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Government Commission publishes revised Corporate Governance Code

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Following consultations, the Government Commission on the German Corporate Governance Code (the "DCGK") adopted the new version of the Code on May 9, 2019 and published it on May 22, 2019 (new version of the DCGK (in German)). The new version of the Code will not be submitted for publication to the German Federal Ministry of Justice and Consumer Protection (the "BMJV") before the Act on the Transposition of the Second Shareholder Rights Directive ("ARUG II") has come into force. Once the new Code is published by the Ministry in the German Federal Gazette (Bundesanzeiger), it will enter into force, replacing the existing Code as amended on February 7, 2017. Since the ARUG II is currently in the legislative procedure of Germany's lower house of parliament' committees (the Bundestag), following its first reading in a plenary session, the Commission has not ruled out possible further adjustments to the Code to comply with the new version of the Shareholder Act according to ARUG II.

By publishing the new version of the Code early, the Government Commission wants to give companies and capital market participants the opportunity to prepare for the Code's new recommendations and suggestions. Companies can start following the recommendations and suggestions as best practices in advance.

1. Background to the re-draft

The DCGK Government Commission presented a draft revision of the Code on November 6, 2018 and gave interested parties until January 31, 2019 the opportunity to participate in a consultation. More than 100 comments from a wide variety of associations, stakeholders, companies, lawyers etc., including White & Case, were subsequently published on the Government Commission's homepage.

Many of the comprehensive suggestions and proposed amendments were taken into account by the Government Commission in a complete revision of the Code that has since been adopted. While the new layout with its 25 principles (instead of the original 30) and suggestions and recommendations was retained, the widely expressed criticism of the draft's heavy focus on remuneration resulted in a new structure as well as a number of substantive adjustments.

Previously, the Code was structured with reference to the corporate bodies of stock corporations. The revised version now includes the explicit objective of making the German dual corporate governance system transparent and comprehensible, especially for foreign investors. That is why the new version has essentially been arranged according to responsibilities. Accordingly, the new section A features a brief outline of the management and supervisory boards' responsibilities as well as the role of the shareholder's meeting.

Moreover, the Commission has tried, as far as possible, to avoid reproducing the legal provisions, and in doing so it has considerably streamlined the Code.

2. No "apply or explain"

In accordance with our suggestion and in response to similar criticism from many market participants, the version of the Code that has now been adopted no longer includes the originally planned obligation of issuers to produce a policy report, in which each issuer should have been required to disclose in the corporate governance statement how it applies the principles set out in the Code („apply or explain"); this would have been a very comprehensive task for issuers. Since it is already the practice to date for the corporate governance report and the corporate governance statement to be summarized in accordance with point 3.10. of the current DCGK and sections 289 et seq. of the German Commercial Code (HGB) respectively, the new DCGK explicitly abolishes the corporate governance report as defined by point 3.10 of the current DCGK. Under the new principle 22 of the DCGK, the management and supervisory board produce an annual report in the corporate governance statement on the company's corporate governance. In doing so, they are required, in line with the current practice, to specify which of the recommendations set out in the Code were not applicable due to other legal prevailing provisions. Thereby in particular the (deviating) legal aspects in relation to the "Societas Europaea" (SE) and the German partnership limited by shares (*Kommanditgesellschaft auf Aktien*, KGaA) are taken into account.

3. Independence of supervisory board members and composition of the supervisory board

While the adopted version of the DCGK largely incorporates the new rules governing the independence of supervisory board members, it has also mitigated the originally proposed requirements, again, to widely expressed criticism, including from us. In particular, the requirement not to serve on more than two supervisory boards (instead of previously three) of listed companies outside of the group, now applies only to management board members of listed companies and no longer to all corporate bodies in companies. The restriction not to serve as the chairman of the supervisory board at a listed company outside of the group now only applies to management board members of listed companies. This means that management board members of listed companies will no longer be able to serve as the chairman of the supervisory board at a listed company going forward. This is significantly stricter than in the previous Code and will lead to a change of chairmen of the supervisory boards in some companies – assuming compliance with the Code.

