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Boardroom 404

Latest news for supervisory boards

Issue 2, 2017

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Restrictions on co-determination permissible

German corporate co-determination compatible with EU law
Does not violate free movement of labour

The European Court of Justice (ECJ) ruled in mid-July 2017 that there is no requirement to amend the German law on corporate co-determination. The ruling was in response to a lawsuit brought by a small shareholder in a company headquartered in Germany.

The plaintiff argued that the German Co-Determination Act (Mitbestimmungsgesetz, or MitbestG) violated EU law. The Act states that shareholders and workers' representatives must each occupy half of the posts on a company's supervisory board. Workers' representatives may only be workers employed in Germany, which the plaintiff argued was incompatible with the blanket ban on discrimination based on citizenship. He further argued that the loss of membership of the supervisory board following relocation to another member state might prevent a workers' representative from exercising his right to freedom of movement of labour.

The ECJ took the view that Union law does not prevent member states from issuing regulations aimed solely at workers in domestic companies, where these have not yet been harmonized or coordinated at Union level. Since the Co-determination Act forms part of German company law and German collective employment law, its scope may be limited to workers in domestic companies.

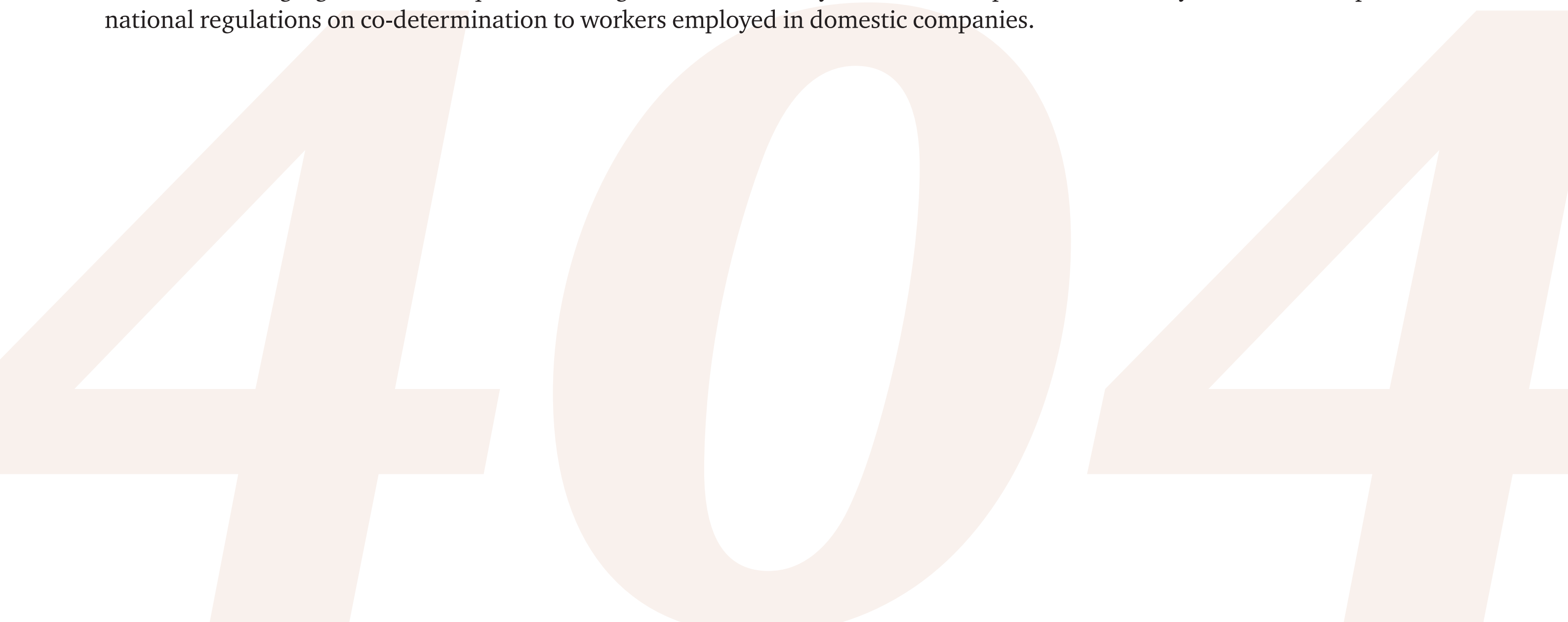
However this limitation must only be based on objective, non-discriminatory criteria. The blanket ban on discrimination based on citizenship is not relevant to workers in subsidiary companies headquartered in member states other than Germany, since it is only applicable to matters that are subject to Union law.

