

What Happens Once the Code is Finalized? -

The German Experience

by

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I. The German Governance Code development

1. Development of a corporate governance code – the German background

Efforts to advance good governance in corporate Germany were not very successful until the late 1990s. Many large companies were still de facto run by management boards with little outside control. The main reasons for the acceleration in German corporate governance matters were:

- Well publicized failures in erstwhile 'blue chip companies' like Metallgesellschaft and Holzmann attracted increased political attention, evidenced by the formation of a Government Commission by the German Chancellor.
- The success of the equity markets in the late 90ies led to broad share distribution in public hands. (Deutsche Telekom, 10.1 million shareholders).
- Increased competition in the asset management sector: to win clients, the pursuit of good governance is a key element.

2. The Start: A 'Code of Best Practice' – a model governance code as a private initiative (1999)

The first step was drafting a 'Code of Best Practice'¹ for the corporate governance of listed German corporations. In the face of considerable corporate resistance, a panel of ten experts in September 1999 representing corporations, auditors, investors and legal practitioners started working on the establishment of a 'Code of Best Practice' as a 'model catalogue' for listed German companies.

¹ <http://www.corgov.de>.

With the advantage of a private initiative, only four months were needed to present the code in early January 2000. The foundations were relevant German laws and regulations and international governance standards (particularly the OECD Principles on Corporate Governance from 1999). Also international institutions leading in the governance field like Calpers and Hermes were invited to comment. The principal goal was to give German companies a market oriented guideline for the drafting of their governance principles.

3. The official 'German Corporate Governance Code' (Feb. 2002) – the result of private sector work with government support

Spurred by the threat of failure of a major construction company with thousands of employees, the German Chancellor in July 2000 convened the first 'Government Commission on Corporate Governance' to develop official standards for German governance and to draft recommendations for future company law developments. The commission consisted of high-level experts from politics, companies, unions, the German stock exchange, private shareholder associations, institutional investors, universities (i.e. economic law) and auditing and consulting firms. After a nearly 400 page report with detailed proposals was presented to the German Chancellor in June 2001, a second Government Commission was put together September 2001 to develop the official 'German Corporate Governance Code'². After five months of intensive work with a draft for public comment, the Code was published in February 2002. Following the 'comply or explain'-mechanism, German companies have to comply at least annually with the code or explain deviations. The code comprises three elements relevant for good German governance:

- The legal stipulations relating to key governance points.
- 'Shall Recommendations' which reflect key international governance standards. Companies that do not comply with these recommendations have to state this in their annual report and/or their website.
- 'Should Suggestions' that represent additional important elements of good governance. These 'suggestions' do not automatically require disclosure in case of non-compliance but companies are encouraged

² Available in German and English in the Internet: <http://www.corporate-governance-code.de>.

to voluntarily report their compliance with these suggestions as well³.

4. The goal: increased self-regulation instead of additional laws

Such a pragmatic and widely accepted self-regulation measure with a 'comply or explain' approach should leave enough room and flexibility for companies to follow their business strategies without being too constrained by endless legal stipulations.

II. The Implementation Experience

1. The political environment

As Germany had no good experience with the acceptance of voluntary guidelines (for insider and takeover issues), a legal background was established to achieve sufficient application of the Code (instead of the alternative of a listing requirement): Section 161 of the Company Law obliges companies to report at least annually about the implementation of the Code. However, the 'comply or explain'-mechanism allows companies to decide individually regarding its individual points. This gives companies full flexibility to adjust to best practice and new developments.

While the German Government Commission on Corporate Governance has an official mandate, it has no legislative powers. All members are non-political representatives. Adjustments do not require any legislation, thus allowing fast responses to major changes in German and international corporate governance.

2. The international influences

Considerable influence on the official German Code had: the OECD Corporate Governance Principles, leading governance-minded institutions like Calpers and TIAA-CREF from the US and Hermes from the UK. In Europe, the EU-Commission's role in corporate governance has been rather general in view of the persistence of major differences in national securities and company laws. They impose a 'natural' barrier towards harmonized corporate governance-standards of now 27 EU countries. This is, however, working against the interest of both companies and investors as they are increasingly international in their scope and therefore have little incentive to work with 27 different codes in Europe

³ German Corporate Governance Code: preamble.

alone.

3. Compliance by companies

In the nineties, only a few companies were really interested to actively engage in the promotion of governance. Intensive resistance—particularly by the chief lawyers—had to be overcome: they generally have a strong position in German companies and reacted negatively to new obligations of a nonbinding legal nature. Even after the introduction of the official Code in 2002, some major corporations are only willing to do the absolute necessary rather than seeing the opportunity to improve the company's image for the benefit of all stakeholders.

4. Self-Determination approach: 'comply or explain'

As mandated by the law 'comply or explain' feature, listed German companies have to explain deviations from the 'Shall Recommendations' of the Code since 2002. The most recent annual survey commissioned by the Governance Commission⁴ shows that the 30 large companies show a 97% acceptance of the 'Shall-Recommendations'.

However, the corporate governance quality aspect is particularly determined by compliance with the 'Should-Suggestions' of the Code where deviations do not have to be reported in the annual 'comply or explain' declaration. Particular improvement opportunities exist in the application of the 'Should-Suggestions' of the Code where only 84 % of the 30 DAX companies report compliance. The most common deviations until the end of last year concerned individual board remuneration, board qualification, implementation of audit committees, deductibles for D&O insurance, and timely financial reporting. Only close monitoring by investors, analysts and the media will ensure continuing quality improvements.

