive Code.

3. Corporate governance trends in the European Union

Ladies and Gentlemen,

My colleague Bertrand Collomb, Spokesman of the European Corporate Governance Forum, of which I am a member as one of two German representatives, reported last night on the forum meeting at the beginning of this week.

At this point I wish to deal with just a few aspects from the German perspective relating to the impact of the European debate.

The EU Commission continues to work consistently on the implementation of its corporate governance action plan of May 21, 2003. This is based largely on the findings of the high level group headed by Professor Jaap Winter. In our conference last year we had the opportunity to discuss key corporate governance themes in depth with the then EU commissioner Frits Bolkestein. And it is perhaps thanks in part to this discussion that we succeeded in making the main differences between the one-tier board and two-tier board systems and the practical implications sufficiently clear that allowance has now been made for them at least to some extent in the EU recommendations, in particular with regard to the independence of supervisory board members. I have already dealt with the two recommendations, the second relates to management compensation.

Many themes of the action plan have met with approval in Germany, too. The fundamental idea is the convergence of corporate governance in Europe. However, given the diversity of the governance systems practiced, a standard code for Europe cannot be the solution. Europe needs standardized principles for the key aspects, but not standardized rules or laws.

There are considerable differences between the countries – their legal systems, ownership structures, financing traditions and corporate cultures. These differences must not be underestimated because they are reflected in the corporate governance practices of the individual countries. National corporate governance codes which are based on common fundamental principles but which take into account national peculiarities are therefore the best way to improve corporate governance in Europe.

To understand these national peculiarities it is important to look at the social and historical parameters together with the corporate and capital market laws, which ultimately impact the shareholder structure of the companies in the various countries. For modern-day shareholder structures it is of decisive importance whether companies in specific countries have been financed in the past more from borrowed capital, pension funds or equity capital. A bank which provides a loan is different from a fund or a broad-based shareholder investment. In addition, in the case of funds a distinction has to be made between long-term investments as with pension funds and short-term hedge funds.

Last but not least, corporate governance systems are influenced by the different shareholder structures. In the end, different shareholders have different interests and expectations with regard to their companies. The national differences increase further in number if other stakeholders such as employees, customers and the general public are taken into consideration for matters of corporate governance.

An objective discussion on corporate governance can only take place in the knowledge of these differences. Unfortunately, matters are often made more difficult by the ill-considered adoption of Anglo-Saxon terms as buzzwords in other governance systems. When complicated terms and legal concepts are equated for the sake of simplification, misunderstandings are inevitable and the discussion is often taken in the wrong direction.

To illustrate this I would like to use the example of the one-tier and two-tier management systems. The one-tier system with one board comprising executive and non-executive directors is in many ways not comparable with the two-tier system comprising two separate boards – executive and supervisory – with distinctly different tasks:

- In the one-tier system the board manages all business and at the same time is responsible for its oversight. By contrast, in the two-tier system the management board handles business while the supervisory board provides advice and oversees its activities. The distinction between executives and non-executives or outside directors within a single body no doubt makes it possible to separate the management and supervision functions within the board. However, this is not comparable with the institutional separation of the two areas in Germany, but requires special measures. I already pointed this out in connection with the independence criteria.

- A chairman in the one-tier system is not the same as a supervisory board chairman because he also bears responsibility for the operating business, and a CEO is not the same as a management board chairman. A management board member cannot at the same time be a member of the supervisory board, whereas the functions of CEO and chairman are frequently performed by one and the same person, particularly in the USA.

- The Audit Committee has a different function to that of the German ‘Prüfungsausschuss’.

- The German two-tier system with supervisory board and management board provides for a clear separation of the two roles and establishes the desired system of checks and balances. This makes for greater transparency of business decisions.

- By contrast, in the USA – where the board positions of chairman and CEO are frequently held by a single person – conflicts of opinion are not debated by several decision-makers but are ‘merged’ so to speak in one person. The undisputed advantage of this system is that decisions are made more quickly; but the lack of institutionalized debate is a serious disadvantage.

- Attempts are being made in Germany to strengthen cooperation between the management board and the supervisory board and to strengthen the role of the supervisory board, for example by intensifying committee work. In the Anglo-American world, efforts are underway to underline the independence of non-executive directors and – in the UK at least – to separate the roles of CEO and Chairman.

Knowledge of these differences is necessary if we are to discuss individual corporate governance issues objectively and make an appropriate assessment of the in part different practical solutions. Given the great practical significance of these differences between the systems, we have chosen this subject as the focus of today’s podium discussion.

Developing general, transnational principles on the basis of this insight is a key task of the European Corporate Governance Forum. My colleague Betrand Collomb reported on this yesterday. Following my remarks we will also have the opportunity for further discussion with two other members of the Forum, Mr. Antonio Borges and Mr. Jaap Winter.

Nonetheless, I would like once again to outline the main aspects being addressed by the European Corporate Governance Forum. They are:

- making it easier to exercise shareholder rights across borders, in particular voting rights
- making supervisory board work more efficient, in particular the internal monitoring processes, and
- applying and harmonizing the “comply or explain” principle in Europe.

