REGIERUNGSKOMMISSION

Deutscher Corporate Governance Kodex

17th Conference German Corporate Governance Code

"Sustainable long-term Value Creation"

Frankfurt School of Finance & Management
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On the progress of corporate governance in Germany

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Chairman of the Government Commission
on the German Corporate Governance Code

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The spoken word applies.

Ladies and Gentlemen,

I would like to welcome you warmly, also on behalf of my colleagues, to this year's Code conference. We are very pleased that so many of you have accepted our invitation, and I promise you an interesting discussion. This will be guaranteed by our guests and members of the Commission, who have kindly agreed to take part in the panel discussions. Unfortunately, Mr Tischendorf has had to cancel his appearance at short notice, but I am very pleased that Ms Helfer, another partner at Cevian Capital, can be with us here today.

What can be said about the current state of corporate governance in Germany?

1. **German corporate governance is based on proven foundations.**

The first foundation is our **two-tier system** of Management Board and Supervisory Board. This concept continues to develop dynamically and it is certainly correct to speak of a convergence between a one-tier and a two-tier system. The importance of the Supervisory Board has steadily increased, and the Code has contributed to this development. I would just like to remind you of the principle that the Management Board develops the strategic orientation and coordinates it with the Supervisory Board.[1]

The convergence of the two systems, however, is not a reason to think about converting to a one-tier system. The practical performance of the governing bodies is much more relevant than a theoretical debate about the system. The better the governance works, the less the two systems differ in practice. It is against this background that I would like to encourage a discussion about how the professionalisation of Supervisory Board work can be further promoted.

In its draft presented in November 2018, the Government Commission proposed to resort to external support for the self-assessment of the Supervisory Board and its Committees in intervals of three years. This proposal was not very well received during the consultation. The revised recommendation D.13 GCGC draft 2019 no longer comprises any statement on external support, but demands transparency as to whether and how a self-assessment was carried out. Thus, the Commission does not give way. It merely relies more on the effect of transparency rather than on direct behaviour control.

The second foundation of German corporate governance is the **co-determination** of employees represented on the Supervisory Board. Co-determination guarantees that the interests of employees in the company are taken into account, and thus makes a

[1] Principle 2 GCGC draft 2019; section 3.2 GCGC 2017; on the increasing importance of the Supervisory Board in a broader context (Hopt ZGR 2019, 507, 514).

decisive contribution to combining economic freedom with social justice, in accordance with the principles of a social market economy.

The third fundamental pillar is the **stakeholder** approach. The objective of a listed company is to ensure sustainable value creation while taking into account the interests of the shareholders, the enterprise's employees and the other groups related to the enterprise. This is what the enterprise's best interests stands for.

The stakeholder approach has recently been discovered in countries where Milton Friedman's doctrine "the social responsibility of business is to increase its profits"[2] had previously prevailed. Instead, the statement on the Purpose of a Corporation of the American Business Roundtable – published in August of this year – concludes with the following sentences: "Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies and our country."[3]

2. We have an established Corporate Governance Code.

Practical experience with the Code based on the concept of "comply or explain" has been positive. Members of the Management Boards and Supervisory Boards understand how to handle the Declaration of Compliance. For investors, the Code is indispensable.

I must add, however, that the Code is still occasionally denied the task of setting up good governance standards that go beyond legal requirements. If the Commission has nevertheless taken up some particularly difficult and sensitive issues, contradiction and criticism were thus inevitable.

This leads me straight to the issue of Management Board remuneration. Our proposals in this matter in the November 2018 draft were widespreadly rejected. There can be no doubt that there are valid arguments against overly specific provisions in the Code for the structuring of long-term incentive plans – and the Commission has taken this into account in the final draft of May 2019. I was surprised, however, that the objectives of comprehensible and strategy-oriented compensation systems are being widely ignored by the critics. Without doubt remuneration systems are overly complex and explanation is missing regularly for which level of performance variable remuneration is paid.

Some comments indicated that the discussion on the remuneration of the Management Board had perhaps only just begun. I would agree with that. In particular, it will be necessary to discuss how the remuneration systems are to be structured so that

[2]The New York Times Magazine from 13 September 1970.

[3]For comparable developments in France and the UK, see Weber-Rey, Lost in detail: setting priorities for corporations in challenging times, British Academy Review Autumn 2018, pp. 14-18.

they are clear and comprehensible in accordance with the requirements of ARUG II – and in order that the subject of remuneration contributes to the promotion of the business strategy and of company's sustainable long-term development and is structured towards the long-term development of the company.[4] ARUG II is not perfect. But those who strive to gain the confidence of investors, other stakeholders and the general public in the enterprises and their governing and supervisory bodies cannot want anything else but to link strategy and remuneration, and ensure comprehensible remuneration systems.

