Corporate Governance –

Status and developments in Germany and Europe

Speech

Dr. Gerhard Cromme

Chairman of the Government Commission

German Corporate Governance Code

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Check against delivery.

Ladies and Gentlemen,
I would like to welcome you all to the 5th conference on the German Corporate Governance Code. I will be reporting to you on developments in corporate governance in Germany since the last Code conference a year ago:

- First of all I will be dealing with the further increase in acceptance for the German Corporate Governance Code.
- Then I will be informing you about the latest meeting of the Code Commission and its results.
- Finally I would like to address current corporate governance developments both in Germany and internationally.

1. Introduction

The Government Commission on the German Corporate Governance Code is focused on continuity. In our plenary meeting on June 12, 2006 we intensively discussed corporate governance developments in Germany and Europe. We identified no major new developments since 2005 which would have made an amendment to the Code necessary. Against this background we were able to restrict ourselves to integrating into the Code the relevant provisions of the Management Compensation Disclosure Law (VorstOG) and the effects of the Law on Corporate Integrity and Modernization of the Right of Avoidance (UMAG). This mainly involved concretizing the individualized disclosure of management compensation and the rights of the chair of the annual general meeting.

I will be dealing with both these issues in more detail later. First of all I would like to remind you of the Government Commission's basic understanding of corporate governance and the German Corporate Governance Code.

The Government Commission is a standing commission which was launched by the Federal Justice Minister in September 2001. However, its job is not to continually change the Code that it developed. Rather, its task is to regularly monitor developments and adapt the Code to new developments where necessary. In the more than four years since the Code was introduced in 2002 there have been two major or substantive changes – namely in 2003 and

2005. On two occasions the changes were minor and more “technical” – in 2004 and now in 2006.

The reason for the way the Code has been changed in the past is that there were was a clear need for concretization in 2003 and 2005. In 2003 several things needed to be defined more precisely following initial experience with the Code by listed companies in Germany. In particular, the transparency of management compensation was significantly improved. The changes in 2005 mainly resulted from the recommendation of the EU Commission concerning the duties of non-executive directors and supervisory board members. The EU Commission’s recommendations are primarily geared to the internationally predominant one-tier board system.

As Germany has a two-tier system of management board and supervisory board, adjustments were necessary. For example, the important issue of the independence of supervisory board members has to be treated differently in a clearly separated system of management board and supervisory board than in a system in which executives and non-executives are combined in one board. As I have said in the past, a German management board chairman cannot be equated with a CEO, and a supervisory board chairman cannot be equated with the Chairman in the one-tier system. The same applies to the boards themselves, because a supervisory board is not the same as a board of directors.

The current international debate on our two-tier system shows in my opinion that the logic of two separate boards and their respective functions is now much better understood. That applies not just to Europe but also at OECD level.

In Europe, the EU Commission and the European Corporate Governance Forum are agreed that following the completion of the latest reform phase attention should focus more on monitoring further corporate governance practice and less on new provisions which are tailored to or predicated on the one-tier system.

The OECD is currently working on a Boardroom Guide as part of the OECD Principles of Corporate Governance. In it, practical examples of good corporate governance are to be given without them being geared specifically to a particular governance system. The OECD has for a long time been of the opinion that there cannot be a one-size-fits-all rule for systems which

have evolved differently in structural, legal, historical and cultural terms. The fact that this is now expressed more strongly in the Boardroom Guide is to be welcomed.

We are taking an active part in these discussions in order to improve the acceptance of the German two-tier system. In doing so we can help ensure that German companies no longer suffer a discount on the international capital markets just because they have a two-tier governance system.

This improved understanding of our system is one success of the German corporate governance debate. That's why I am delighted to have recruited such a high-caliber group of participants for today's panel discussion on these issues. The speakers come from both systems and have broad international experience, which promises an informative discussion.

But now back to the Code Commission's basic philosophy. I mentioned earlier the two-year cycle of substantive Code changes that we have had so far. It wasn't planned that way, but it has a lot to do with the Commission's philosophy. The Government Commission wishes to give companies the time they need to work with a stable Code. Only thus can companies implement best practices. Only thus can highest-possible acceptance of the Code's recommendations and suggestions be achieved. I will be dealing with the current acceptance of the Code shortly.

The aim of the German Corporate Governance Code is to create transparency of corporate decisions and thus allow clear and fair presentation of business actions. In our opinion, this can be best achieved by a voluntary scheme such as the German Corporate Governance Code. While it is important that the Code should be flexible, this does not mean that the Commission should seek to change it at every opportunity. For all the need to adapt certain provisions in the light of internationally accepted corporate governance in an Anglo-Saxon capital market philosophy, the Code must not become a bureaucratic hotchpotch.