5. The importance of the media

National and international media involvement has played an increasing role in the broader perception of governance issues and problems. In the early phases, the private investors had to engage the relevant media actively to interest them in an issue that was less spectacular than the dramatic rise of the stock market. After

⁴ Der Betrieb: Kodex Report 2007: Die Akzeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex, Issue 16, 20 April 2007.

the publication of the Code in February 2002, the media helped to create a better understanding about the new requirements not only for companies but for all stakeholders. Today, a lively debate on the further development issues of German governance supports the further reviews of the code.

6. The one big deficit factor: the (non-executive) supervisory board

Improvements in governance quality are still necessary for many German companies that do not go beyond formally accepting the 'Shall-Recommendations'. The main deficits regard supervisory board issues:

- insufficient independence of directors
- the impact of co-determination
- the lack of international representation.

The recent governance problems at Siemens and Volkswagen can also be attributed to a considerable extent to the insufficient independence on their boards.

The conceptually good solution of 'checks-and-balances' between the executive and the supervision of the German 'two-tier-board'-system is seriously impaired by the German co-determination issue. It impacts negatively on board size, independence and international composition: the inevitable 20 supervisory board members for large companies are simply too many for an engaging and serious discussion of complex issues. The employee representatives are by nature dependent and they should be nationals.

The recent implementation of the European Company (*Societas Europaea*) can provide a good solution: It reduces the number of board members to 12 and thus improves the efficiency of the board, apart from providing the opportunity to increase the representation of international directors.

7. Reviewing & monitoring process of the German Code

The Code is reviewed at least annually by the Government Commission that acts as a standing commission:

- The Commission mandates the annual survey mentioned above
- Additionally, it organizes an annual conference to review progress in general and selects a timely topic for broader discussion

The companies monitor their corporate governance mostly through annual reviews or internal evaluation sessions by boards and committees.

To practically evaluate the execution of their corporate governance companies, analysts and investors can use the corporate governance-scorecard devised by the German Society of Investment Analysts (DVFA). The practical application of the Scorecard for German corporate governance⁵ and the interpretation of the evaluation-results are evidenced by concrete examples in German companies. Its main features are:

- Facilitate the work of analysts and investors through a systematic and easy overview of all relevant issues of good governance.
- Enable companies to easily assess the 'reach' and the quality of their own governance situation.
- Enable comparisons across industries and countries.
- Be readily available to all interested parties via the internet.
- No or very little cost for implementation and application.
- Ensure high degrees of usage: the completion of the scorecard via programmed tools (MS Excel) should also enable active dialoguing.
- Allow to set minimum scores by investors for governance as part of general investment politics.

Conceptually, the scoring system enables a company displaying an active corporate governance commitment and fulfilling all 'shall-recommendations' of the German corporate governance code to reach a score of 75%. If the additional 'should-suggestions' of the Code and further international best practice-standards are fulfilled, the maximum 'total score' of 100% can be achieved. This 25% fulfilment gap is clearly meant to incentivise companies to pursue higher governance standards than just the 'shall-recommendations'. German companies with demanding governance standards today reach scores between 80% and 95%.

III. A compelling enforcement and incentive environment

1. Enforcement

Only with efficient enforcement by the authorities, good governance and

⁵ The Scorecard and a user guide are available in the Internet at: <http://www.dvfa.com>.

efficient markets are possible. This obviously requires excellent cooperation and division of labour (instead of duplication) by the public regulatory and supervisory bodies for the capital markets and the banking system.

The 'comply-or-explain' principle, as a central enforcement element for better governance, must be pursued intensively. In Europe the 'comply-or-explain' principle has become a main feature of the approach to corporate governance. Since the establishment of the Code in early 2002 the German experience suggests that the 'comply-or-explain' mechanism works satisfactorily on the whole. There is, however, still room for improvement (missing explanations in case of deviations, wrongful declarations of conformity).

However, enforcement of codes is no box-ticking exercise. The quality of the implementation must be evaluated by an expert body. Sufficient resources and adequate number of people with appropriate expertise are imperative to monitor the acceptance of the Code. A coordinated approach between the Stock Exchanges, the Financial Supervisory Authorities and other relevant bodies is essential for convincing Code enforcement. Centralized competencies for court procedures are also necessary for an efficient enforcement process.

Finally, effective enforcement needs appropriate sanctions that are a deterrent to misdemeanor and are enforceable in the courts. This requires timely, transparent and well-reasoned rulings of both private and public authorities.

2. Incentives

Apart from convincing regulatory and enforcement procedures, it is desirable to create incentives for companies to comply with best practice. The United Arab Emirates (UAE) utilizes an incentive programme: Companies that voluntarily adopt the newly developed governance related listing rules receive a 'Good Practice' classification in the Abu Dhabi Securities Market (ADSM). Companies that additionally comply with the voluntary Corporate Governance Code⁶ can claim to be 'Best Practice' in their governance and disclosure.

Examples also include Brazil, whose special stock market segment ('Novo Mercado') is to be met for respective listing only with increasing levels of

⁶ Abu Dhabi Securities Market (ADSM): Corporate Governance Code – Guidelines for Best Practice, 2005 (<http://portal.adsm.ae/wps/portal>).

governance quality.⁷

IV. Conclusion

A good governance framework is essential but demonstrated quality makes the difference. Best practice principles for corporate governance developed by the OECD, the Worldbank/IFC, and the ICGN are mandatory guidelines that satisfy global requirements and serve as benchmarks. With a good tailor-made framework, good governance can be successfully applied in most countries.

It is, however, up to all persons responsible to live good governance. Specialized training programs are an important element of this.

Successful implementation of good governance is in the self-interest of companies, investors and the public bodies alike:

- Enterprises will accept that good governance is paramount for access to cost efficient financing.
- Investors will have higher returns if they pursue governance through active and responsible engagement.
- Financial institutions must be exemplary in their pursuit of best practice for depositors and borrowers.

⁷ See <http://www.bovespa.com.br>.