

31st January 2019

Government Commission on the German Corporate Governance Code

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Germany

By email: regierungskommission@dcgk.de

Dear Professor Nonnenmacher,

Consultation on the Proposed Revision of the German Corporate Governance Code

We welcome the opportunity to provide our comments on the proposed revision of the German Corporate Governance Code published by the Commission on 6th November 2018. Hermes Investment Management (Hermes) is an asset manager with a difference. With £36 billion in assets under management¹, we focus on generating holistic returns and consider the impact our decisions have on society, the environment and the wider world – outcomes for our clients that go far beyond the financial. Our stewardship team, Hermes EOS, is one of the world's leading engagement resources, advising on £389.4 billion on behalf of over 40 international institutional investors. Our approach to stewardship is detailed in our 'Hermes Responsible Ownership Principles'², as well as our expectations for corporate governance in Germany³. The views expressed in this communication are those of Hermes EOS and do not necessarily represent the views of all clients.

Hermes EOS commends the German Corporate Governance Commission on their work to review the German Code (the Code) and the continued emphasis on creating sustainable long-term value. We further welcome that the Commission has chosen to address complex and potentially controversial issues such as independence criteria for Supervisory Board members and guidelines for executive remuneration.

We would like to make specific comments regarding the new approach, as well as on key aspects such as independence, diversity and remuneration. Further, we believe that the

¹ As of September 2018.

² Hermes, 2018, Hermes Responsible Ownership Principles, available at <https://www.hermes-investment.com/ukw/wp-content/uploads/sites/80/2018/03/final-responsible-ownership-principles-2018.pdf>

³ Hermes, 2017, Corporate Governance Principles Germany, available at <https://www.hermes-investment.com/wp-content/uploads/2018/10/germany-cg-principles-dec-2017.pdf>

revision of the Code would be most effective in conjunction with the development of a German Stewardship Code that sets out investor expectations to drive effective stewardship and responsible ownership and, in doing so, contributes to a more sustainable financial system.

A new approach

In particular, we appreciate the benefits of moving towards an ‘apply-and-explain’ approach, as this encourages companies to specifically communicate how they approach corporate governance in contrast to the ‘comply-or-explain’ approach. We urge the Commission to issue supplementary guidance to help companies implement this new approach.

Furthermore, we applaud the fact that the Code calls for a more meaningful dialogue between the chair of the Supervisory Board and investors. For more than a decade we have been advocating that a regular and constructive dialogue between investors and Supervisory Boards on issues that fall within the remit of the Supervisory Board would strengthen the governance of German companies. We would also like to see further clarification on what good practice looks like as the current formulation of “within reasonable limits” seems rather vague (Principle 3, A.2). Therefore, we would encourage the Commission to explicitly incorporate a recommendation which outlines the topics that can be part of a dialogue between investors and the Supervisory Board, such as⁴:

- The composition of the Supervisory Board, its nomination process, and remuneration of the Supervisory Board;
- Supervisory Board-related matters, such as the corporate governance report, internal organisation of the Supervisory Board and the Supervisory Board’s efficiency review;
- Requirement profiles for Management Board members, without discussing specific proposals of individual candidates;
- The Supervisory Board’s participating role within the strategy process and its assessment of the implementation of the strategy; and
- The selection process of the auditor and the cooperation between the auditor and the Supervisory Board.

We believe the guiding principles are an effective tool to inform the dialogue on specific topics that will benefit both parties to enhance and facilitate robust discussions between investors and Supervisory Boards, which ultimately we consider to be good corporate governance practice.

We also welcome the fact that the Code puts emphasis on the importance of risk management in principle 6. In this regard, the Code should make clear that risk management should also focus on effectively managing environmental and social factors that are relevant to the business, with a view to enhancing sustainability. The board ought to regularly disclose to

⁴ Hermes EOS co-led the initiative ‘Developing Shareholder Communications’ which brought together various stakeholders including several large German listed corporations, and institutional investors. The principles are available at: [https://www.ey.com/Publication/vwLUAssets/ey-buiding-principles-for-the-dialogue-between-investors-and-german-supervisory-boards/\\$FILE/ey-buiding-principles-for-the-dialogue-between-investors-and-german-supervisory-boards.pdf](https://www.ey.com/Publication/vwLUAssets/ey-buiding-principles-for-the-dialogue-between-investors-and-german-supervisory-boards/$FILE/ey-buiding-principles-for-the-dialogue-between-investors-and-german-supervisory-boards.pdf)

shareholders how they identify and efficiently manage these material risks and provide evidence that the processes in place to do so are effective. Furthermore, companies should clearly define board and senior management responsibilities for environmental and social issues, such as climate change. Directors of companies should be accountable to shareholders for the management of material environmental and social risks, as over the long term these will affect the value and ability of companies to do business. We therefore urge the Commission to state explicitly that Management Boards should give an account of the effectiveness of the design and operation of their internal risk management and control systems to include material Environmental, Social and Governance (ESG) risks.

