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Via email: regierungskommission@dcgk.de

15 December 2016

Subject: Consultation response regarding the proposed amendments to the German Corporate Governance Code 2017

To whom it may concern

Hermes EOS[1] and the undersigned institutional investors, California State Teachers' Retirement System (CalSTRS)[2] and Universities Superannuation Scheme Limited (USS)[3] – representing in total more than €510bn assets under management (30 September 2016) – welcome the opportunity to provide comments on the proposed amendments to the German Corporate Governance Code (the 'Code') by the Regierungskommission ('the Commission').

As foreign institutional investors, we acknowledge in this response the distinct features of the German corporate governance system, in particular the dual board structure and co-determination.

Comments on the proposed amendments and changes to the Code

We commend the Commission's efforts to encourage more transparency for a better governance assessment by stakeholders on the basis of international best practice and the

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[1] Hermes is an asset manager in the City of London, and is wholly owned by the BTPS, one of the UK's largest corporate pension schemes. As part of our Equity Ownership Service (Hermes EOS), we also respond to consultations on behalf of many clients from around Europe and the world, including Coal Pension Trustees Services Ltd (UK), Environment Agency Pension Fund (UK), PNO Media (the Netherlands),and VicSuper (Australia). In all, Hermes EOS advises over 40 clients with regard to assets worth a total of over €273.7bn (as at 30 Sept 2016).
[2] CalSTRS' mission is to secure the financial future and sustain the trust of California's educators. We serve the investment and retirement interests of more than 896,000 plan participants. CalSTRS is the largest educator only pension fund in the world, with a global investment portfolio valued at approximately $193.2 billion as of 30 Sept 2016. http://www.calstrs.com/current-investment-portfolio.
[3] Universities Superannuation Scheme is the principal final salary pension scheme provided for academic and senior administrative staff in UK universities and other higher education and research institutions. The fund is one of the largest pension schemes in the UK, with assets of over £56bn (€66.5bn).The majority of assets are managed in-house by USS Investment Management, a wholly owned subsidiary of USS, authorised and regulated by the FCA. See www.uss.co.uk.

clear recommendation regarding the communication of investors with Supervisory Boards of German companies. Most importantly, we appreciate that this year – for the first time in the existence of the Commission – responses to the consultation will be made publicly available unless the respondent requests otherwise. In our view, this improves the overall consultation process, increases transparency, and strengthens the corporate governance culture in Germany.

In the following, we provide our detailed comments on four major proposed amendments to the Code:

1. Dialogue between investors and Supervisory Boards (Number 5.2)
2. Board composition (Number 5.4.1)
3. Exercise of ownership rights by institutional investors (Number 2.1.3)
4. Audit committee independence (Number 5.3.2).

1. Dialogue between investors and Supervisory Boards (Number 5.2)

We strongly believe that a regular and constructive dialogue between investors and supervisory boards – on topics which fall into the remit of the Supervisory Board – will strengthen the governance of German companies. Therefore, we appreciate and support the Commission's recommendation under Number 5.2 in the Code, that "the Chairman of the Supervisory Board shall be prepared to engage into discussions with investors […]" (Code, p. 10).

Such dialogue enables investors to gain an impression of whether the composition of the Supervisory Board is appropriate and whether it carries out its duties effectively. In turn, the Supervisory Board has the opportunity to promote the understanding of company-specific corporate governance approaches and, in the case of foreign investors seeking a dialogue, to explain the two-tier German corporate governance model with employee co-determination.[4]

We would encourage the Commission to make reference to the *Guiding Principles for the Dialogue Between Investors and German Supervisory Boards* developed by the initiative "Developing Shareholder Communications"[5] which outlines many of the areas for dialogue between investors and Supervisory Boards, such as:

- The composition of the Supervisory Board, its nomination process, and remuneration of the Supervisory Board;
- Supervisory Board-related matters, such as the corporate governance report, internal organisation of the Supervisory Board and the Supervisory Board's efficiency review;
- Requirement profiles for Management Board members, without discussing specific proposals of individual candidates;
- The Supervisory Board's participating role within the strategy process and its assessment of the implementation of the strategy;
- The selection process of the auditor and the cooperation between the auditor and the Supervisory Board.

We believe the guiding principles are an effective tool to inform the dialogue on specific topics that will benefit both parties to enhance and facilitate robust discussions between investors and Supervisory Boards.

Also, we would suggest that the Commission considers including a recommendation in the new section under Number 5.2 to the effect that the Chair of the Supervisory Board shall report back to the entire Supervisory Board on the content of the meetings that he/she has

[4] See *Hirt and Viehs, 2016: Building Trust in German CG; in: Governance, September 2016 Issue 267*.
[5] The initiative 'Developing Shareholder Communications' brought together various stakeholders including several large German listed corporations, and institutional investors including Hermes. The 2016 guiding principles can be found here: http://www.ey.com/Publication/vwLUAssets/ey-buiding-principles-for-the-dialogue-between-investors-and-german-supervisory-boards/$FILE/ey-buiding-principles-for-the-dialogue-between-investors-and-german-supervisory-boards.pdf.

held with investors. That way it is ensured that the information asymmetry between the Chair and the entire board is reduced. Finally, we would suggest rewording of the new second section of Number 5.2 to enhance clarity as follows:

"Discussion with investors on aspects which do not fall into the remit of the Supervisory Board shall be led by the Management Board, which has the discretion to take the Chair of the Supervisory Board along to investor meetings if it considers this to be appropriate."

Overall, we strongly believe that the revised wording for provision Number 5.2 of the Code will lead to improved investor communication, which in turn enhances the overall quality of corporate governance in Germany and fosters mutual trust between companies and – in particular, foreign – institutional investors.