Additionally, for the first time, the Code sets out more sophisticated criteria than in the draft concerning the independence of shareholder representatives in the form of a catalogue of indicators, which serve as the basis for determining whether a supervisory board member is no longer considered to be independent. With regard to supervisory board members of shareholder representatives, particular consideration is to be given to whether the supervisory board member (i) in the two years prior to their appointment was a member of the company's management board, (ii) currently has, or in the year leading up to their appointment had, a significant business relationship with the company or one of its affiliated companies (e.g. as a client, supplier, lender or advisor), (iii) is a close family member of a management board member or (iv) has been a member of the supervisory board for more than 12 years. When assessing a member's independence, the ownership structure shall also be taken into account; a certain number of members must be independent of any controlling shareholder. Whether there is independence in a given case is decided by the shareholder representatives on the supervisory board at its due discretion considering the criteria mentioned above. If one or more of the indicators above applies and the supervisory board member in question is nonetheless deemed to be independent, this must be justified in the corporate governance statement.

Furthermore, as had already been set out in the draft, there is a limit to the number of supervisory board seats that can be held. Supervisory board members who are not members of any management board of a listed company will not be able to hold more than five supervisory board seats altogether at listed companies outside of the group, with the chair of a supervisory board counting as double. The previous point 5.4.1 paragraph 5 of the DCGK, pursuant to which the supervisory board is required when proposing the election of new supervisory board members to check with the respective candidates that they are able to commit the expected amount of time, has been dropped.

The proposal providing for a standard term of three years for appointments to the supervisory board, criticized by us, among others, has been completely omitted; the prevailing view was that due to the complexity of the work of the supervisory board, a short electoral cycle might be counterproductive.

Self-evaluation by the supervisory board is a recommendation. There is now a requirement to disclose in the corporate governance statement whether and how self-evaluation was carried out. The time interval for carrying out this self-evaluation – unlike as originally planned in the draft – is no longer specified in the Code.

4. Term of initial appointment of management board members

The new version of the Code now provides that the initial term for the appointment of members to the management board shall not exceed a maximum of three years (instead of the previous five-year limit), which is in line with the prevailing practice.

5. Remuneration of management and supervisory boards

The adopted Code now has only three principles dedicated to the subject of management board remuneration – instead of the originally envisaged seven. In this respect, the Code is explicitly informed by the provisions of the ARUG II.

The recommendation on management board remuneration is now based on a three-stage approach: (1) establishing a remuneration system, the substance of which is informed by section 87a paragraph 1 sentence 2 of the revised German Stock Corporation Act (AktG-E) (i.e. contribution of remuneration to promoting the business strategy and long-term development of the company) and is the subject of a resolution of the shareholder's meeting in accordance with section 120a AktG-E; (2) establishing the target and maximum remuneration (cap) for the coming financial year and (3) setting the value of the variable remuneration components and thus the total remuneration package for the past financial year.

In particular, the remuneration system shall set out:

- How the target and maximum total remuneration package is determined for the individual members of the management board,
- What relative proportion of the target total remuneration is comprised of the fixed remuneration on the one hand, and both the short and long-term variable remuneration components on the other hand,
- What financial and non-financial performance criteria are decisive for awarding the variable remuneration components,
- What the relationship is between meeting the previously agreed performance criteria and the variable remuneration,
- When and in what form the management board member can dispose of the awarded variable remuneration components.

The new version of the DCGK provides that the supervisory board establishes for the forthcoming financial year how much each management board member can receive across all remuneration components in the way of target and maximum remuneration. After the end of the financial year, the supervisory board determines the value of the individually awarded variable remuneration depending on the attainment of targets.

The long-term variable remuneration amounts awarded to the management board members are to be predominantly invested by the management board members in shares in the company or awarded as shares accordingly. The management board members shall not be able to dispose of the long-term variable remuneration until four years have passed.

The proportion of long-term variable remuneration shall not exceed the proportion of short-term variable remuneration.

The new rules are quite comprehensive when compared with the preliminary draft of the Code, allowing for more flexible models for remuneration components.

Regarding supervisory board remuneration, the revised Code advocates a fixed remuneration. If the supervisory board members are nonetheless awarded performance-based remuneration, this must be aligned with the long-term development of the company. The new Code forgoes recommending presenting remuneration in the reference tables, as section 162 AktG-E provides for a comprehensive remuneration report.

6. Conclusion

The adopted DCGK is a suitable compromise that systematically implements the new layout, yet, at the same time, does not lose sight of the objective of clearly presenting the standards of good and responsible corporate governance of German companies as recommendations and suggestions.

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