However the question to be tested was whether the foreign workers might face restrictions with respect to their freedom of movement. This would constitute a specific ban on discrimination based on terms and conditions of employment. However the ECJ ruled that the situation of the workers outside a member state is not subject to the freedom of movement of labour, since provisions relating to this situation are in fact entirely inapplicable for workers who have never exercised their freedom of movement and have no intention of doing so.

The plaintiff had further argued that workers employed in Germany who wish to take up a position in a subsidiary company in another member state were obliged to relinquish their position on the supervisory board in the parent company and would lose their active and passive voting rights in the elections of the workers' representatives. This might, in his view, inhibit workers from exercising their right to freedom of movement.

The ECJ took the view that neither the loss of active and passive voting rights in the elections of workers' representatives to the supervisory board nor the relinquishing of a position on the supervisory board constitute prevention of freedom of movement. Freedom of movement does not provide a guarantee that a move to another EU member state will be neutral in terms of social provision. Nor were workers entitled to expect to work in other member states under the same terms and conditions of employment as those in their own country of origin. In fact, there will quite simply be benefits and disadvantages for individual workers based on the differences in systems and legal provisions in the individual member states.

The loss of voting rights is a consequence of a legitimate decision by the Federal Republic of Germany to limit the scope of its national regulations on co-determination to workers employed in domestic companies.



Code update

Amendments to German Corporate Governance Code approved

Guiding principle of “reputable businessperson” adopted

The government commission responsible for the German Corporate Governance Code (Deutscher Corporate Governance Kodex, or DCGK) approved amendments to the Code in early February. These are designed to increase transparency and draw on international best practices.

The commission responsible for the Code issued proposed amendments for consultation at the end of 2016 (see *404 Issue 3, 2016*). The numerous responses to the consultation were published on the Internet for the first time. The commission concurred with many concerns but retained several of its own proposals.

Additions were made to the foreword at two points. By referring explicitly to the “guiding principle of the honourable businessman”, which was heavily criticised in some responses, the commission intends to emphasise that good corporate governance entails acting not simply by the letter of the law but also in an ethical and responsible manner. The decision was also taken to include the statement in the foreword, instead of at 2.1.3, that institutional investors are of particular importance for companies and they are expected to exercise their ownership rights actively and responsibly. This was the commission’s response to the criticism that otherwise a new class of regulation would appear in a sub-item in the Code without being directed at any specific corporate body.

There were also amendments to 4.1.3 relating to compliance. The commission recommends that a compliance management system that reflects the company’s risk situation be set up by the executive board. The establishment of a whistleblowing system is also explicitly recommended, to provide workers reporting on violations of the law within the company with adequate protection. It is suggested that this should also be extended to third parties. A further recommendation is that companies should publish the principal features of the entire compliance management system to allow the public to form its own view.

With respect to board members’ remuneration, a recommendation was added to the legal provision that variable remuneration should normally be assessed on a multi-year basis, stating that a substantial proportion should be forward-looking. Instead of a recommendation as originally planned, the commission picked up on the suggestion that components of multi-year, variable remuneration should not be disbursed early when a board member stepped down.

The most discussed proposal arising out of the consultation concerned communications between chairs of supervisory boards and investors (5.2). Instead of a detailed recommendation as planned, the Code will in future contain a brief suggestion that the chair of the supervisory board should be willing to discuss topics specific to the supervisory board with investors as far as reasonably practicable. The government commission believes that this reflects actual international practice which is already encountered in major German companies. With respect to concerns expressed about the legal admissibility of investor contacts by the supervisory board, the commission notes that part of the DCGK’s purpose is to indicate best practices that are not themselves part of statutory regulation.

The consultation proposals relating to the recommendations in 5.4.1 on the staffing of the supervisory board were essentially unaffected. As well as specifying concrete targets for its composition, the supervisory board should in future compile a profile of skills and expertise for the entire board and make every effort to ensure that this is taken into account when nominations are considered. Another new recommendation is that every nomination should be accompanied by a resumé with relevant knowledge, skills and experience, with the candidate’s key activities on the supervisory board post. The resumés of all supervisory board members should be published on the company website and updated annually.

In future, members classed as independent by the supervisory board should be named. The supervisory board should take into account the shareholder structure when setting the appropriate number of independent members (5.4.2). According to the commission this is intended to make it clear that free-float shareholders may also be considered for the supervisory board.

