Client Alert | Corporate

German Federal Ministry of Justice and Consumer Protection publishes draft Act on the Transposition of the Second Shareholder Rights Directive

October 2018 I **German version**

Authors: **Dr Alexander Kiefner**, **Dr Lutz Krämer**, **Sabine Küper**, **Julia Sieber**, **Dr Robert Weber**

On 11 October 2018, the German Federal Ministry of Justice and Consumer Protection (BMJV) published the long-awaited draft Act on the Transposition of the Second Shareholder Rights Directive (ARUG II) (Link). The deadline for transposing the second EU Shareholder Rights Directive (Link), which came into force on 10 June 2017, is 10 June 2019. Statements on the draft bill can be submitted to the BMJV until 29 November 2018.

The 115-page draft of the Transposition Act contains, in particular, new rules concerning director remuneration ("say on pay"), related party transactions, better transparency regarding the behaviour of institutional investors, asset managers and proxy advisors and improved shareholder identification and information ("know your shareholder"). It is expected that a number of amendments will be made to the bill in the course of the legislative process.

1. Remuneration policy for the management board and supervisory board ("say on pay")

With Directive (EU) 2017/828 of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement (the "Second Shareholder Rights Directive"), the European legislator sought to ensure that the remuneration policy for directors would promote long-term corporate success throughout Europe and that shareholders would have a greater say in this policy. The German legislator is now meeting this requirement in the draft of the ARUG II by laying down requirements in the Stock Corporation Act concerning:

- the remuneration policy of listed companies; and
- the obligatory vote by the general meeting on the remuneration policy and the remuneration report for the management board and the supervisory board.

Establishment of a remuneration policy for the management board

The draft act introduces a new section 87a into the revised AktG (AktG-E), which obligates the supervisory board of a listed company to adopt a remuneration policy for members of the management board. The bill contains a list of purely descriptive requirements for the elements of the remuneration policy. The principles set forth in section 87 AktG will continue to apply as substantive guidelines for management board remuneration.

Henceforth, the general meeting of a listed company must vote at least once every four years to adopt the remuneration policy proposed by the supervisory board (section 120 para. 1 AktG-E). If the general meeting does not approve the remuneration policy, a revised remuneration policy must be submitted to the next general meeting for adoption. However, this resolution does not establish any rights or obligations, but rather has the character of an advisory vote and cannot be challenged under section 243 AktG.

The supervisory board may set the management board's remuneration only in accordance with the remuneration policy that was submitted to the general meeting for approval (even if the general meeting did not give its approval). The legislator is of the opinion that the requirements for the current discretionary vote by the general meeting on management board remuneration do not satisfy the remuneration policy requirements set out in the ARUG II. Therefore, in its explanatory memorandum, the legislator recommends that listed companies satisfy the new remuneration policy requirements even before the act comes into force in the event that they plan to submit a remuneration policy or a remuneration system to the general meeting for adoption prior to entry into force of the new regulation. Otherwise, a resolution on the remuneration policy would possibly have to be adopted at two consecutive general meetings (before and after entry into force of the ARUG II).

The company can only refuse to define a remuneration policy under extraordinary circumstances. The current arrangement in the AktG concerning modification of management board remuneration in the event of a deterioration in the company's situation (section 87 para. 2 AktG) remains unaffected.

Establishment of a remuneration policy for the supervisory board

In accordance with the amended wording of section 113 para. 3 AktG-E, a remuneration policy is also to be adopted for members of the supervisory board of a listed company, and because the provision refers to the new section 87a AktG-E, the same requirements are to apply as for the management board. Since, however, the current legislation already provides for the general meeting to approve the remuneration of members of the supervisory board, the legislator assumes in the explanatory memorandum accompanying the bill that in future the information concerning the remuneration policy that is specified by section 87a AktG-E will also be contained in the resolution on the specific supervisory board remuneration (see section 113 AktG-E). This is intended to ensure that the specific remuneration of the supervisory board also corresponds to the remuneration policy for the supervisory board.

If, in exceptional cases, the supervisory board receives no remuneration, a listed company must, in the future, nevertheless, hold a vote on supervisory board remuneration. Also with respect to supervisory board remuneration, the legislator now requires that for listed companies a resolution is to be adopted at least once every four years, even if the supervisory board remuneration does not change.

