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Comment on the European Commission's Green Paper "The EU corporate governance framework"

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Dear Sir/Madam

Green Paper: The EU corporate governance framework

We are writing to contribute to the consultation on the Green Paper "The EU corporate governance framework". We appreciate the opportunity to comment on the European Commission's Green Paper and support the Commission's efforts to assess the effectiveness of the current corporate governance framework for European companies. Hereinafter, please find our responses to the 25 questions which have arisen.

General Questions

(1) Should EU corporate governance measures take into account the size of listed companies? How? Should a differentiated and proportionate regime for small and medium-sized listed companies be established? If so, are there any appropriate definitions or thresholds? If so, please suggest ways of adapting them for SMEs where appropriate when answering the questions below.

No; the differentiation should still follow the criteria of listing or capital market-orientation, also for considerations of clarity. The accounting law, for instance, also differentiates with these criteria. Although, following Directive 78/660/EEC, there is a distinction by means of size criteria in place, in Germany, for example, a capital market-oriented corporation is always viewed as a large corporation (§ 267 Section 3, Sentence 2, German Commercial Law (HGB) in conjunction with § 264d HGB).

In our opinion, it is more a matter of taking care to ensure that, in principle, *soft law*-measures are applied, that member states still remain flexible within the implementation of Directives, and that *soft law*-measures, such as corporate governance codes and recommendations, do not become de facto binding measures and do not affect unlisted or non-capital market-oriented companies ("spill over"). Implicit reliefs already exist for small and medium-sized listed companies with an appropriate understanding of the *comply or explain*-principle.

(2) Should any corporate governance measures be taken at EU level for unlisted companies? Should the EU focus on promoting development and application of voluntary codes for non-listed companies?

No; in principle, the EU should rely on a market solution. Unlisted or non-capital market-oriented companies are free to commit themselves to stricter regulations (bonding). If considered necessary, a possible need for regulation is found to be present on a member state level.

Board of Directors

(3) Should the EU seek to ensure that the functions and duties of the chairperson of the board of directors and the chief executive officer are clearly divided?

In Germany, as in other member states, this separation is already secured by the application of the dualistic corporate governance system ("two-tier-system"). However, it should be ensured that its primary function to control the management is not impaired within the scope of the currently observable broadening of the supervisory board's duties. In addition, there should be no immediate switching between both bodies in order to exclude potential conflicts of interest and self-monitoring.

With regard to the monistic corporate governance system ("one-tier-system"), in our opinion, this system should also strive for the clear separation of management and supervision. Concerning this, the Council Regulation No 2157/2001 on the Statute for a European company (SE) already contains the first approaches.

(4) Should recruitment policies be more specific about the profile of directors, including the chairman, to ensure that they have the right skills and that the board is suitably diverse? If so, how could that be best achieved and at what level of governance, i.e. at national, EU or international level?

In principle (excluding the appointment of employee representatives), it is up to the shareholders to select appropriate supervisory board members who represent their interests and are able to protect the shareholders, their property and the company itself from potential harm through their supervisory activity. The national legal requirements resulting from Directive 2006/43/EC already secure that one member is required to have accounting or auditing expertise. According to Recommendation 2005/162/EC, all members should possess necessary expertise, ability to judge and experience to complete their tasks properly.

In case market failure might be observed when appointing the supervisory board, especially for companies with a high free float quota, it might be appropriate to take measures on a member state level and in compliance with the principle of subsidiarity in order to correct those market failures. National regulations are suitable to take regional differences into account (different ownership and financing structures, etc.).

Due to the experiences of the financial crisis, the codifying of special requirements should be considered – if not yet done – combined with a public supervisory mechanism for systemic credit and financial service institutions, as well as for insurance companies. Such regulations have already been enacted within some member states. The financial crisis demonstrated that the damage within those systemic companies was not limited to single corporations, countries or regions. This could act as justification for the necessity of a regulation.

(5) Should listed companies be required to disclose whether they have a diversity policy and, if so, describe its objectives and main content and regularly report on progress?

This matter should be dealt with on a member state level in accordance with the principle of subsidiarity. Regarding this, the market solution of the *comply or explain*-principle in Germany is already implemented in the German Corporate Governance Code. Therefore, no need for further measures exists for the moment.

