How to Ensure That Directors and Executives Adhere to the Rules of Good Corporate Governance? Lessons from Germany

„Corporate governance related training of board directors and senior managers“
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Awareness for the Challenges of Good Corporate Governance increases

Some Reasons:

- Increased demands and complexity for directors as well as executives

- Higher awareness for the role of effective governance for firm-level competitiveness in global competition

- Higher need for effective corporate governance due to corporate scandals, the financial crisis and related problems
Collaboration between Management and Supervisory Board

- Supervisory Board: approves, advises, supervises, appoints, dismisses
- Management Board: informs, reports, seeks advice

Close cooperation for the benefit of the company
Providing annual corporate governance report
Three Pillars of Corporate Governance Regulations in Germany

**German Stock Corporation Act (Aktiengesetz)**
- E.g. three corporate bodies – Annual meeting, management board, supervisory board
- E.g. clear separation of management and supervisory board

**German Co-determination Act (Mitbestimmungsgesetz)**
- E.g. Up to one half of seats at supervisory boards have to be held by employee representatives
- E.g. work councils in all larger firms

**German Corporate Governance Code**
- Published by a government commission consisting of managing and supervisory board representatives, academics, auditors and a trade union federation
- Members are appointed by the German Federal Minister of Justice and Consumer Protection.
- The Code expresses commitment to good corporate governance
- The commission consults the Code with companies and their stakeholders (including politics and the general public)
German Corporate Governance Code (GCGC)

- Clarification of obligations of the management and supervisory board
- Legal Basis: Declaration of conformity to §161 Aktiengesetz (Stock Corporation Act)
  - „Comply or Explain“ - Recommendations and suggestions are not mandatory. Deviations from the recommendations – not suggestions – have to be disclosed and explained

Main Goals
- Making the German corporate governance system transparent and understandable
- Promoting trust of investors, customers, employees and the general public in the management and supervision of listed German stock corporations

Source: http://www.dcgk.de/de/kodex.html
Focus and Development of the GCGC

Shareholders and Annual Meeting Rights
  e.g. invitation and rights to vote

Compensation of Executives and Directors
  e.g. composition and level

Work of the Two-Tier Board System
  e.g. cooperation between management and supervisory board

Transparency
  e.g. treatment of all shareholders in respect of information

Focus Topics

Latest development of the German Corporate Governance Code:

2002  First version of the German Corporate Governance Code

...  

2012  Supervisory Board members have to reveal personal and business relationships

2013  Specification under which conditions deviations from recommendations and suggestions are explicitly allowed and rational

2014  15 new recommendations regarding management board members compensation (e.g. defining limits)

## Generally High Acceptance and Application of the GCGC

### Data for acceptance and application of the GCGC in 2014

<table>
<thead>
<tr>
<th>Recommendations</th>
<th>DAX</th>
<th>TecDAX</th>
<th>MDAX</th>
<th>SDAX</th>
<th>Prime</th>
<th>General</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average #</td>
<td>96</td>
<td>87</td>
<td>85</td>
<td>85</td>
<td>73</td>
<td>73</td>
<td>84</td>
</tr>
<tr>
<td>Share of application</td>
<td>92%</td>
<td>83%</td>
<td>81%</td>
<td>81%</td>
<td>70%</td>
<td>70%</td>
<td>80%</td>
</tr>
</tbody>
</table>

| Suggestions     | Average # | 5    | 4    | 4    | 4     | 3       | 3     | 4     |
| Share of application | 82% | 72%   | 65%  | 61%  | 47%   | 54%     | 64%   |

| Total           | Average # | 101  | 91   | 89   | 89    | 76      | 76    | 88    |
| Share of application | 91% | 82%   | 80%  | 80%  | 69%   | 69%     | 79%   |

Exemplary Areas With Lower Acceptance

Management board compensation should be defined in *vertical relation* to the compensation level of middle managers

- 59% of firms consider the compensation level of managers at the second hierarchical level for the setting of executive compensation levels
- Only 24% consider also the third hierarchical level

Clear regulations for higher independence of supervisory board members

- Consideration of employee representatives as independent directors?
- Nearly 80% of firms consider employee representatives as independent
- Less than 50% of firms have clear quotas for the number of independent directors (at the side of shareholder representatives)
- However, two-tier-board system in itself supports board independence

Prominent Problems – CEO Chairman Continuity

GCGC as well as stock corporation act suggest that CEOs should take a „cooling-off phase“ of at least 2 years before entering the supervisory board!