2. Board composition (Number 5.4.1)

In general, we commend the Commission's proposed changes to Number 5.4.1 of the Code.

We welcome the proposal that the Supervisory Board shall set up "profiles of competencies" to ensure that the board is comprised of diverse individuals with the skills, education, experiences, expertise and personal qualities that are appropriate to the company's current and long-term business needs. These could possibly be communicated to shareholders through a skill-sets matrix.

We would encourage the Commission to ensure that the "profiles of competencies" and how the individual directors fulfil such briefs, along with their names and biographies, are disclosed to shareholders, ideally within the Corporate Governance Report of the Annual Report.

Furthermore, we welcome the proposed addition to Section 4 of Number 5.4.1 on the disclosure about appropriate numbers of independent Supervisory Board members. However, we would welcome a strengthening of the Code to ensure that the directors considered to be independent are named, ideally alongside the disclosures outlined above in the Corporate Governance Report. We believe that more transparency about who on the Supervisory Board can be considered to be independent and explanations of why the Supervisory Board believe that these persons are independent will improve governance and accountability.

3. Exercise of ownership rights by institutional investors (Number 2.1.3)

We welcome the proposed addition of a section on the responsibilities of institutional investors to carry out their ownership rights actively under Number 2.1.3. Especially against the backdrop of the intended revision of the Shareholder Rights Directive in the European Union, which sets out measures to increase shareholder engagement with investee companies leading to an overall better sustainability of EU companies, we find the proposed addition useful for both companies and investors.

Since the launch of the UK Stewardship Code in 2010, similar codes or guidance have emerged in various other markets around the world, such as the International Corporate Governance Network (IGCN) Global Stewardship Principles in 2016[6].The proliferation of stewardship codes and increased reflection about the role of investors in the governance of companies are important trends in international corporate governance. Thus, we applaud the Commission for specifying that institutional investors are required to exercise their ownership rights actively and responsibly. We would encourage the Commission to ensure that any impediments to stewardship e.g. practical limitations regarding the exercise of voting rights by proxy, are reviewed.

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

4. Audit committee independence (Number 5.3.2)

We commend the Code's recommendation that the chair of the Audit Committee shall be independent and not a former member of the Management Board. Since the law in Germany does not require the financial experts on the Supervisory Board to be independent, this recommendation will in our view enhance the Audit Committee's role and oversight of the company's financial reporting processes, internal controls and independent auditors.

Our best practice expectation regarding the composition of Audit Committees goes beyond the independence of the committee's chair: we consider all members on the Audit Committee should be demonstrably independent. We strongly encourage the Commission to consider the inclusion of a recommendation to that effect as well.

We would also suggest that the Commission includes recommendations to ensure that the independence of the audit is not compromised by paying significant non-audit related fees to the auditor which may impact the independence of the auditor; and that the tenure of the audit firm is disclosed. In our view, such recommendations would help in protecting the integrity and trustworthiness of the audit as well as increase investors' confidence in the overall audit process.

Further comments and suggestions

Following our detailed comments on the proposed changes to the Code, we would like to also comment on further proposed amendments and other key corporate governance themes which are not currently addressed by the proposed changes to the Code but which the Commission should, in our view, consider including in future versions of the Code:

- **Numbers 2.1.3 and 2.2.1 – Directors' discharge vote**
  - In line with individual director elections we would also welcome the opportunity for shareholders voting by proxy to exercise their votes on the discharge of the Supervisory and Management Boards separately for each individual director. This will enable investors to exercise their stewardship more effectively and escalate concerns appropriately if necessary. The ability to discharge the directors individually will also somewhat mitigate concerns regarding the unusually long five year directors' terms, where we consider all directors should be subject to shareholder approval at least once every three years.

- **Numbers 2.2.1 and 4.2.3 – Advisory shareholder votes on remuneration**
  - We have promoted advisory votes on remuneration policies in our Corporate Governance Principles for some time. We therefore welcomed the introduction of the legal framework concerning the appropriateness of Management Board remuneration which facilitates such advisory votes. We would suggest that the Commission considers enhancing provision 2.2.1 to stating that German companies shall provide shareholders with the opportunity to vote on their remuneration policy at the General Meeting if there have been amendments to the remuneration policy or if there were a significant number of votes against the policy in the previous year.

- **Number 4.1.3 – Compliance system**
  - We applaud the Commission for the extension of Number 4.1.3 on the reporting on the compliance management system and whistleblowing mechanisms. In addition to the legal requirement to have a compliance system, this recommendation improves overall transparency and hence strengthens the governance of German companies.

- **Numbers 5.4.1 and 5.4.5 – Overboarding**
    - We hope that the enhanced disclosures regarding directors' essential activities further to the Supervisory Board mandate (under 5.4.1) will help shareholders to monitor concerns regarding overboarding. We would encourage the Commission to consider whether the Code should limit the number of external appointments a Supervisory Board or Management Board member is allowed, in order to ensure that the candidate is able to dedicate sufficient time to his or her board duties. Such a recommendation would in our view be more effective than the existing recommendation under Number 5.4.1 in ensuring that board members can devote sufficient time towards their board duties.

- **Number 5.6 – Board assessment**
    - We welcome the recommendation in the Code (Number 5.6) regarding the regular examination of the Supervisory Board's own efficiency. We consider such practices have contributed to a positive development in boards. We believe that the Commission should now take the next step by recommending that the Supervisory Board conduct regular, externally-facilitated board evaluations; and that the high-level results and outcomes from such evaluation be disclosed to investors.

We hope that our comments and suggestions are of assistance. If you would like to discuss our views in further detail, please do not to hesitate to contact Dr Michael Viehs (Michael.Viehs@hermes-investment.com, tel. +44 (0)20 7680 4673).

Yours sincerely,

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