Allow me to make a comment on the transparency of Management Board remuneration. In the new section 162 of the German Public Limited Companies Act (*Aktiengesetz* – "AktG"), legislators correctly focus on the fact that the remuneration report specifies how the remuneration components are derived from the relevant remuneration system, how the remuneration promotes the long-term development of the enterprise, and how the performance criteria are applied – in short, the focus is on explaining "pay for performance". The new legal requirements for remuneration reports cannot be met with the applicable sample tables. It is not the task of the Government Commission to develop recommendations on the format for implementing a statutory reporting duty. The Code will therefore no longer comprise sample tables. Hence, the Government Commission can only refer enterprises and report addressees to the guidelines the European Commission is developing, and hopefully also to contributions of the ASCG (*Deutsches Rechnungslegung Standard Committee* – "DRSC"). Where the recent Code doesn't apply anymore and the new provisions of ARUG II don't apply yet enterprises should be able to find appropriate solutions.

In response to our draft Code from November 2018, we received a whole series of high-quality responses. We are enormously grateful for this and we have gladly taken up much of the well-founded criticism and constructive proposals and included them in the version of May 2019. It was disappointing, however, how often individual proposals were simply generally rejected without even going into some degree of detail on the justification or pointing out alternatives.

I can only attribute such a defensive stance to the fact that it is still widely unknown how standards of good and responsible corporate governance contribute to the confidence in the actions of Management Boards and Supervisory Boards of listed enterprises. This is all the more astonishing as investors have not just recently begun to take an interest in corporate governance issues and no longer shy away from imposing their ideas at General Meetings – or in advance. For example, some remuneration systems have failed in the hitherto voluntary 'Say on Pay' system, individual Supervisory Board members were discharged with previously unimaginably low ratios of approval votes, and candidates for the Supervisory Board have had to be removed from the list of nominees again. If it is not in this situation that everything points to the

[4] cf. section 87 (1) sentence 2 and section 87a (1) sentence 2 no. 2 of the AktG.

companies remaining 'at the wheel', further strengthening the Code as their instrument of self-regulation and giving even greater support to the Commission's work, then when?

Professor Seibert from the German Federal Ministry of Justice and Consumer Protection recently stated in an interview that the Code should always be courageous. Allow me at this point to remind you that during the last revision in 2017 the Code Commission, under the leadership of Manfred Gentz, took up the suggestion that the Chairman of the Supervisory Board should be prepared, within an appropriate framework, to hold discussions with investors on issues specific to the Supervisory Board, and did so despite partly facing fierce opposition. It goes without saying that the Chairman of the Supervisory Board does not have to talk to investors about the strategy – this is the task of the Management Board. But with whom are investors supposed to talk about the composition of the Supervisory Board or about the remuneration system for the Management Board? The narrow interpretation of the role of the Supervisory Board as a purely internal body had to be adapted to investors' expectations, and the Code has admirably succeeded in this with the aforementioned suggestion.

As all of you will have read, ARUG II passed the Committee on Legal Affairs on 13 November 2019 and was adopted by the Bundestag the following day. If tomorrow the Bundesrat also approves the law, the path is clear for the law to enter into force on 1 January 2020. Yesterday, the Code Commission discussed what is required to adjust the draft published in May 2019 to the final version of ARUG II. These amendments will be limited to text details on the issue of sustainable remuneration systems and maximum remuneration ("cap") as an element of the remuneration system.

The amended Code will be presented to the Federal Ministry of Justice and Consumer Protection by the latest in January 2020 and, at the same time, be pre-published. The new Code might then enter into force upon publication in the Federal Gazette, expected for February or March 2020. Up until this publication, the Code as amended on 7 February 2017 will be applicable to the annual Declaration of Compliance. In other words, first-time application is unproblematic for most companies as the Declaration of Compliance is often resolved during the fourth quarter. The few companies that usually resolve their Declaration of Compliance during the first quarter may want to reconsider this practice.

3. Good corporate governance promotes confidence

The development of corporate governance over the past ten years has been strongly influenced by the consequences of the financial crisis in 2007 and 2008. A contribution had to be made to restore damaged confidence. This task hasn’t become easier due to 'defeat devices' in cars and cum/ex trades executed by banks.

The lack of confidence – or even mistrust – on the part of investors weighs heavily on share prices, whilst general public and political confidence deficits affect the 'Social Licence to Operate', provoking government regulation. Good corporate governance aims to promote confidence in the management and supervision of companies amongst investors, employees, customers and the general public. It is the task of the German Corporate Governance Code to provide listed companies with assistance in this regard.

It would be a serious misunderstanding to assume that rules alone would be sufficient. First and foremost, the integrity of the acting persons is what counts. For this reason, the Code does not begin with recommendations and suggestions, but emphasises the importance of ethically sound and self-reliant behaviour. The members of the Management and Supervisory Boards must be able to assume their responsibilities personally. They determine the 'tone from the top' and bear the accountability for corporate culture and strategy. It takes people that do the right thing – without being obliged to do so by the rules.

But it would also be a serious misunderstanding to assume that we could manage without rules at all. Listed enterprises gain trust if they have the right checks and balances, incentive structures and responsibilities in place, and report these reliably to the outside world. If, for example, all stakeholders and the general public understand the rules according to which Management Board remuneration is determined, this matter can be discussed objectively. Otherwise mistrust arises.