4. Outstanding issues

Ladies and Gentlemen,

Even after the latest amendments to the Code, there are of course still some outstanding issues which are as yet unresolved. But I would very much like to discuss some of the important issues with you.

Firstly the issue of compensation: on June 2, the Commission decided against making any further recommendations or suggestions on the subject of disclosing management board salaries. But that does not mean that we can be entirely satisfied with the situation we have achieved and that there is no further need for discussion. The subject of transparency of management board compensation is still a topical one.

First of all, the individual components of a management board member's total compensation need to be clarified. They include not just the cash compensation plus stock options or similar compensation components, but also the non-cash benefits, pension rights and severance payments as well as payments due in the event of premature termination of the period of office. In other words, we are talking about the complete compensation package. This compensation package must be appropriate overall, and it is the job of the supervisory board, and in particular the personnel committee, to ensure this appropriateness.

Transparency of management board salaries also means explaining to investors how the overall amount is put together and how the individual compensation components are weighted, as otherwise it is not possible to judge the appropriateness.

That is why preparing a separate compensation report as part of the corporate governance report already recommended by the Code may be advisable. This compensation report could set out the structure of the company's compensation system and the status of its implementation in the past fiscal year. Of course, this would have to be done in a generally understandable way so that people who are not absolute experts can also comprehend the compensation system. To provide a clear picture of stock option plans or similar instruments with long-term incentive effect and risk elements, the value upon issue and the current value of these compensation components could also be indicated. The value of pension rights could be made transparent e.g. in terms of the expense allocated to accrued pension liabilities or pension funds.

The Commission will be addressing all of these possibilities in its further discussions. This will of course also include the subject of individualized disclosure. Thinking this subject through to its logical conclusion, individualized disclosure should really include all components of a management board member's total compensation, that is to say not just the non-earnings-related components, the earnings-related components and the components with long-term incentive effect, but also the non-cash benefits, pension rights and severance payments as well as payments due in the event of premature termination of the contract of employment.

Ultimately, however, whether the Government Commission discusses these subjects further and possibly resolves Code recommendations or suggestions will depend on the legislators. If these points are already considered in the forthcoming law on the disclosure of management board compensation, there will be no reason to address these subjects further. We will have to await the final version of the law.

On now to the qualifications of supervisory board members: we have provided a more precise definition of the qualifications required for membership of the audit committee (Prüfungsausschuss). The chairman of the audit committee must have specialist knowledge and experience in the application of accounting principles and internal control processes. This recommendation supplements the general Code recommendation for the formation of committees with sufficient expertise. Taking both recommendations together, it is clear that in the future the supervisory board will have to consider very carefully which members it elects to the audit committee and which of these members should take the chair. Failure to meet these requirements may result in liability risks both for the supervisory board members who elected the audit committee members and for the audit committee members who accept such posts without the requisite specialist qualifications, and in particular for the chairman of the audit committee. If we also bear in mind that the recent draft of the Act on Corporate Integrity and Modernization of the Right of Avoidance (UMAG) indicated the intention of legislators to facilitate the filing of liability actions by the company, including by stockholders, then it becomes clear that the subject of specialist qualification is one which must be taken seriously.

To close I would like to take up an aspect of this year's AGM season: the issue of the transparency of funds as stockholders of a company. All kinds of funds – including but of course not limited to hedge funds – profit from transparency of business decisions. This was clearly shown in the past AGM season. However, the funds themselves should also make their decisions more transparent. There is a very clear need for progress on this point, and to that extent the "Special Code" now available for asset management companies is a useful tool in a special case.

The need for transparency of funds is particularly great in the case of special forms of funds such as the hedge funds I just mentioned. Although I am opposed to legal restrictions, these funds also need to be monitored by the financial watchdogs.

Ladies and Gentlemen,

That brings me to the end of my remarks. Corporate governance in Germany has made good progress. Previous criticism of our need to catch up on governance issues has been answered. At the beginning of 2002, the Government Commission drew up a Code which has since been amended on two occasions to reflect major changes in framework conditions and legal requirements, in particular the recommendations of the EU Commission. We can now keep pace with international developments and discuss them on an equal footing. Corporate governance in Germany is now “state of the art” compared with international capital market practice, even making allowance for certain German particularities.

Against this background, the Government Commission’s work in the coming years will be focused more on monitoring; we will continue to closely observe developments on the fast-moving international capital markets and in international corporate government practice. Future legislation will of course also have to be taken into account; in the immediate future this will be the law on the disclosure of management board compensation.

We certainly do not expect developments in the next three years in Germany, Europe and the USA to match the pace of those seen in the past three years. You will recall the scandals involving Enron and WorldCom whose impact triggered massive changes in legislation – I need only mention Sarbanes-Oxley. That was important and it was right. But now the main thing is to ensure that good corporate governance is really put into practice. The corporate governance codes must be applied and lived out.

That is why I am particularly pleased to be able to welcome leading international experts in this area for our subsequent discussion. They will give us a greater insight into international corporate governance, looking both back at the in part turbulent developments of recent years and forward to the future.