



ICGN

International Corporate Governance Network

Regierungskommission
Deutscher Corporate Governance Kodex
c/o Deutsches Aktieninstitut e.V.
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Via email: regierungskommission@dcgk.de

ICGN comment on proposed revisions to the German Corporate Governance Code.

31 January 2019

The International Corporate Governance Network (ICGN) welcomes the opportunity to respond to the Regierungskommission's (Commission's) consultation on the German Corporate Governance Code (Kodex).

Led by investors responsible for assets under management in excess of US\$34 trillion, ICGN is a leading authority on global standards of corporate governance and investor stewardship. Our membership is based in more than 45 countries, including Germany, and includes companies, advisors and other stakeholders. ICGN's mission is to promote high standards of professionalism in governance for investors and companies alike in their mutual pursuit of long-term value creation contributing to sustainable economies world-wide. Our policy positions are guided by the ICGN Global Governance Principles¹ and the ICGN Global Stewardship Principles², both of which have been developed in consultation with ICGN Members and as part of a wider peer review. They inform the base of our response to the questions posed in this consultation. For more information on ICGN please see: www.icgn.org.

Germany is a leading global capital market, and many of ICGN's investor members have significant holdings in equities and debt of German issuers. ICGN has been regularly involved with the discussion of German corporate governance, both through our conference activities and policy work. Our most recent policy intervention was our submission for the 2016 German Corporate Governance Code consultation.³ This 2016

¹ See ICGN Global Governance Principles: http://icgn.flpbks.com/icgn_global_governance_principles/

² See ICGN Global Stewardship Principles: <http://icgn.flpbks.com/icgn-global-stewardship-principles/#p=1>

³ See ICGN 2016 German Corporate Governance Code response: <https://www.icgn.org/sites/default/files/ICGN%20response%20German%20Corporate%20Governance%2>

response noted our recognition of Germany's distinct system of governance, reflected in both the two-tier system that prevails in Germany, separating the management board from the supervisory board and in the system of co-determination, or *Mitbestimmung*, which gives a prominent employee voice to German supervisory boards. ICGN's own Global Governance Principles continue to differ in some ways from the German Kodex, but we note that these distinctive governance features have generally proven to be effective in a German context.

At the same time, all systems of corporate governance have their challenges, and from an institutional investor perspective ICGN is alert to potential areas of concern in the German system that can include:

- Effectiveness of co-determination: ensuring the fiduciary duty of care of employee-elected directors to support the long-term interests of the company as a whole, and not just the German labour unions;
- Quality of Communication between Supervisory Board and Management Board: the two-tier structure raises risks of ineffective coordination between the two governing bodies;
- Independence in Germany is less far reaching than other jurisdictions where majority independence is a norm;
- Concerns about influences of controlling shareholders and respect for the rights of minority shareholders;
- Limited historical willingness by Aufsichtsrat members to engage with institutional investors;
- Cultural concerns: scandals at key German bluechips in recent years.

Our specific comments in this consultation on the Kodex are set against this background.

Draft of the amended German Corporate Governance Code dated 25 October 2018

It is clear that the Commission gave considerable, and fresh, thinking to the amended Kodex, and we applaud the spirit of starting with principles and building a more concise code that is relevant for German companies and reflects international corporate governance standards. This submission by ICGN will acknowledge some of the key improvements that we see in this latest version. But the nature of consultations is such that the greatest focus is on areas of potential concern. We will outline these concerns,

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along with recommendations in some cases, where we believe that the German Kodex may still lag international best practice and investor expectations.

Comments on the German Corporate Governance Code Consultation .

Foreword

New reference is made to the need for executive management and board directors to be aware of a company's "responsibility vis-à-vis society, noting that social and environmental factors can influence corporate success". We support this new wording and agree that this is an important awareness to build-- for companies, boards and investors. However, this new text does not appear to be linked to other modifications in the revised Kodex. This might benefit from greater clarification or expansion, particularly with regard to company strategy, director training and reporting. We note, as a comparison, that the new UK Corporate Governance Code places considerable new emphasis on stakeholder relations as part of a company's broader social role. The Commission may wish to elaborate on these points, and possibly to link this discussion to the EU's Sustainable Finance agenda.

New text states that "shareholders generally exercise their membership rights at the General Meeting". We agree with this basic point, but this should not be construed as the only way in which shareholder rights can be exercised. We also believe that shareholder engagement with companies and boards is an important means through which membership rights can be exercised and shareholder concerns most clearly communicated to companies and directors. We elaborate further in Principle 3 below.

Principle 3

While it is positive to have the "shall" recommendation require a company to publish its own rules of procedure on its website, we believe a fundamental weakness of this Principle remains the lesser importance (as reflected in a "should" suggestion) than we think is merited for investor engagement with the board. The body language is not good here. Moreover, we do not believe that engagement with the supervisory board should be limited to the chairman, particularly if other non-executive directors (an audit or remuneration committee chair, for example) may be better positioned to engage with investors in particular governance issues (which could include lack of confidence in the chair). Taken together, this does not reflect global best practice, and the Commission should consider strengthening its position on engagement with supervisory board members, perhaps providing guidance in the form of "Leitsätze für den Dialog zwischen Investor und Aufsichtsrat. "

8.8 We do not believe that two years is an adequate cooling off period for a company executive to join the supervisory board as an independent director. We generally discourage management board members from joining supervisory boards in the first

place. But if this were to occur, we are skeptical that a former executive manager could ever be classified as independent given the link to past company strategy and history.