„I do not want to generalize but for BMW I think this is wrong. In our company, it is well-proven that successful management board members are elected to the supervisory board and the chairman position immediately following their work at the management board“

Joachim Milberg, Chairman BMW Group

- In 2011 long-standing CEO Josef Ackermann plans to take over the Chairman position immediately after resigning as CEO in 2012.

- Announcement of the plan were followed by heavy critics of shareholder representatives and politicians („Ackermanns role will be that of an absolute monarch“).

- Finally, Ackermann had to give up his plan and left Deutsche Bank.

Source: manager magazin, Spiegel, Deutsche Bank, BMW
Prominent Problems – Corporate Illegal Activity

Increased importance of compliance issues for firms that face criminal activity after accounting and corruption scandals in the 2000s and the financial crisis!

- Several prominent scandals even within the largest German firms:
  - e.g. incidents of corruption at Siemens or ThyssenKrupp
  - e.g. Libor and other manipulations at Deutsche Bank

- Some industries have a long history of illegality, similar violation rates and spread of misconduct, which might induce some top managers to tolerate such behavior.

Source: manager magazin, Spiegel
What can be done to “train” directors and executives in good corporate governance

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Training</td>
<td>Formel and informal training either in-house or external to improve knowledge and skills regarding excellent execution of board or executives roles</td>
</tr>
<tr>
<td>Consulting</td>
<td>Seeking advice for special problems or general board tasks with specialized consulting firms</td>
</tr>
<tr>
<td>Evaluation</td>
<td>External or internal evaluation of board (or TMT) work to help to improve efficiency of board members</td>
</tr>
<tr>
<td>Structural changes</td>
<td>Establishing positions and structures that help providing excellent and efficient corporate governance</td>
</tr>
</tbody>
</table>
Training

Internal Training, with specialized consulting firms or universities

By University

Example:

- Corporate Governance and legal requirements in practice
- Obligations of the board: competences, role and function allocation
- Corporate monitoring systems and audit committees
- Specialisation modules (e.g. risk management)

By Consultancies

Example:

- Tasks and responsibilities of the board within the legal framework
- Monitoring of the internal control system
- Overview of functionality of Risk management systems
- Formation of committees

In-house

Example:

In-house training in compliance
- Training of all new employees regarding compliance standards and Audi principles of conduct
- Foundation of the „Compliance-Akademie“ planned in 2015

Consulting

Typical fields of corporate governance related consulting services by external consulting firms

Evaluation

“The Supervisory Board shall examine the efficiency of its activities on a regular basis” (5.6 GCGC)

<table>
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<tr>
<th>Self-evaluation</th>
<th>External evaluation</th>
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| - Usually **responsibility** of the **chairman of the board**  
- Standardized **questionnaire** adapted to company specific requirements and **individual interviews**  
- Comparison with own targets and previous results | - Usually done by **external consultants**  
- Responsible for **development of questionnaire**, conducting **individual interviews** and **final analysis**  
- Guarantee of **objective assessment** |

*Often regarded as „annoying“ exercise; Regular statement: "The board has reviewed the efficiency and discovered no need for improvement."*
Chief Compliance Officers

An increasing number of firms have established the position of the Chief Compliance Officer in their TMT as a reaction to intra- and extra-firm conditions.

CCOs’ duties comprise leading a firm’s compliance activities, ensuring that all employees adhere with applicable law and standards, supervising investigations, audits and related legal issues in the firm.