(6) Should listed companies be required to ensure a better gender balance on boards? If so, how?

Basically, the appointment of the supervisory board is incumbent on the shareholders. Additionally, the measures, for instance, which are provided by the German Corporate Governance Code and which are already carried out by the companies should be evaluated in a first step. An increasing diversity can already be observed, indicating that the market itself cares about a better (gender) balance. Furthermore, we take the liberty of pointing out that international comparisons regarding international diversity need to take into account the regional differences (e.g. ownership structures, business models and international orientation of the companies). Additionally, holding companies and their locations cannot be easily compared to producing companies with codetermination or industrial companies with regional roots. These arguments are indicative that a regulation, if any, should be implemented on a member state level.

(7) Do you believe there should be a measure at EU level limiting the number of mandates a non-executive director may hold? If so, how should it be formulated?

The existing duties of care in conjunction with the natural limitation of available time already constitute a de facto restriction. Furthermore, the time spent on monitoring cannot be generalized due to differences between industries and business models. Therefore, a strict limitation of the number of mandates should be rejected or disestablished. Instead, a principle-based approach should be followed.

In fact, an appropriate effort by supervisory board members could be secured by introducing a compensation system which is solely input oriented. Provided that the supervisory board members' compensation is primarily based on the amount of time spent, there is a virtual limitation of the number of mandates one can execute.

(8) Should listed companies be encouraged to conduct an external evaluation regularly (e.g. every three years)? If so, how could this be done?

In companies exhibiting a concentrated ownership structure, a control of the supervisory board should already be guaranteed by its blockholders, as they follow their own interests when appointing the supervisory board members. However, an external evaluation might be a reasonable measure especially for companies with a high free float quota. Correspondingly, the shareholder meeting could decide if an evaluation should be performed. In such a case, the shareholders should be informed about the results of the evaluation. Such an assessment must not lead to the fact that supervisory board members exculpate from their own responsibility. It is important that such an evaluation is not performed by the auditor to avoid conflicts of interest.

(9) Should disclosure of remuneration policy, the annual remuneration report (a report on how the remuneration policy was implemented in the past year) and individual remuneration of executive and non-executive directors be mandatory?

In accordance with the principle of subsidiarity, this matter should be dealt with on a member state level. In our opinion, the comprehensive legislative regulations in Germany, as well as the existing *soft law*-measures of the German Corporate Governance Code, are sufficient. We are not able to comment on the circumstances within other member states.

(10) Should it be mandatory to put the remuneration policy and the remuneration report to a vote by shareholders?

It is doubtful to us to what degree such a vote could be binding. The shareholders already vote on the choice of supervisory board members, who themselves are responsible for the negotiation of contracts and remuneration for the management board. A non-binding say on pay-vote (in terms of the approval, as in place in Germany) could lead to a better culture of debate (management board, supervisory board and shareholders), but in our view, this is, however, alien to the system. The responsibilities are already clearly regulated.

(11) Do you agree that the board should approve and take responsibility for the company's 'risk appetite' and report it meaningfully to shareholders? Should these disclosure arrangements also include relevant key societal risks?

An universally necessary approval of the "risk appetite" would mix up the functions of management and supervisory board. The management and therewith investment and disinvestment decisions are strictly incumbent upon the management board. In Germany, the supervisory board is involved and its approval is needed only for questions of fundamental importance or certain transactions outlined within the articles of association. In this context solely, the company's "risk appetite" is part of the supervisory board's forward-looking monitoring task.

Moreover, to avoid liability, the supervisory board members are obliged to secure a sufficient information base in the sense of the *business judgment rule*, so that they are able to conduct their monitoring task properly. This implies that the supervisory board members only inform themselves adequately about chances and risks and use, for example, the *follow up*-reporting instrument (as imposed in § 90 German Stock Companies Act (Aktiengesetz)). An approval and a responsibility for the company's "risk appetite" would, therefore, create a potential conflict of interest, as well as possible self-monitoring.

Concerning the reporting requirements, we consider the current reporting of the management and the supervisory board as sufficient. The shareholders already receive comprehensive reporting concerning chances and risks and the underlying risk management system at the shareholder meeting, as well as through the management report.

(12) Do you agree that the board should ensure that the company's risk management arrangements are effective and commensurate with the company's risk profile?