Remuneration report for the management board and the supervisory board

Prior to the reform, director remuneration already had to be disclosed. The legal basis for this has been, in particular, the accounting principles specified in the German Commercial Code (HGB) and the requirements of the German Corporate Governance Code. The ARUG II now inserts a new section 162 into the AktG-E, which requires a remuneration report to be published as a publication instrument derived specifically from the law of stock corporations. In order to avoid excessive overlapping of various publication rules in the area of director remuneration, the relevant HGB rules are to be largely abolished. As is the case with the Corporate Governance Code declaration, a single report is proposed that covers the remuneration of both the management board and the supervisory board. In this regard, the remuneration report must be prepared by the company directly and not by any group of which it may be a part.

In accordance with the requirements of the Second Shareholder Rights Directive, the remuneration report is in future also to contain information about the ratio of the average remuneration for directors to the average

remuneration for the company's full-time employees over the past five years. In this regard, it is up to the company to decide how to structure the comparative group for ascertaining average remuneration. In order to ensure a proper selection of the comparative group; however, the company is also required to explain in the remuneration report how it chose the comparative group.

Pursuant to section 120a para. 4 AktG-E, in the case of listed companies, the general meeting must, in the future, vote to approve the remuneration report each year. As is the case with the resolution on the ratification of the acts of the management board members, but contrary to the resolution on the remuneration policy, the legislator has made this resolution on the remuneration report subject to challenge under section 243 AktG. For listed SMEs within the meaning of section 267 HGB, the ARUG II provides for relief by exempting them from having to adopt a resolution at the general meeting if the remuneration report is submitted to the general meeting for discussion.

Practice notes:

- In accordance with the general arrangement on entry into force (Article 16 ARUG II), the supervisory board is obligated to enact a remuneration policy for the management board beginning on the first day of the month following promulgation of the ARUG II. By contrast, the obligation to have the general meeting vote on the remuneration policy for the management board and the supervisory board, and the subsequent obligation to set the remuneration of management board members in conformity with the proposed remuneration policy, first applies beginning with the fourth month following entry into force of the ARUG II (section 26 para. 1 of the revised Introductory Act to the Stock Corporation Act (EGAktG-E)) – i.e. generally not before the 2020 annual general meeting season. Until the initial vote by the shareholder's meeting on the remuneration policy, the supervisory board may remunerate the management board on the basis of past practice (section 26 para. 1 EGAktG-E).

- Issuers that plan to have the general meeting adopt a resolution concerning "say on pay" in 2019 or otherwise intend to make changes to the system for remunerating the management board should review whether they are meeting the requirements for the remuneration policy set forth in the new section 87a AktG even prior to entry into force of the ARUG II in order to avoid having to make substantive changes to the remuneration system again.

- The obligation to prepare a remuneration report that conforms to the new requirements (section 162 AktG-E) applies beginning with the first general meeting that takes place four or more months after the general entry into force of the ARUG II (section 26 para. 2 EGAktG-E), i.e. normally as of the annual general meeting in 2020. Even though the wording of the AktG-E points in a different direction, the explanatory memorandum accompanying the draft bill suggests that the general meeting should vote on the remuneration report under the new law at that first general meetings after the act comes into force, meaning that the remuneration report must be prepared prior to that meeting. In light of this, it is advisable to pay close attention to further deliberations regarding the bill.

- Under the new law, the general meeting may no longer resolve to opt out of disclosing the remuneration paid to each management board member.

- Employment agreements for management board members that are concluded prior to entry into force of the ARUG II and prior to approval of a remuneration policy pursuant to section 87a AktG-E should contain a modification proviso. It is hoped that the further legislative process will clarify whether current employment agreements for management board members can be grandfathered.

2. Requirement of approval for the company's related party transactions

With the Second Shareholder Rights Directive, the European legislator is seeking to ensure that company and shareholder interests are adequately protected in cases involving related party transactions. In order to achieve this objective, a new section 111b AktG-E specifies that related party transactions are subject to the supervisory board's approval if the economic value of the transaction exceeds 2.5% of the total of the company's fixed and current assets (as defined in section 266 para. 2 A and B HGB) pursuant to its most recently approved annual financial statements.