2. Acceptance of the Code: BCCG Study 2006

Ladies and Gentlemen,

The Government Commission is delighted at the high level of acceptance achieved by the German Corporate Governance Code. As in every year, the empirical study carried out by the

Berlin Center of Corporate Governance (BCCG) on behalf of the Government Commission has provided us with reliable acceptance indicators for 2006. Prof. Dr. Axel von Werder from the Technical University of Berlin is responsible for the high scientific standard of the study.

As you know, the Code was extended from 72 to 82 recommendations in June 2005, while the number of suggestions remained unchanged at 19. As I already mentioned, these amendments were mainly based on the recommendations contained in the EU Commission's action plan. Eight out of the ten Code changes related to supervisory board issues, above all its independence. Specifically, the recommendations are as follows:

- The chairman of the audit committee shall have specialist knowledge and experience in the application of accounting principles
- and internal control processes.
- The supervisory board shall include what it considers an adequate number of independent members.
- Elections to the supervisory board shall be made on an individual basis.
- An application for the judicial appointment of a supervisory board member shall be limited in time up to the next annual general meeting.
- Proposed candidates for the supervisory board chair shall be announced to the shareholders.
- It shall not be the rule for the former management board chairman or a management board member to become supervisory board chairman or the chairman of a supervisory board committee.
- If this is intended, special reasons shall be presented to the annual general meeting.

According to the current BCCG survey, of these eight new recommendations only two – those regarding individual elections and the move by management board members to prominent supervisory board positions – will be followed by on average fewer than 90% of the DAX companies by the end of 2006. To this extent we can describe the level of acceptance as high; especially as the two recommendations falling short of the 90% threshold have also met with high acceptance: individual elections have 85.7% acceptance and the board switch recommendation 77.8%.

The overall picture is as follows: after the AGM season, i.e. at the end of 2006, on average 79.3 of the Code's 82 recommendations will be followed by the DAX companies. In the

previous year the figure was 70.0 of the 72 recommendations then applying. It is also pleasing that the positive trend in the DAX is also reflected in the two other indices studied: In the M-DAX segment, 75.7 of the 82 recommendations will be met by year-end, compared with 65.4 of 72 a year earlier. The S-DAX companies will meet on average 72.9 of the 82 recommendations, against 61.8 of the 72 recommendations in 2005. And one result gives me particular pleasure: at the end of 2006, seven DAX companies and five M-DAX companies will comply with all the Code's recommendations. We presented the overall study at a press conference in April; the information is available to you in the foyer.

However, these quantitative data do not give the full picture of what I would call the "internal acceptance" of corporate governance in Germany. Naturally, we in the Government Commission are realistic enough to know that corporate governance reports are still frequently regarded as a necessary obligation. But overall, things are moving in the right direction. This is shown by an analysis of the corporate governance passages in the 2005 annual reports of the DAX companies. As an example, and without mentioning any names, I would like to present you with three, in my opinion, important quotes:

- "Good corporate governance means responsible company management and control oriented to long-term value. It involves the Executive and Supervisory Boards efficiently cooperating together, respect for the interests of shareholders, and open, transparent corporate communications. … Corporate governance … is seen as a constantly self-renewing process."
- "Corporate governance is not determined by adherence to formal rules and regulations but above all by corporate management focused on long-term objectives and value creation. Transparency and value added are therefore also key elements of our management concept…"
- "Accordingly, our Executive and Supervisory Boards regularly evaluate the latest national and international standards in responsible, transparent and efficient company management with the objective of enhancing corporate governance … and creating sustainable value."

For me, these admittedly subjectively chosen quotes are qualitative proof of how far we have come in recent years with corporate governance in Germany. The importance attached to sustainability, value growth and the process aspect was anything but natural only a few years

ago. In addition, more and more emphasis is being placed on open communications with all stakeholders and particularly with shareholders.

Ladies and Gentlemen,
In international terms, not just in European terms, Germany's standing in corporate governance is now quite good. There are specific issues which are being discussed both at European level and in Germany, but fundamental changes to the corporate governance system are not regarded as necessary. A phase of consolidation and experience-gathering is beginning. I will return to the specific issues later.

3. Meeting of the Code Commission on June 12, 2006

Ladies and Gentlemen,
On June 12, 2006 the Government Commission adapted the Code to the Management Compensation Disclosure Law (VorstOG). Based on the structure of the law, we have integrated Code amendments as follows:

- Section 4.2.3 defines overall compensation.
- Section 4.2.4 relates to disclosure obligations.
- Section 4.2.5 regulates the way disclosures are to be made, namely in a compensation report which, as part of the corporate governance report, will also describe the compensation system for the Management Board members.