As planned, the commission responsible for the Code applied some non-material adjustments and excisions to enforce legislative amendments and make the Code easier to read. The amendments entered into force on April 24th 2017 when they were published in the Federal Gazette by the Federal Ministry of Justice and Consumer Protection. The new recommendations shall be taken into account in the future-oriented section of the Declarations of Conformity which follow publication.

Clear criteria

Appointments to management and supervisory posts
New ECB Guidelines

Is a potential appointee a "fit and proper person"? The ECB's remit includes assessment of the suitability of members of the management bodies of significant institutions. A new Guide explains the principles, practices and processes involved.

The European Central Bank (ECB) is responsible for taking decisions on the appointment of members of management bodies. In Germany this relates to positions on management and supervisory boards of the significant institutions that fall under the ECB's direct supervision. In May 2017 it published a Guide to fit and proper assessments. A similar guide has been in place for some time for institutions supervised by Germany's Federal Financial Supervisory Authority (BaFin).

The ECB paper explains in detail the principles, practices and processes it applies when assessing members of the management bodies of significant institutions. The Guide aims to harmonise the criteria applicable to fit and proper assessments and achieve common supervisory practices.

The ECB starts by citing its principles. These include its gatekeeper function by which individuals who would pose a risk are prevented from entering a management body or from exercising their management role. The ECB's fit and proper supervision also seeks to ensure a higher level of harmonisation in the assessments of management body members across the euro area, for which a high level of consistency and convergence is needed.

The ECB must also ensure criteria are commensurate with the size of the entity and the nature, scale and complexity of its activities. In all cases the assessment will come down to an individual analysis and supervisory judgement. The ECB's assessments should be part of its supervision of the governance of the institutions. The new Guide sets out five criteria used to assess the fitness and propriety of members of management bodies:

Practical and professional experience is required, as well as theoretical experience gained through education and training. All members of the management body, including in its supervisory function, are required to possess, as a minimum, basic theoretical banking experience and an understanding of the institution's activities and main risks. The level and nature of the experience required in the body's management function may differ from that required in its supervisory function, in particular if these functions are - as in Germany – performed by separate bodies. Not all members of the management body in its supervisory function are required to have practical experience in areas related to banking or financial services. However, for example, for Chairs of Audit Committees or Chairs of Risk Committees, specialised experience in the relevant area needs to be identified.

The second criterion is reputation. Since a person can either have a good or a bad reputation, the principle of proportionality does not apply here. Pending – as well as concluded – criminal or administrative proceedings may have a negative impact on the reputation of the appointee and the supervised entity.

The ECB provides very detailed explanations and requirements with respect to potential conflicts of interest and independence of mind. These largely reproduce recognised standards under company law. However the ECB makes it clear that it views handling of conflicts of interest as one of its highest priorities. If the conflict of interest poses a material risk, the company must take appropriate action as described in the Guide, including issuing a "Conflict of interest statement" to the competent authority.

On the subject of time commitment, the ECB makes it clear that in addition to the quantitative limits on the number of directorships, sufficient time should also be allowed for ongoing learning and development, as well as unexpected circumstances.

The fifth criterion is collective suitability. The company must identify gaps in the collective suitability through the self-assessment of its management body, for example based on a suitability matrix. In Germany this should be conducted at regular intervals as part of the assessment required under Article 25d para. 11 of the German Banking Act (KWG). Any gaps thus identified must be reported to the ECB and discussed with it.

The Guide also refers to interviews conducted to assess candidates. At stand-alone banks this applies in the case of new appointments to CEO and supervisory board chairman positions. If there are specific concerns regarding the fitness and propriety of other (potential) members, interviews may also be held with these persons.

The Guide shall be updated regularly. The ECB emphasises that it is not a legally binding document and does not substitute the relevant legal requirements stemming either from applicable EU law or applicable national law.

Increased transparency

Revised Shareholders Rights Directive published

Focus on greater shareholder involvement

The revised 2007/36/EC Directive opens up the prospect of an improvement in the exercise of co-determination rights and longer-term participation for shareholders in publicly listed companies. The role of the Annual General Meeting in board remuneration is to be enhanced in future.

Following a lengthy debate the revised Shareholder Rights Directive was passed by the EU Parliament last March and adopted by the Council of the EU. It was then published in the Official Journal of the EU in May.

The key changes in relation to supervisory boards are that the Annual General Meeting will have more rights with respect to board remuneration in future. In future, shareholders should be able to take a binding vote at the Annual General Meeting on remuneration policy, at least every four years or at every material change. This type of shareholder vote has previously been optional and non-binding in Germany (*say on pay*). However the member states remain free to continue to stipulate that the vote will only have an “advisory” effect.