Related party transaction

The definition of the term in the draft ARUG II (section 111a AktG-E) is based on the International Accounting Standards (IAS) and is to be understood broadly from a functional standpoint. It covers both contractual and in rem transactions. The term “related party” likewise is consistent with the IAS definition (in particular, IAS 24). It comprises both natural persons, as well as legal entities and partnerships. In evaluating whether a party is related, the formal legal structure of the relationship is not the sole determining factor. Rather, its economic substance is also to be taken into account.

Exempt transactions

The Second Shareholder Rights Directive exempts certain related party transactions, and the German legislator has made extensive use of them in section 111a AktG-E in the interest of affording the greatest possible relief to companies, given that related party transactions currently already enjoy a high level of protection.

For instance, such transactions do not qualify as a related party transaction if they were executed in the ordinary course of business and on an arm's length basis, although the legislator intends for this to be interpreted narrowly. In addition, the bill contains a definitive list of other exemptions for certain types of transactions for which, owing to specific circumstances, special protection of shareholders is not required or is already ensured otherwise, as well as for transactions that serve an overriding objective. These include, for example, transactions with subsidiaries that are wholly owned by the company, either directly or indirectly, or in which no related party holds a stake. Transactions that require the approval of or authorisation by the general meeting or are undertaken in execution of approval or authorisation are likewise exempt. By expressly referring to corporate agreements, the German legislator also takes into account the complex protective mechanisms contained in the German law governing corporate groups formed by contract, which already satisfy the protective standard expected to be introduced by the Second Shareholder Rights Directive.

Approval procedure

The approval procedure is set down in sections 111b and 111c AktG-E. The supervisory board must approve related party transactions covered by the new provisions before they are concluded. To facilitate the process, the ARUG II allows for the appointment of a supervisory board committee, which makes proposals for resolutions on related party transactions.

If such a committee is in place, and if it proposes that the transaction be approved, the supervisory board can grant approval as a plenary body without excluding voting rights for supervisory board members with a conflict of interest. Otherwise, a related party involved in a transaction requiring approval may not participate in the approval procedure. If the responsible committee proposes that the supervisory board refuse to approve the transaction, the supervisory board may grant approval only if an auditor or auditing firm confirms that the transaction is appropriate.

If the supervisory board does not establish a committee for approving related party transactions, the supervisory board makes the decision on its own. Members of the supervisory board with a conflict of interest may not take part in the vote in such cases. Confirmation of appropriateness by an auditor is not envisioned in this case.

If a supervisory board member with a conflict of interest participates in a vote, this does not as a rule render the transaction ineffective. However, this may result in members of the supervisory board being liable for damages.

If the supervisory board refuses to approve a related party transaction, the management board may request that the general meeting vote on conclusion of the transaction. Related parties involved in the transaction may not vote on the resolution in the general meeting.

In accordance with the newly introduced section 48a of the German Securities Trading Act (WpHG), listed companies must publicly disclose related party transactions requiring approval without delay. The obligation does not apply if the transaction was already published as an ad hoc disclosure pursuant to Article 17 of the EU Market Abuse Regulation.

Practice note: Although the legislator has provided for extensive exemptions for related party transactions, listed companies should nevertheless modify the internal processes for related party transactions early on so that they are in conformity with the future statutory framework. In particular, it will often be advisable for a supervisory board committee responsible for related party transactions to be set up in a timely manner. The provisions enter into force without a transitional arrangement on the first day of the calendar month following promulgation of the ARUG II.

3. Disclosure obligations on institutional investors, asset managers and proxy advisors ("better transparency")

In connection with the Second Shareholder Rights Directive, the European Commission was critical of the fact that institutional investors and asset managers are often not transparent about their investment strategies, their engagement policy and the implementation thereof. It is noted that these investors often make use of the services of proxy advisors when exercising their voting rights. Now, on the basis of requirements in the European directive, institutional investors, asset managers, and proxy advisors will henceforth be subject to extensive disclosure obligations (sections 134a et seq. AktG-E).

For instance, institutional investors and asset managers must in future publish an engagement policy in accordance with detailed requirements. The approach that applies in this respect is "comply or explain", i.e. institutional investors and asset managers must publish their engagement policy and their voting behaviour or explain why they failed to satisfy one or more of these statutory requirements. In addition, institutional investors and asset managers must disclose how the main elements of their investment strategy are consistent with the profile and duration of their liabilities and how they contribute to the medium-term to long-term performance of their assets. Liabilities, within this context, means the contractual relationship with the investor/ultimate beneficiary.