In an ideal world, companies would continuously work on their own corporate governance, develop best practices in the purest sense of the word, and provide input for the Code. Unfortunately, this is not the case. By and large, in Germany corporate governance is seen as a compliance exercise. This means that businesses are foregoing a great chance.

4. Good corporate governance serves sustainability

We have named this conference “Sustainable long-term Value Creation“. The panel discussions will focus on long-term value enhancement, variable Management Board remuneration, and sustainability. Without pre-empting the keynote speeches, I would like to note the following:

The foreword to the Code states that the Management Board and Supervisory Board must ensure sustainable value creation. The enterprise value, that is to say, the value of the enterprise for shareholders, is to be increased permanently. Sustainable here stands for the long-term. The codes of other European countries, in this matter, also speak of long-term value creation. However, the task of sustainable value creation is put into perspective in the foreword, to the extent that reference is made to the interests of the enterprise – not only of the shareholders’ interests, but also those of employees and other groups associated with the enterprise must be taken into account.

The stakeholder approach anchored in the Code has also been the focus of investors for some time now. This is not attributable to altruism though – it is due to the realisation that the enterprise value can only be increased in the long term if all critical stakeholder concerns are adequately taken into consideration. In his January 2018 letter to the CEO, Larry Fink of BlackRock expressed this as follows: "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society."[5]

The stakeholder approach, the concept of the enterprise's best interests, and last but not least CSR reporting say (or expect) that enterprises have a responsibility towards society. This is not the place to spell out how assuming social responsibility and profit orientation relate to each other, and to what extent there may be a need for regulation in the case of conflicting goals. It is quite clear, however, that enterprises that do not live up to their social responsibility will find it increasingly difficult to operate successfully in the market. Then again, unprofitable enterprises lack the means to invest in climate-friendly business models, products and production methods. Enterprises that fail to generate an appropriate return lose the confidence of investors. And enterprises that do not succeed in finding answers to social and environmental questions first lose the confidence of the general public and then the confidence of investors.

"What does this have to do with corporate governance?", you might ask. This is a very legitimate question, as corporate governance concerns only the institutional mechanisms at the regulatory level and not the specific responsibilities and actions of the individual enterprise. Corporate Governance is understood as the legal and factual regulatory framework for the management and supervision of an enterprise, as stipulated in the foreword (section 1 sentence 1). It is not the objective of corporate governance to establish certain business models and strategies. Nor can corporate governance become the engine of a sustainable economy, as Accountancy Europe recently suggested.[6] Not for corporate governance reasons, but due to the obligation to increase corporate value and the associated social responsibility, Management and Supervisory Boards have to encourage the breakthrough of climate-friendly business models, for example.

Nobody needs to start developing sustainability governance mechanisms. Where sustainability governance means sustainable and long-term corporate development, we are talking about a target and not about governance mechanisms; the Code should

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[5] cf. https://www.blackrock.com/hk/en/insights/larry-fink-ceo-letter.

[6] "10 Ideas to make corporate governance a driver of a sustainable economy", p. 8 et seqq., https://www.accountancyeurope.eu/wp-content/uploads/190527-Corporate-Governance-Cogito.pdf.

say it all, and with ARUG II, legislators have added clarity on Management Board remuneration. Where actual governance mechanisms at legislative or regulatory level are concerned, there is no need for rules concerning sustainability: good corporate governance as such will result in companies making sustainability a priority, according to a comprehensive empirical study by an international group of professors, published in September 2019.[7] Demanding action that serves the priority of sustainability is most effective where it means demanding improvements in corporate governance. It has been recognised that the composition of a Board is of particular relevance in this respect.

One way in which good corporate governance serves the purpose of sustainability is the dedicated use of governance mechanisms in the development and implementation of corporate strategies. Questions asked in this context can be:

1. Does the composition of the Management Board and the Supervisory Board allow for business models to be developed along the lines of "return through sustainability"? Are the right checks and balances in place?
2. How can the remuneration structure be designed for sustainable and long-term corporate development? Which ecological performance indicators are the right ones for the enterprise in question? Are share-based remuneration components enough to ensure alignment with the business strategy?
3. Does the internal and external reporting on ecological risks, goals, actions and successes meet addressees' requirements?
4. In particular: does external reporting include the significance placed on climate change in the work of the Management Board and the Supervisory Board?[8]

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Ladies and Gentlemen, you will have noticed that our conference title "Sustainable long-term Value Creation" has been kept deliberately ambiguous. This may be a tiny bit of conference marketing, but above all it is due to our conviction that long-term earnings require sustainability also in the sense of ESG.

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[7] Dyck, I.J. Alexander and Lins, Karl V. and Roth, Lukas and Towner, Mitch and Wagner, Hannes F., Renewable Governance: Good for the Environment? (18 September 2019). Available at SSRN: https://ssrn.com/abstract=3224680 or http://dx.doi.org/10.2139/ssrn.3224680

[8] cf. Recommendations of the Task Force on Climate-related Financial Disclosures, June 2017, p. 19