

Regierungskommission Deutscher Corporate
Governance Kodex
c/o Deutsches Aktieninstitut e.V.
Senckenberganlage 28
60325 Frankfurt am Main
Germany

One Coleman Street
London
EC2R 5AA
Tel: +44 (0)20 3124 3000

Dear Dr Nonnenmacher and colleagues,

LGIM response to proposed amendments to the German Corporate Governance Code 2019

Legal & General Investment Management (LGIM) is one of Europe's largest asset managers and a major global investor with total assets of EUR 1.1 trillion¹. We manage assets for a wide range of global clients, including pension schemes, sovereign wealth funds, fund distributors and retail investors.

As long term investors with significant equity holdings in Germany, we are committed to good stewardship in the German market and seek to promote good corporate governance by taking an active approach to our engagement with investee companies. This is because we believe that well governed companies that manage all stakeholders are more likely to deliver sustainable long-term returns.

We appreciated meeting you in June and December 2018 for positive discussions. LGIM welcomes the opportunity to provide comments to the proposed amendments made to the German Corporate Governance Code. **We are supportive of the proposed amendments made by the Regierungskommission Deutscher Corporate Governance Kodex ('the Commission') and believe the proposed version of the Code will contribute to build solid foundations for corporate governance in Germany.** In particular, we welcome:

- The introduction of independence indicators applicable to shareholder representatives on the supervisory board;
- The limitation of supervisory board members' tenure from five to three years. **Going forward, LGIM will expect this rule to evolve to a one-year term period in alignment with best practice;**
- The rule on the number of additional mandates supervisory board members can undertake;
- The introduction of additional recommendations on remuneration.

As a significant investor who has regularly been engaging with German companies for many years, we have the responsibility to ensure that global markets operate efficiently and uphold the highest level of transparency to protect the integrity over the long-term. **LGIM believes the Code could benefit from further aligning with market best practice.**

¹ Source: LGIM internal data as at 30 June 2018. These figures include assets managed by LGIMA, an SEC Registered Investment Advisor. Data includes derivative positions.

We suggest the following additional improvements:

1. Clarify expectations on company explanations;
2. Strengthen board composition requirements, including the role of the Lead Independent Director;
3. Further align remuneration with best practice;
4. Facilitate better board – investor dialogue.

Our comments can be found in the Appendix that follows this letter. We look forward to hearing your response and please do not hesitate to contact us directly if you have any further questions.

Yours sincerely



Sacha Sadan
Director of Corporate Governance



Marion Plouhinec
Corporate Governance Analyst

APPENDIX:

LGIM response to proposed changes to the German Corporate Governance Code

1. Clarify expectations on company explanations

- 1.1. LGIM welcomes the introduction of “apply and explain” principles in the proposed Code. We believe the use of high level principles will help better ensure German companies follow fundamental corporate governance best practice rules and will contribute to the overall strengthening of their governance.
- 1.2. However, the effective application of these principles will also rely on the quality of the supporting explanation provided by companies. These explanations indeed help stakeholders such as investors get a better understanding of how the company has decided to apply the principles and get a better sense of their overall approach to governance.
- 1.3. Given that the Code has also traditionally used a “comply or explain” approach to its recommendations, their quality in the case where companies deviate from the Code is also paramount. Explanations under the “comply or explain” approach should help investors better understand the reasons why the company has chosen not to follow the Code and assess whether this is sufficiently justified. This ultimately contributes to help investors better manage governance risks.
- 1.4. LGIM values meaningful commentary and encourages companies to move away from boiler plate ‘generic description’ of risks. **We would therefore encourage the Commission to clearly set out its expectations regarding the quality of explanations to be provided by companies.** Similar to what is required under the UK Code, we would expect the explanation to set out the background, provide a clear rationale of the action taken by the company and explain the impact the action has had².
- 1.5. In addition, to promote best practice reporting, **the Commission could set up a separate committee or body to facilitate discussions on disclosures by companies.** In the UK, the Financial Reporting Lab (part of the Financial Reporting Council) undertakes this work by targeting key areas of reporting and bringing together market participants (companies and investors) together to debate best practice and expectations. Following the research, the Financial Reporting Lab produces guidance for the market. An example of recent work conducted by the Financial Reporting Lab was on performance metrics³.

2 Strengthen board composition requirements

2.1 Recommend that a Lead Independent Director (LID) be appointed on the supervisory board

- 2.1.1 We acknowledge that the Code requires a two-tier board structure and therefore the supervisory board operates separately from the management board.
- 2.1.2 LGIM has been engaging with companies, regulators and other stakeholders globally for many years. Based on these discussions, we believe the presence of a LID is indispensable on a well-run board as they play a key role in supporting the board chair and are also an independent counter-power.
- 2.1.3 Whilst the role of the LID has been introduced in many governance systems which allow the combination of the functions of board chair and Chief Executive Officer, we think that a LID

² <https://www.frc.org.uk/document-library/corporate-governance/2018/uk-corporate-governance-code-2018>, page 2

³ The report can be found here: <https://www.frc.org.uk/getattachment/cd978ef7-72ad-4785-81ee-e08bb7b7f152/LAB-Performance-metrics-FINAL.pdf>

does not replace a board chair. A LID's presence on the board is vital to ensure there is an independent counter-balance to the chair.