Increasingly, the compensation report will become a central source of information on all issues relating to management board compensation. This is the view of the European Commission, whose recommendation on management board compensation calls for a separate compensation report. This is also the view of the German legislators, who made a compensation report outlining the compensation system and optionally including individualized compensation figures a condition of the VorstOG. The Code supports this development toward a single condensed presentation of management board compensation and recommends in Section 4.2.5. that this be disclosed in a compensation report as part of the general corporate governance report. This section also includes two new Code recommendations concretizing the VorstOG. Firstly, if pension awards are made to management board members, the allocations to accrued pension liabilities or pension funds

shall be stated each year. Secondly, the compensation report shall also include information on the nature of the fringe benefits provided to management board members by their company. In the Government Commission's view, these two items of information will help create transparency with regard to overall management compensation.

In adapting the Code to the VorstOG, the Government Commission has taken account of developments in the German legal framework over the past year. Previously, the Code only recommended that monetary compensation should include fixed and variable components, and that the variable compensation should include one-time and annually-payable components linked to business performance as well as long-term incentives containing risk elements. The monetary compensation components thus defined were to be disclosed on an individualized basis.

With the VorstOG, legislators have now set out more concrete requirements relating to disclosure of management board compensation, in particular including non-cash benefits, pension schemes and severance payments. The Commission discussed introducing more specific requirements last year, but decided to await the VorstOG, which at the time was going through parliament, and to make changes after its enactment. As you can see, the new law matches our view.

The second change to the Code relates to the effects of the Law on Corporate Integrity and Modernization of the Right of Avoidance (UMAG). This law reinforces the rights of the person chairing the general meeting. We have included a new suggestion in section 2.2.4 of the Code to give greater attention to the wishes of the legislators, which to date is only found in the preamble to the law. A "normal" general meeting should accordingly not last more than four to six hours, and the chair should be able to take appropriate measures to observe this time period.

Including the resolved changes, the Code now contains a total of 81 recommendations. Two new recommendations have been added by adapting the Code to the VorstOG, while several other recommendations have been removed. The number of suggestions has risen from 19 to 20. The changes have still to be published by the Federal Justice Ministry in the Electronic Federal Gazette, which is expected to be done shortly. Only then will the new version of the Code become binding. However, the updated version of the Code dated June 12 is available for you today in the foyer.

4. Current corporate governance debate

Ladies and Gentlemen,
In my opinion, the debate surrounding corporate governance in Germany will focus on the following aspects in the coming months:

- Following the introduction in 2005 of several Code recommendations relating to the independence of supervisory board members, we will now have to analyze how companies are interpreting the term independence, which was deliberately defined in very general terms in the Code. We will observe how supervisory boards are meeting their responsibility to include an "adequate" number of independent members tailored to the concrete situation of their company.

  The Code deliberately refrained from defining a detailed list of criteria for independence. It contains only a general definition. But given our two-tier governance system, the very strong protection of minorities under German corporate law, and the traditionally strong role played by major shareholders in German stock corporations, the Government Commission feels it is inappropriate to classify representatives of major or even majority shareholders as not being independent per se. We feel we are backed in this by the OECD, which defines independence as being independent of the management board, and not additionally of the majority shareholder.

  The Code recommendation that proposed candidates for the chair of the supervisory board be made known to the general meeting and that specific reasons be provided if it is intended that a previous management board chairman or member should become chairman of the supervisory board or a supervisory board committee is also directed at the supervisory board and its responsibilities. If the supervisory board is of the agreed opinion that one of the proposed candidates should be appointed to the chair of the supervisory board, this opinion should also be communicated to the general meeting prior to the election. The Government Commission regards this as an act of "regular communication" which will strengthen the relationship of trust between the company and its shareholders by enhancing transparency. Of course, this does not mean that an extraordinary general meeting has to be convened for those exceptional cases when the

supervisory board chairman is to be elected at a different time to the other supervisory board elections. The recommendation also does not represent an interference into the statutory division of responsibilities and has nothing to do with infringing the secrecy of deliberations. It merely describes a fair way of dealing with shareholders. In the meantime, this recommendation is being very largely followed in corporate practice.

To this extent, the public will play a major role – as in many other areas of good corporate governance – when it comes to acceptance of the practical interpretation of independence.

- Moreover, we will be able to see and judge in the coming months what the effects of the new statutory disclosure requirements for management board salaries will be, which was originally intended by the Code to be voluntary. We will also be able to observe how shareholders use the possibility allowed by the Management Compensation Disclosure Law to release their companies from the requirement to disclose management board compensation individually.

  In this connection I would like to point out that the Government Commission would definitely have preferred a voluntary arrangement on this issue. However, it has no problem with the law, which follows the Code extensively in terms of structure and terminology. To remind you: 20 of the 30 DAX companies had committed voluntarily to disclose their management board salaries on an individualized basis, broken down into fixed salary, bonuses and variable long-term incentive components, by the end of 2005. However this two-thirds was not enough politically, which is why the government prescribed individualized disclosure from 2007 by means of the Management Compensation Disclosure Law. Incidentally, Germany is not alone in this. Switzerland, the UK, France, Luxembourg and the Netherlands also have corresponding binding disclosure rules.