Independence

We welcome the Code's new guidance regarding the definition of, and level of independence for, the Supervisory Board. An adequate level of independence on the Supervisory Board is of utmost importance so that it can exercise its proper oversight and advisory function. We therefore commend the fact that the Code provides guidance on the criteria to evaluate the independence of Supervisory Board members in its recommendations B.7 and B.8.

We suggest that the Code should give further clarification on what is considered the appropriate proportion of independent members to have on the Supervisory Board. The Supervisory Board as a whole and each director individually must be mindful of these responsibilities in the performance of their duties. We note that any non-independent director, including employee representatives and representatives from a major shareholder or founding family, may feel greater pressure to represent the interests of particular stakeholder groups than those of the company. The entire Supervisory Board must be mindful of this risk.

As a general rule, we advocate that at least 50% of the shareholder representatives on the Supervisory Board are demonstrably independent. We accept that large shareholders call for representation on the board, however, we suggest that the Code makes a recommendation to the effect that representation of any major shareholder in a company should be proportionate with that shareholder's ownership stake within the company.

Representation of former Management Board members on the Supervisory Board may impact its independence. However, we believe that the mandatory waiting period of two years as stipulated by law may lead to the loss of valuable experience and relevant knowledge from the Supervisory Board, potentially resulting in a diminishing rather than a strengthening of the board's efficiency. The global financial crisis has shown that company-specific knowledge and sector experience are of high importance for the overall efficiency of Supervisory Boards. In some cases, we are therefore willing to support shareholder proposals for the election of suitable executives to the Supervisory Board. However, this ought to be the exception, and should be fully explained to shareholders well ahead of the shareholder meeting at which approval is sought.

Diversity

It is also of fundamental importance that the Supervisory Board is made up of members with an appropriate and diverse range of competencies, knowledge, skill sets and experience to enable it to discharge its duties and responsibilities effectively. That is, the Supervisory Board should be composed of diverse members, along the dimensions of experience, skills, social background, age, gender, ethnicity and personality characteristics. We are concerned that other than a brief mention, the current version of the Code does not offer sufficient guidance on this important issue.

We strongly urge the Commission to provide guidance on a holistic understanding of the concept of diversity, which is needed in leadership positions. We believe that Supervisory Boards should seek such a holistic form of diversity, taking into account a company's long-term strategic direction, business model, suppliers, employees, customers and geographic footprint along the diversity dimensions outlined above.

We believe that German companies are significantly lagging behind international peers with regards to an appropriate level of gender diversity, especially at the executive management level. We are concerned about the slow progress of German companies in this regard, and we urge the Commission to address this issue in the new version of the Code much more explicitly.

The "law for the equal participation of women and men in leadership positions"⁵, passed in 2015, introduced a mandatory gender quota of 30% for the Supervisory Board level, but has left it to companies to set voluntary targets for gender diversity within Management Boards. We are very concerned about the lack of progress and the prevalence of many listed companies setting themselves 0% women targets for their Management Boards.⁶ According to the Allbright Foundation, the proportion of women in executive management is only 12.1% in Germany, putting it behind the US, Sweden, the UK, France and Poland.⁷ This highlights how far Germany lags behind on gender diversity in senior leadership positions.

Hermes EOS is disappointed about the Commission's apparent lack of ambition on gender diversity in leadership positions, particularly at the Management Board level. We strongly urge it to provide companies with guidance regarding adequate gender diversity targets for the Management Board. In our view, the Commission should encourage companies to set ambitious diversity targets. The aim should be to reach at least 30% female representation on Management Boards in the medium term with a stretching interim target towards that

⁵ Bundestag, April 2015, Gesetz für die gleichberechtigte Teilhabe von Frauen und Männern an Führungspositionen in der Privatwirtschaft und im öffentlichen Dienst, available at https://www.bmfv.de/SharedDocs/Gesetzgebungsverfahren/Dokumente/BGBl-Frauenquote.pdf;jsessionid=89680357443B857EBCB9ACBC6383149C.1_cid297?__blob=publicationFile&v=5

⁶ Allbright, September 2018, Die Macht der Monokultur: Erst wenigen Börsenunternehmen gelingt Vielfalt in der Führung.