Principally, it is the management board's responsibility to implement such arrangements. However, the control of its effectiveness is part of the monitoring task of the supervisory board and its audit committee. The audit committee "shall, *inter alia:*

(a) monitor the financial reporting process;

(b) monitor the effectiveness of the company's internal control, internal audit, where applicable, and risk management systems;

(c) monitor the statutory audit of the annual and consolidated accounts;

(d) review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity." (Article 41 Section 2 Directive 2006/43/EC)

Therefore, we regard the existing regulation as sufficient.

Shareholders

(13) Please point to any existing EU legal rules which, in your view, may contribute to inappropriate short-termism among investors and suggest how these rules could be changed to prevent such behaviour.

It is occasionally expressed that contemporary reporting (e.g. ad hoc-reports or disclosures) and reporting during the fiscal year could lead to short-termism among investors. On the other hand, these reporting measures serve investor protection (e.g. to avoid insider dealing). Against this background, the extent and the time schedules of reporting should, in principle, remain unchanged. Eventually, the short-termism among investors could be opposed by a corresponding taxation structure and, therewith, associated incentives.

(14) Are there measures to be taken, and if so, which ones, as regards the incentive structures for and performance evaluation of asset managers managing long-term institutional investors' portfolios?

First of all, potential conflicts of interest should be disclosed, respectively a disclaimer should report their absence. Furthermore, whether the incentive structures or the remuneration systems of asset managers include any misdirected incentives has to be analysed accurately.

(15) Should EU law promote more effective monitoring of asset managers by institutional investors with regard to strategies, costs, trading and the extent to which asset managers engage with the investee companies? If so, how?

According to our response to question 14, potential conflicts of interest should be disclosed, respectively a disclaimer should report their absence.

(16) Should EU rules require a certain independence of the asset managers' governing body, for example from its parent company, or are other (legislative) measures needed to enhance disclosure and management of conflicts of interest?

According to our response to question 14, potential conflicts of interest should be disclosed, respectively a disclaimer should report their absence. This also applies to the relationship to related parties.

(17) What would be the best way for the EU to facilitate shareholder cooperation?

The current regulations concerning the cooperation of shareholders are basically directed towards the control of undesired acting in concert of financial investors (Directive 2004/25/EC). To encourage the desired cooperation in terms of effective corporate governance, a market solution emphasizing that effective corporate governance is in the shareholders' own interest should be still trusted. Concretely, companies could encourage shareholders' monitoring through voluntarily installing a communication platform. On the part of the regulator, shareholders' monitoring tasks could be encouraged by enabling an online shareholder meeting. Of course, it would be still up to the shareholders to remain passive, but nevertheless, it has to be secured that they are still exposed to the risk up to capital loss.

(18) Should EU law require proxy advisors to be more transparent, e.g. about their analytical methods, conflicts of interest and their policy for managing them and/or whether they apply a code of conduct? If so, how can this best be achieved?

Yes; within this context, proxy advisors could be required to disclose their recommendations, including their rationale, on the internet. Moreover, the number of total votes a proxy advisor controls if each of the clients follows the recommendation could be published.

(19) Do you believe that other (legislative) measures are necessary, e.g. restrictions on the ability of proxy advisors to provide consulting services to investee companies?

Yes; even potential conflicts of interest should be disclosed within this context, respectively a disclaimer should report their absence.

(20) Do you see a need for a technical and/or legal European mechanism to help issuers identify their shareholders in order to facilitate dialogue on corporate governance issues? If so, do you believe this would also benefit cooperation between investors? Please provide details (e.g. objective(s) pursued, preferred instrument, frequency, level of detail and cost allocation).

No; principally, we regard the regulation of the Transparency Directive (2004/109/EC) as sufficient. Additionally, issuing registered shares can improve the issuers' knowledge about the shareholder structure. The dialogue between company and shareholder could be enhanced, for example by voluntarily installing a communication platform (see response to question 17).

(21) Do you think that minority shareholders need additional rights to represent their interests effectively in companies with controlling or dominant shareholders?

In principle, we consider the measures currently provided to be sufficient (e.g. "one share, one vote", shareholder litigation, disclosure of transactions with related parties, and regulations protecting minority shareholders within squeeze-outs and other structural measures). Extending the rights of minority shareholders could create potential for abuse.

