ICGN
International Corporate Governance Network

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ICGN comment on proposed changes to the German Corporate Governance Code

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

The ICGN is a body which represents corporate governance professionals of the world, particularly those working within global investment institutions. ICGN's mission is to promote good governance in companies and responsible investment practices by investors-- with a long-term perspective on sustainable value creation and supporting healthy financial markets. It was established over 20 years ago, and today our members span over 40 countries—including Germany-- and include investors representing assets under management in excess of US$26 trillion. Many of our members have significant investment holdings in German companies.

Our policy positions are guided by the ICGN Global Governance Principles and Global Stewardship Principles both of which have been developed in consultation with ICGN Members and as part of a wider peer review.[1] They inform the base of our response to the questions posed in the Kodex consultation. Our comments reflect the perspective of an institutional investor-led body, and we have also taken the liberty to emphasise the important role that shareholders play as de-facto guardians of good corporate governance to help ensure the health and prosperity of financial markets -- and ultimately society as a whole. This is a role we take very seriously, and one of the roles of ICGN is to serve as platform for balanced and constructive dialogue between investors and companies.

[1] For further background on ICGN, including its core policy documents please see: https://www.icgn.org/policy

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As a starting point to our response, we would like to note that investors recognize many positive features of the German corporate governance system. Germany benefits from strong macro factors, including the rule of law and regulatory quality. Its industry is generally respected for its long-term perspective and its diversified industrial economy – with world leading companies in many sectors and a strong "*Mittelstand*" base of smaller private companies.

We recognize that Germany has its own distinct system of governance relative to other jurisdictions. This is 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 *Mittbestimmung*, which gives a prominent employee voice to German supervisory boards. While ICGN's own Global Governance Principles differ in some ways from the German Kodex, we respect the German system, and understand that these distinctive governance features have generally proven to be effective in a German context.

At the same time, some aspects of corporate governance in Germany are held up to scrutiny institutional investors and at least for some companies questions 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[2];

- 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.

[2] Among leading European companies, the average proportion of independent board members is 49.6%, whereas in Germany it is 38.2% (Institutional Shareholder Services, 2016).

Against this background we will not comment on all proposed changes to the Kodex, but would like to make some specific comments with regard to the potential changes that are being proposed.

Foreword

The foreword to the Kodex only contains a few changes, but we think they are important ones and are supportive of these introductions. Specifically, we support the addition of the term "ethically oriented", as well as the new insertion that is important for companies to establish proper legitimacy in a broader social context – in addition to being simply legally compliant. We think this is particularly important in Germany in light of some of the recent corporate scandals in Germany referred to above.

ICGN believes that the core of governance goes beyond rules, and must ultimately relate to values and behaviours-- and that it is appropriate for the Kodex to recognize this. Particularly in an era of low trust in business, and where social media allows for intense scrutiny of company actions, it is to the long run interest of sustainable value creation for companies to govern themselves in a way that inspires appropriate behavior and establishes a legitimate license to operate.

We appreciate that this shift in perspective might come across as subjective to some observers, particularly to the companies themselves, in terms of how to interpret this new language relating to ethics, legitimacy and the "Leitbild des Ehrbaren Kaufmans" (Honourable Business Person). In this context the Commission may wish to provide some additional guidance on what practical changes might be expected by this embrace of this more aspirational wording.

Observers from outside of Germany might also appreciate a clearer understanding of what is meant by the "Leitbild des Ehrbaren Kaufmans"; this appears to be an intuitively appealing concept, though it is important to appreciate what this term means in a German context.