⁷ Analysis of 30 largest corporations on the stock exchange in Germany, France, Great Britain, Poland, Sweden and the USA, which were listed as of April 1, 2018, on their respective national benchmark index, found in Allbright, May 2018, Germany in Last Place: Corporations across the world get more women into top management.

objective in 2021. Furthermore, Hermes EOS highlights the need to include a clear a definition of what the Code means by ‘wider leadership levels’ and calls on companies to set stretching targets to improve the gender balance below Management Board as well.

Executive Remuneration

The remuneration of Management Board members of listed companies in Germany has been an issue of contention as the complexity and lack of transparency of Management Board remuneration systems have made them difficult to understand and analyse, and benchmark against performance. Some of the flaws include the lack of clear alignment of payment with company performance; payments being made despite serious misconduct or missed targets; and inappropriate termination payments.

Hermes EOS therefore welcomes the Commission’s aim to provide guidance on remuneration systems that focus on ‘pay for performance’ and alignment with corporate strategy whilst being transparent and comprehensible. The underlying principles are aligned with our Hermes remuneration expectations and principles that we published in 2016⁸.

We are supportive of the Commission’s objectives, underlying principles and the principal elements of the proposed model and recognise the need for significant change in executive remuneration practice. However, we are concerned that the proposed approach to executive remuneration, which suggests that one-size-fits-all, may be too prescriptive and rigid.

Instead, the Code should encourage company-specific solutions which account for the company’s sector, business model, maturity, and its exposure to different markets and geographies. At the same time, management behaviours should be aligned with the company’s purpose and strategy, so that long-term performance leads to appropriate rewards. The Commission’s model could of course be one of the models that companies choose to adopt.

Hermes EOS has worked with a group of key stakeholders, including chairs of several DAX companies and the main German institutional investors, to devise simple, sustainability-focused, best practice guidelines for Management Board remuneration at German listed companies.⁹ Whilst these guidelines do not require immediate radical change, they encourage companies to alter current practice and as such may be more successful in shaping best practice in Germany than the Commission’s proposed approach. Therefore, we suggest that the updated Code could make reference to the guidelines which will develop over time in line with best practice.

⁸ Hermes Investment Management, 2016, Remuneration principles: Clarifying Expectations, available at <https://www.hermes-investment.com/wp-content/uploads/2018/10/remuneration-principles-clarifying-expectations.pdf>

⁹ Leitlinien für eine nachhaltige Vorstandsvergütung/Guidelines For Sustainable Management Board Remuneration Systems, <http://www.leitlinien-vorstandsverguetung.de/> (July 2018)

Need for a German Stewardship Code

Generally, we welcome that the proposed amendments to the German Corporate Governance Code stress that institutional investors are “expected to exercise their ownership rights actively and effectively”, echoing the Shareholder Rights Directive.¹⁰ We believe that the new Code should be complemented by a German Stewardship Code setting out the obligations and expectations of investors. To drive effective stewardship and active ownership, asset owners and asset managers should report explicitly on how they fulfil their stewardship responsibilities, including the type of company interaction undertaken, the seniority of investor staff involved and the company representatives engaged, the specific issues covered, whether and how there has been collaboration with other investors and stakeholders, and, under certain circumstances, how an engagement has been escalated. All reporting should be outcome focused rather than just summarising activity. We believe investors should report on how stewardship activities help their organisation and specific funds to deliver on their purpose and contribute to the long-term sustainability of the assets under stewardship, thus serving millions of ultimate beneficiaries.

Only if investors become responsible and active owners of the companies they part-own and hold their boards to account, will the new Code be effectively implemented and have a real practical impact.

We hope that our comments and suggestions are of assistance. If you would like to discuss our views in further detail, please do not to hesitate to contact Lisa Lange.

Yours sincerely,

Dr Hans-Christoph Hirt
Executive Director, Head of Hermes EOS

Enclosures:

- Working Group, 2018, Guidelines for Sustainable Management Board Remuneration Systems
- Hermes, 2018, Hermes Responsible Ownership Principles
- Hermes, 2017, Corporate Governance Principles Germany
- Hermes, 2016, Remuneration principles: Clarifying Expectations
- EY, 2016, Guiding principles for the dialogue between investors and German Supervisory Boards

¹⁰ Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017L0828>