- At the plenary meeting of the Government Commission two weeks ago, further proposals for Code changes were discussed but not finally resolved:

  - A discussion will probably develop over the question of whether and to what extent the statements made on corporate governance in the annual reports of listed companies should be standardized. This relates to the corporate governance

Report as such and particularly to the separate compensation report within the corporate governance Report. The aim must be to make the compensation reports objectively comparable.

- In recent years, the Government Commission has concerned itself intensively with questions relating to the supervisory board. In the future, we will have to focus more strongly on issues connected with the other corporate governance body, namely the management board. In this connection, the question arises of a general limitation on the regular term of management board contracts to three instead of five years. The Government Commission sees long-term business development as a high good worthy of protection. From our point of view, this kind of development is not compatible for example with one-year contracts for management board members, like in the USA. But irrespective of that, it might be possible to think about limiting the initial appointments of management board members to three years – the Code already includes a suggestion to this effect in section 5.1.2. The question of financial arrangements in the event of premature contract termination can likewise be dealt with independently of the actual appointment term.

- The Government Commission may also have to look more closely at the question of takeover bids and particularly at defense measures to counter a hostile takeover bid. In this connection, the EU Takeover Directive, now translated into German law, needs to be taken into account. The law will enter into force shortly. Under it, German companies subject to a takeover bid will continue to be able to take defense measures in so far as they are approved by the supervisory board. However, the company can be obligated to neutrality by its articles of association. So here again we have the question of whether and under what conditions neutrality of the board in a takeover situation is an expression of good corporate governance.

At European level, important impulses for the current debate are being provided by the European Corporate Governance Forum. They are focused primarily on the following points:

- The Forum supports the proposal of the European Commission to simplify the cross-border exercise of voting rights in listed companies. As a basis for discussion of the

rights of shareholders at European level, the Commission believes that a thorough analysis of the situation in the individual EU member states is necessary. In this connection, the Forum is heading a study into proportionality between ownership and control, which can be summarized under the heading “one share one vote”.

- A further statement by the Forum will be published shortly concerned with the issue of internal control. The general tenor will be that no further statutory measures to standardize and improve internal control systems should be taken in Europe at present. In particular, a critical view is taken of the developments in this area caused by the Sarbanes Oxley Act in the USA. Instead of further measures, the intention is to monitor the existing rules and the rules adopted as a result of the latest changes in the accounting directives.
- In addition, the Forum intends to analyze at European level how the comply-or-explain rule is interpreted in the various countries under the national codes. In Germany, for example, some companies simply state where they deviate from the Code, while others also supply reasons for the deviations. From the point of view of the Code Commission, the latter approach is more sensible in the interests of understandability and transparency. The already resolved amendment to the 7th Company Law Directive (accounting directive) will probably result in a change in the comply-or-explain mechanism to the effect that in the future deviations from the Code must be not only be disclosed but explained. This subject will therefore occupy the German legislators for some time to come.

Finally, let us take a brief look beyond the borders of Europe. In the future we must look very carefully at the rules applying in the USA before adopting them in Europe. One example is the Sarbanes Oxley Act. German companies listed in New York report of painful experiences with this very complex statute. We in Europe and Germany take a different approach. Our laws are traditionally less specific and more general and abstract. In the context of corporate governance they are supplemented by voluntary arrangements, which preserve maximum possible flexibility and promote the use of best practices.

The basic issue of “Rules versus Principles” will stay with us in the future as it based on differences in legal interpretation. However, the successful comply-or-explain rule allows deviations from the Code in areas where they are perhaps wanted with regard to specific American practices. For that reason it is important that not only the mechanism is laid down but also that the deviations are also explained where necessary. Of course, this applies particularly to Germany. Here, it is important not only to highlight the differences between the

USA and Europe but also to explain the special features of the two-tier system of management board and supervisory board in comparison with the American understanding of a board.

5. Final remarks

Ladies and Gentlemen,
I began by saying that the Government Commission is focused on continuity. However, I don't want my remarks in the last half-hour to give you the impression that there have been no new developments. But for the moment at least, these are not significant enough to require further Code changes. The less the Code is changed, the more acceptance it will receive.

The current year is therefore a year of observation. Judging by the current debate, however, no doubt the odd aspect will be integrated into the Code when opinion on it has settled. This conference is part of the opinion-forming process. I invite you now under the chair of FAZ publisher Holger Steltzner to contribute your opinion on the status and the development of corporate governance in Germany and Europe. After the coffee break we will then hold a panel discussion on the common goals and different approaches of the two governance systems.