Shareholders and the General Meeting

Section 2.1.3. We think this new section is a positive addition, as it recognizes both the ownership rights and the responsibilities of institutional investors. In particular we agree that investor stewardship should include a consideration of sustainability and other relevant environmental or social factors that might affect a company's sustainable value creation. In the absence of a stewardship code for Germany, we can recommend ICGN's

Global Stewardship Principles as a global framework with regard to investor responsibilities.[3]

As an observation on translation, in the English text we would note that the phrase “respecting also the concept of sustainability/Corporate Social Responsibility” could be misunderstood. A possible rewording might be “… a consistent and transparent framework of rules that also takes into consideration sustainability and corporate social responsibility factors.” For native English speakers that might be a clearer expression of the original German text regarding “…die Nachhaltigkeit berueksichtigenden Regelwerks auszuueben.”

Management Board

Section 4.1.3 We are supportive of the expanding on proportionate compliance systems, and that the basic parameters of risk management oversight – both at the board and supervisory board level—are presented in the annual report. We also welcome the introduction of the provision calling for a confidential mechanism for employees to report misconduct. We believe this is consistent with broader need for companies in all countries to promote stronger cultures with respect of laws and social norms.

Supervisory Board

Section 5.2 We think the new language that supports investor engagement at the Supervisory Board level is a positive development. ICGN’s Global Stewardship Principles place considerable importance on the role of engagement between companies and investors, and this engagement can and should take place, where relevant, at both the management board and supervisory board levels. Given that engagement between investors and supervisory board members has been relatively limited to date, it would be helpful to spell out more specifically what comes under the umbrella of “Supervisory Board related topics”.

There is a risk that those who may be resistant to this change may choose a very narrow definition of topics for discussion at the supervisory board. So a bit more granularity might be welcome to ensure that the scope for dialogue is substantial and robust-- and should include topics such as supervisory oversight of: the CEO and management board, succession planning, oversight of risk management and audit quality, remuneration, and supervisory board nomination and composition.

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[3] ICGN Global Stewardship Principles: http://icgn.flpbks.com/icgn-global-stewardship-principles/#p=1

We note that the focus on investor engagement at the supervisory board level lies exclusively with the Chairman. We appreciate that this is a new change in German corporate, and that beginning this dialogue with the Chairman is a positive step forward. At the same time we would observe that in other jurisdictions where board dialogue is more established it is common for investors to meet, where relevant, with other board members as well, for example with a lead independent director, and audit committee chair or a remuneration committee chair. As the practice of board engagement with investors becomes better established in Germany we would encourage the Commission to keep in mind the potential for more extensive engagement outreach beyond the supervisory board Chairman.

Section 5.3.2 We support the principle that the Chairman of the supervisory board shall not also be a member of the audit committee at the same time. We also believe that best practice calls for a fully independent audit committee, whose members are all financially literate. We should note that we do not regard employee-elected directors as fully independent, and would discourage their inclusion as members of the audit committee on the basis of independence.

Section 5.4.1 We support the additional language calling for a profile of competencies, outlining the needed skills and requirements for board effective, which supports existing language relating to appropriate board diversity and independence. We agree that the question of board composition should take into consideration a company's ownership structure, but do not believe it is clear what this means in terms of the Code. For example for companies whose ownership structure is diversified, the Code could suggest a higher board independence threshold than for a company with controlling owners.

What in Section 5.4.2 is called an "adequate number" ("angemessene Anzahl") of independent directors is arguably vague, and reflects indifference to the company's ownership structure. ICGN's own Global Governance Principles encourages a majority independent board, particularly when companies have dispersed ownership. We believe that the German Kodex is moving in the right direction but could still go further in promoting board independence. We also believe that there is scope for clearer independence criteria in the Kodex, to ensure that companies are objective and justified in classifying directors as independent—particularly where real or perceived director conflicts might exist.

We hope our comments are useful and would welcome the opportunity to meet directly with the Commission to elaborate on our observations or to provide a view on the questions expressed in your consultation. Once again we would like to congratulate the Commission for leading this very important consultation, and please to contact ICGN Policy Director George Dallas if you have any questions or comments: george.dallas@icgn.org

Yours faithfully,

Kerrie Waring
Executive Director, ICGN

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Erik Breen, Chairman, ICGN Board of Governors