Principle 9

We note that new text allows audit committee matters to be dealt with by the full board rather than a full audit committee, and we question if this is a positive addition of flexibility—or a possible dilution in audit quality oversight. We believe that not only should the audit committee chair be independent and have specific knowledge and experience in applying accounting principles and internal control procedures as well as the audit, but also the majority of the committee.

Principle 10

We suggest that in addition to the disclosure of conflicts of interest to the chairman of the supervisory board and/or the management board, significant conflicts of interest should also be reported in the annual report and on the website. Good governance also means that conflicts of interest should be monitored and managed to avoid inappropriate outcomes.

Principle 11

It is important for the supervisory board to approve material related party transactions (RPTs), as an application of ARUG II and the European Shareholder Rights Directive. But we believe this Principle does not go far enough to protect minority shareholder rights. We believe that related party transactions shall be disclosed and made available for shareholders. Moreover, we believe that shareholders would have the greatest protection if material RPTs were reviewed by a fully independent committee, rather than the board as a whole.

Principle 14

ICGN supports director training and professional development, and we believe the company should reporting on significant training initiatives to enhance board effectiveness. This could include basic disclosures relating to the board evaluation process. To link this with the language in the Kodex's Foreword, we would specifically encourage director training with regard to corporate social responsibility and building an understanding of its key environmental, social and governance (ESG) risks.

Principle 15

We support the basic point about equal treatment of shareholders with regard to

information. We also believe in equal rights in terms of “one share one vote” structures. We note that this new draft Kodex has eliminated reference to this important principle and would strongly advise against any interpretation that might implicitly encourage non-voting or differential ownership structures in German companies.

Principle 19

We support the introduction of the three-year term as a way to enhance the accountability of supervisory board members. However, we understand this is not consistent with German law-- e.g. § 102 AktG and § 13 MitbestG – so some clarification may be warranted. While this is a positive direction of travel, we would also observe that in other jurisdictions annual director elections take place at AGMs to reinforce director accountability.

Principle 20

It may be helpful to clarify the parameters of diversity for supervisory board members. We recommend articulation of specific factors, including gender, age, internationality, professional backgrounds and experience, as well as industry and specialist knowledge as components of diversity.

Principle 21

B5. We would argue that the chair of the audit committee should also be counted twice.

B6. Most investor guidelines see a maximum of one external mandate for the CEO.

B7. We think the language on an “appropriate” number of independent members is weak, and a higher standard should be adopted. ICGN believes generally that boards should be majority independent, and this is the standard of best practice particularly for widely held companies. At a minimum we believe a company with controlling shareholders should have one-third board independence. The German Kodex lags other global governance standards in this context.

B8. It is helpful to tighten independence criteria. We have no strong issues with establishing twelve years on the board as an independence threshold, as we recognise the inherent subjectivity in a “hard” metric for independence. But we note that in many markets a stricter nine-year rule relates to board independence, and the Commission want to consider a nine- or ten-year threshold as being more consistent with international best practice. We also believe the term “*close family relationship*” with a controlling shareholder is inadequate. It should read “*related or associated relationship*”.

Principle 22

As in our response to Principle 20, it may be helpful to clarify the parameters of diversity

for management board members. We recommend articulation of specific factors, including gender, age, internationality, professional backgrounds and experience, as well as industry and specialist knowledge as components of diversity.

Principle 23

We would note that best practice in some jurisdictions is a binding vote on the voting policy. This would be in line with the Shareholder Rights Directive, as well as law in most member states; it would also strengthen shareholder rights.

Principles 24-29

We appreciate that these Principles have been amended to encourage greater rigour in achieving responsible remuneration practices, and we support that aim. At the same time, we believe many of the specific requirements articulated in the draft Kodex are too prescriptive and generic – particularly those relating to the structural components of short- and long-term incentive awards. We are cautious about the introduction of rigid remuneration structures, particularly if they are not based on clear evidence of effectiveness. Finally, while we understand that this new Kodex is designed to be shorter and more focused, we believe you may wish to consider keeping the remuneration tables that are in the Appendix of the old Kodex. This does provide a helpful, and standardised, frame of reference for investors and other stakeholders.

Rationale for deleted recommendations and suggestions

We take issue with the removal of point 3.7 of the old Kodex. In the event of a serious takeover bid we believe the voice of shareholders should be heard in a general meeting.

We hope these comments are useful in your deliberations. If you would like to follow up with us with questions or comments, please contact our Policy Director George Dallas:

Yours sincerely,

Kerrie Waring
Chief Executive Officer, ICGN