(22) Do you think that minority shareholders need more protection against related party transactions? If so, what measures could be taken?

Principally, we regard the current transparency and the existing possibilities for legal protection as sufficient. Transactions with related parties should be elevated to a procedure subject to approval by the supervisory board. This would emphasize the supervisory board members' responsibility.

(23) Are there measures to be taken, and is so, which ones, to promote at EU level employee share ownership?

No; a market solution should be relied on within this context. Furthermore, this question cannot be answered cross-sectorally or regardless of the specific business model. Aim and purpose, as well as the importance of employee share ownership or contribution of capital differ, for example, within large industrial companies and those being comparatively young and research-intensive.

Monitoring and implementation of Corporate Governance Codes

(24) Do you agree that companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and describe the alternative solutions adopted?

No; the measures which are currently provided voluntarily on member state level, as well as the recently implemented measures of Directive 2006/46/EC concerning the corporate governance statement, are at least sufficient. Before extending the regulation, the effectiveness of currently existing measures firstly has to be evaluated. If necessary, even a deregulation has to be carried out. How far the capital market reacts to deviations from the recommendations of corporate governance codes, and how far it assigns value relevance to the degree of code compliance have to be especially scrutinized. Capital market reactions to the degree of compliance with corporate governance codes are an essential assumption of the *comply or explain*-principle.

With regard to Germany, there are several studies with different results concerning the effect of the degree of compliance with the German Corporate Governance Code on a company's capital market performance. Jahn et al. (ZCG 2011), for instance, recently found that for companies facing strong ownership concentration, complying with the German Corporate Governance Code primarily causes costs, whereas for companies whose shares are mainly in free float, complying with the code has a positive effect on the company's value on the capital market. Stiglbauer (ZfM 2010) worked out, based on data of 2007, that there is principally no significant relation between code compliance and capital market performance; however, additional voluntary corporate governance reporting has a positive effect on stock returns. Based on data of 2003, Nowak/Rott/Mahr (ZGR 2005) analysed the impact of the declaration of conformity with the German Corporate Governance Code on the capital market performance measured in cumulated abnormal returns. They found a lack of correlation between both parameters. Also based on data of 2003, Bassen/Kleinschmidt/Prigge (DBW 2006) found a positive correlation solely for the disclosure of information concerning the management board. Compliance within other areas of the German Corporate Governance Code is not found to affect the company's value on the capital market significantly. Opposing these results, Goncharov/Werner/Zimmermann (Corporate Governance: An International Review 2006) found evidence that within the evaluation period from 2002 to 2003, the capital market rewarded the degree of compliance with the German Corporate Governance Code with a positive price premium and, therefore, built up market pressure which forced compliance with the code.

Regarding this range of results of the (few mentioned) studies, how these results can be interpreted must be scrutinized. In particular, more recent studies show no capital market reaction or rather only if the company's shares are mainly in free float. This could be indicative that additional regulatory procedures should not be carried out. Instead, a partial deregulation should be realized. The main features of the self-regulation of the economy by corporate governance codes should be maintained in principle, but an extension of codes through detailed regulations in terms of self-reinforcing of code-committees should be emphatically opposed. In fact, a market solution should be relied on: Companies whose shares are mainly in free float can signal having a "good corporate governance" through a high degree of code compliance or through publishing additional voluntary corporate governance reporting, as well as disclosures and comments (e.g. to deviations from the code). Companies facing a concentrated ownership structure need to communicate "good corporate governance" in a trustworthy manner, especially to their blockholders.

(25) Do you agree that monitoring bodies should be authorised to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary? If yes, what exactly should be their role?

No; thereby the desired *soft law*-character would get lost. It is more important to discuss if deregulation should be carried out and if corporate governance codes could be reduced to frameworks. Self-reinforcing tendencies of code-committees in terms of adopting political and public moods should be opposed. The aim of codes should remain to make the "Corporate Governance system transparent and understandable" and "to promote the trust of international and national investors, customers, employees, and the general public in the management and supervision of listed […] stock corporations" (Preamble of the German Corporate Governance Code, both citations), but not to enforce a political or public will by *soft law*. Legislation is the task of a democratically legitimated legislator.

If you would like any further explanation or clarification of our responses, please do not hesitate to contact us.

Yours sincerely,

Frankfurt/Main, July 21st 2011

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