The Directive also contains detailed provisions on the remuneration report. For the first time in Germany, this would include details of how board remuneration relates to company performance and the average remuneration on a full-time equivalent basis of employees in the company. This information should cover at least the five most recent financial years. In future shareholders will be able to vote annually on the remuneration report, although the vote will not be legally binding. For small and medium-sized companies an exemption clause was created to allow discussion rather than a vote at the Annual General Meeting.

The Directive contains clear and differentiated criteria for awarding components of variable remuneration. The remuneration policy should also contain information on any deferral periods and on the possibility for the company to reclaim variable remuneration. The remuneration policy shall also explain how the pay and employment conditions of employees of the company were taken into account when establishing the remuneration policy.

The revised Directive is intended to make it easier for companies to identify their shareholders, including those represented at the Annual General Meeting by proxies such as investment funds. This includes the possibility of communicating directly with shareholders and collaborating more easily with them. A concession was made to allow electronic vote transmission at Annual General Meetings.

Under the “comply or explain” principle, institutional investors and asset managers should in future either compile a strategy for shareholder engagement, or explain why they have chosen not to do so.

Proxy advisors will in future also be subject to greater accountability. They shall be required to comply with a code of conduct publicly and report on their application of that code. This also applies to proxy advisors from third countries if these provide services through an establishment in the EU.

In future, material related party transactions must be approved by the shareholders or supervisory board. Provided certain conditions are met, member states may define such transactions themselves. Member states may also decide at their own discretion whether an additional report should be published assessing whether or not the transaction is fair and reasonable. Material transactions must be announced at the latest at the time of the conclusion of the transaction. The announcement should contain all information necessary to assess whether or not the transaction is fair.

Member states have two years in which to implement the new requirements into national law.

Right misrepresented

Meaning of Business Judgement Rule clarified
Wide discretion for supervisory boards

The Munich Higher Regional Court (Oberlandesgericht, or OLG) has ruled that supervisory boards have wide discretion in the appointment of new board members. In addition, the Business Judgement Rule cannot simply be argued away. Faults relating to the way in which supervisory board meetings are convened can be remedied.

The case before the court related to the urgent appointment of a new board member by the supervisory board after the former member of the board (the son of the chair of the supervisory board) was found guilty of market manipulation. An outvoted member of the supervisory board had submitted a claim stating that the resolution adopting the appointment was void (*judgment dated January 1st 2017 – 23 U 3582/16*).

The plaintiff argued that the meeting of the supervisory board in question had not been properly convened and the agenda item had not been properly announced. The son of the chair of the supervisory board had issued the invitation to the meeting of the supervisory board on the chair's behalf. The court however found that faults relating to the convening of meetings did not invalidate such meetings if all supervisory board members attended and no-one opposed the resolutions. In the case all members of the supervisory board had attended and explicitly agreed to dispense with all formal requirements and deadlines arising from the articles of association or legislation.

The court also dismissed the plaintiff's argument that the supervisory board had not been provided with sufficient information about the candidate for the board and his qualifications. The plaintiff knew that the new board member was a lawyer. It had also been announced that the candidate was thoroughly familiar with governance issues. The plaintiff had not subsequently asked any additional questions or requested any details of previous posts or specific tasks she had performed. Although he had made it clear by voting "No" that he did not agree to the candidate's appointment, he had not reported any need for additional information before the vote was held.

Nor was the plaintiff's citing of the Business Judgement Rule helpful to his case. The supervisory board or management board are not liable in law in cases where company bodies can reasonably assume that the information before them forms a suitable basis for taking a managerial decision in the company's interests. The Munich OLG ruled that the plaintiff was mistaken in deriving the *argumentum e contrario*, ie, that taking a decision based on insufficient information necessarily entails a breach of duty, from the Business Judgement Rule. The rule merely provides members of the executive bodies *safe harbour* for managerial decisions. The purpose of the rule is to minimize rather than increase liability risks for members of supervisory and executive boards.

The plaintiff further argued that the new board member was not sufficiently qualified due to lack of experience. The court took a different view: the lawyer had a broad knowledge of civil law, commercial and company law as well as employment law. The defendant was also a small public limited company (*Aktiengesellschaft*) with a very limited business purpose, and the law did not specify any qualifications that a board member must have. In addition, the appointment of a new board member was urgently required following the conviction of the former board member.