This information must be made publicly available on the websites of institutional investors or asset managers for at least three years and must be updated at least once a year.

Proxy advisors must henceforth explain once a year, in particular, whether they have complied with the requirements of a code of conduct or why they failed to do so. In addition, they must promptly notify their clients about conflicts of interests and relevant countermeasures.

Practice note: IR departments should explore early on what opportunities the new sources of information (better transparency) offer for IR work and investor dialogue – where appropriate, also with respect to activist shareholders. In the future, IR departments are likely to be better placed to anticipate voting behaviour and the underlying motives. The provisions enter into force without a transitional arrangement on the first day of the calendar month following promulgation.

4. Arrangements concerning improved shareholder identification and information ("know your shareholder")

In keeping with the Second Shareholder Rights Directive, the ARUG II (in particular, sections 67a et seq. AktG-E) is intended to improve the possibilities for communication between companies and their shareholders with the aim of facilitating the exercise of shareholder rights.

Listed companies are given expanded rights to request information about their shareholders from "intermediaries", which is how credit institutions will be referred to in the future. Intermediaries will be obligated to forward corresponding information about shareholders to the company. If in the case of cross-border constellations, a number of intermediaries are involved, they will be obligated to forward to shareholders any requests for identification and information about the exercise of shareholder rights. The distinction in German law between registered and bearer shares will however be retained.

In addition, shareholders will be given the right in the case of electronic voting to receive confirmation that their vote was received, as well as to request confirmation about whether and how their vote was counted.

Practice note: The arrangements on improved communication between companies and shareholders that are contained in sections 67a et seq. AktG-E and several other provisions will become applicable

for the first time in 2020. Issuers and intermediaries are advised to address the requirements and necessary system modifications well in advance of the annual general meeting season.

5. Entry into force and transitional provisions

The ARUG II is scheduled to enter into force on the first day of the month following promulgation in the German Federal Law Gazette (Article 16 ARUG II). As indicated above, the provisions dealing with the obligation to set the remuneration for members of the management board in conformity with a remuneration policy submitted to the general meeting for approval, as well as the new arrangement concerning the remuneration report in section 162 AktG-E, will first apply four months after entry into force of the ARUG II (section 26 EGAktG-E). The same applies to the modified reporting duties under commercial law. Up until the first vote by the annual meeting on the remuneration policy, the members of the management board and the supervisory board may continue to be paid remuneration in accordance with current remuneration practice. This allows the legislator to solve the problem that the supervisory board would otherwise be unable to set management board remuneration after entry into force of the act until such time as a remuneration policy is submitted to the general meeting for approval. With respect to the information in the remuneration report on the ratio of the average remuneration of directors to the average remuneration of the company's full-time employees, it will initially be sufficient to provide information about average remuneration for the most recent year instead of for the past five years.

In accordance with the transitional provisions, the new arrangements concerning improved shareholder identification and information are not yet to apply in the year of promulgation of the ARUG II, meaning that they will first become relevant in 2020.

6. Outlook

The draft ARUG II will now be deliberated by the Federal government to begin with. Then, the bill as adopted by the Federal government, will be sent for comment to the Bundesrat (upper house), which may express a contrary opinion. Thereafter, the bill will be submitted by the Federal Government to the Bundestag (lower house) for further deliberation.

It is expected that a number of changes will be made to the current version of the draft ARUG II in the course of the legislative process. The amended Stock Corporation Act will likely enter into force shortly before expiry of the transposition deadline in June 2019. However, the arrangements concerning remuneration policy will probably have an impact even before the act enters into force.

White & Case LLP
John F. Kennedy-Haus
Rahel Hirsch-Straße 10
10557 Berlin
Germany

T +49 30 880911 0

White & Case LLP
Graf-Adolf-Platz 15
40213 Düsseldorf
Germany

T +49 211 49195 0

White & Case LLP
Bockenheimer Landstraße 20
60323 Frankfurt am Main
Germany

T +49 69 29994 0

White & Case LLP
Valentinskamp 70 / EMPORIO
20355 Hamburg
Germany

T +49 40 35005 0