The plaintiff also took the view that the new board member was acting as a "straw woman" for the son of the chair of the supervisory board. The plaintiff's allegation was not contained in the written submissions to the courts of first or second instance. The allegation was therefore not examined by the court. The judges noted generally that acting as "straw woman" might constitute grounds for revoking an appointment if this subsequently proved to be the case. However this did not affect the original resolution appointing the member.

Findings and news

DPR Activity Report
Proportion of errors stable

The audit of the year-end accounts and consolidated financial statements of German capital market oriented companies by the German Financial Reporting Enforcement Panel (Deutsche Prüfstelle für Rechnungslegung, or DPR) revealed an error rate of 16% for 2016. This is comparable with that of the past three years. Smaller non-indexed companies have a higher error rate compared with the previous year (25%) than indexed companies (5%). There have also been some changes to legislation and procedures.

In 2016 the DPR audited a total of 96 companies, with accounting errors identified in 15 cases. Once again, all of these can be traced to the scope of, and difficulties in applying, IFRS when recognizing complex transactions as well as inadequate reporting in the Notes and management report.

The errors relate to information on segment reporting and one company acquisition. Errors identified in the management report related to information on financial covenants and forecast and risk reporting.

Errors relating to recognition of complex transactions mainly involved financial instruments, company acquisitions and sales, goodwill and purchase price allocation. Those relating to financial instruments included errors in recognition requirements for one receivable and recognition of one liability arising from a call option within a business transaction.

In December 2016 the DPR published new principles for random selection of companies to be audited. This modified risk-based selection (step 1). A new risk factor, “Issues noted in previous enforcement audits” was added. This will now trigger a repeat of the procedure along with first listing or unusual transactions.

The size of the random sample in risk-based audits was increased to 40%, up from 30%.

The Act on the Implementation of the Directive Amending the Transparency Directive also led to three changes: Enforcement now only applies to issuers whose country of origin is the Federal Republic of Germany, examinations with cause or at the request (*Anlass und Verlangensprüfungen*) can also be initiated for the previous year and also include country-by-country reporting, including consolidated reports. The Audit Reform Act (Abschlussprüfungsreformgesetz, or AReG) means that the audit oversight body APAS (Abschlussprüferaufsichtsstelle) now also must inform the DPR of specific indications of errors identified in accounts during inspections.

Follow-up by the DPR showed that almost all companies, at least those listed in the regulated markets, corrected errors identified in the previous year in the next year-end accounts. Where warnings were issued these were also predominantly implemented. Ongoing preventative measures include annual meetings with representatives of the five largest auditing companies, workshops with board members and publication of focus areas for 2017.

One focus area will be a check on whether companies are complying with the Guidelines on Alternative Performance Measures. These form part of the management report and were developed by the European Securities and Markets Authority (ESMA). The distinction between equity and borrowing, as well as impairment of fixed assets also remain focus areas for 2017. Information in Notes on the impact of the future new accounting regulations on financial instruments, revenue recognition and leasing will also be considered. The fifth focus area is shares in other companies. This involves “atypical” cases in a group’s Consolidated Financial Statements, for example consolidation in the absence of a voting majority and changes in this respect.

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PwC Boardroom. The programme for supervisory board members.

The responsibility and the significance of regulatory bodies have increased significantly in recent years. This development has been accompanied by numerous regulatory changes and a sharp rise in the expectations of the general public. We have introduced PwC Boardroom to keep you up to date on current issues and offer you an exclusive platform for networking and exchanging ideas and perspectives. The programme is aimed at members of supervisory boards, boards of directors and advisory boards with a monitoring function.

Publications

- *The Chairmanship of the Supervisory Board – Guidelines on Value-Added Board Management* presents the central value drivers behind the work of the supervisory board from the chair's perspective.
- *Die Unternehmensüberwachung – Überblick und Praxistipps* gives you a concise look at the work to be carried out by the supervisory board (available in German).
- *Der Prüfungsausschuss – Best Practices einer effizienten Überwachung* is our standard reference on how to create an audit committee and ensure it functions correctly and efficiently (available in German).
- *404 – Latest news for supervisory boards* is published regularly and keeps you abreast of the latest developments in corporate governance, accounting standards and capital market regulation – short, concise and relevant.

Events

- Regular meetings for supervisory board members:
  Exclusive events give you the opportunity to learn about the latest developments and to network with other supervisory board members from companies like yours. At the same time, you can also expand your supervisory board network.
- Workshops and seminars:
  Whether you are interested in training on the fundamentals, updates on accounting standards, or seminars on new regulations concerning the supervisory board's work, we can provide the ideal customised solution, from exclusive one-to-one conversations to events for the entire board.

Imprint

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