- 2.1.4 In the case of Germany, we note that supervisory boards often include the presence of a deputy chair who is an employee representative. LGIM believes the roles of the deputy chair and the LID are different and designed to be complementary.
- 2.1.5 The role of the LID is not to lead the supervisory board but to support the supervisory board chair. They have a complementary set of skills and experience to the supervisory board chair's own. We find the LID can help contribute to the good relationships and functioning of the supervisory board. They serve as a sounding board and therefore have the ability to exercise independent judgment. Key responsibilities include leading the performance evaluation of the supervisory board chair and leading the search for a new supervisory board chair.
- 2.1.6 The LID should be an alternative communication channel for supervisory board members and this can be especially useful when they have concerns which they believe have not been properly considered by the supervisory board chair or supervisory board as a whole.
- 2.1.7 They can also be an important point of contact for investors to raise issues and concerns in normal times or where contact through the channels of board chair or management board has failed to resolve or where such contact is inappropriate.
- 2.1.8 **LGIM would like to see the German Code recommend the appointment of a LID on the supervisory board, and also set out key guidelines and expectations as to what this role entails.** We recently published a thought piece on the role of the LID⁴ which provides more information on what we believe is the benefit of having such a role on a board (one-tier and two-tier) and our expectations on the role.

2.2 Strengthen the criteria of supervisory board director independence (recommendation B.8)

- 2.2.1 LGIM welcomes the introduction of criteria to define what an independent shareholder representative is. An independent board is essential to ensure the board exercises efficient oversight and consistently acts in the best interests of the company and its stakeholders. We would like to suggest the following amendments which should strengthen the definition.

Appointment of management board members to the position of supervisory board chair

- 2.2.2 We acknowledge it is common practice in Germany to appoint a former member of the management board to the position of chair of the supervisory board after a so-called two year "cooling-off" period. Whilst we can understand companies may see benefits in choosing a former management board member, we find there is an inherent conflict. We therefore generally discourage companies to do so. This is important as the skillset and role expected from a supervisory board chair is different from that expected from a management board chair.
- 2.2.3 We note the required cooling-off period of two years is prescribed by German law. However, investors need assurance that the former management board member has stepped away from management for a sufficient amount of time. **Therefore, we would like to see the Code go beyond what is required by the law, and recommend a best practice cooling-off period of at least five years.**

⁴ <http://www.lgim.com/files/document-library/capabilities/the-role-of-the-lead-independent-director.pdf>

Award of other material variable remuneration to supervisory board members

- 2.2.4 We find that the use of the wording “other material” potentially confusing as this is subject to individual company interpretation. As explained further below in our response, LGIM considers that only fixed fees should be paid to supervisory board members. We believe the award of any other form of remuneration including variable remuneration is likely to impair the independence of their judgment and should therefore be discouraged.

Material business relationships

- 2.2.5 We note the Code’s criterion where the individual supervisory board members are not considered independent if they are maintaining or have maintained business relationships with the company or one of the entities dependent upon the company in the year before their appointment. **We believe a one year period is not sufficient and would encourage the Commission to extend this period to three years.** This is generally considered best practice globally.

Controlling shareholder

- 2.2.6 We note the criterion that a supervisory board member who is a controlling shareholder cannot be considered independent. However, LGIM believes the threshold set by the Code is too high. We believe that a non-controlling but significant personal shareholding in a company can also impair a supervisory board member’s independence. We expect supervisory board members to act in the best interests of the company and its stakeholders. **We would therefore encourage the Commission to consider introducing a stricter threshold.** The Code considers a shareholder who holds more than 10% of voting shares in a company to have a material interest. However, this could be considered a high threshold especially in large cap companies. **LGIM would consider a shareholding of 1% to constitute a significant shareholding which can potentially impair the independence of supervisory board members.**

2.3 Board committees

- 2.3.1 We support recommendation A.6 that the chair of the audit committee should be independent. LGIM believes that the role of the audit committee is one of the most important functions of the supervisory board. As highlighted in our response to the 2017 Code consultation, whilst it is essential that the audit committee chair is independent from management, we also think they must be independent from the audit firm being appointed. This is especially important to ensure that a fair and effective process is undertaken when supervising the auditor as stated in the Code. We would also expect recommendation A.6 to be strengthened and explicitly recommend that the chair of the audit committee shall be a financial expert with relevant accounting experience.
- 2.3.2 Board committees are responsible for key board functions. We therefore believe it is essential to ensure they exercise independent judgment in oversight and decisions related to essential board responsibilities. **We would expect the recommendation to go further going forward and recommend that all shareholder representatives sitting on board committees are independent.** We believe this would provide further assurance to investors that stakeholders’ interests are looked after.

2.4 Recommend disclosures on the self-assessment of the supervisory board (recommendation A.15)

- 2.4.1 LGIM welcomes the introduction of a recommendation that supervisory boards should undertake an external evaluation every three years. We also note the extension of the recommendation on the self-assessment exercise to board committees. **LGIM would like to see the Code require companies to disclose the outcome of the self-assessment exercise undertaken, without having to disclose confidential or commercially sensitive information.** We see this increased transparency in other European markets. This is important so that stakeholders get, from the outside, a better insight into the functioning of the board, the key areas of priority to address, and the steps taken by the board to address these issues. In the past, LGIM has published a thought piece on the topic⁵.

3 Further align remuneration with best practice

- 3.1 LGIM welcomes the introduction of additional remuneration rules which will provide guidance to companies on the topic. However, we believe the recommendations could further align with best practice. We provide below a highlight of the essential points we would like the Commission to address.

Remuneration committee

- 3.2 LGIM notes the absence of a recommendation that a separate remuneration committee should be put in place. The remuneration committee plays an essential role on the board in terms of setting and operating the company's remuneration strategy for executive directors and generally also senior executives. We think its importance on the board of German companies is likely to be reinforced with the introduction of mandatory say on pay by the Code. Given its important role and the time commitment it requires, we believe it should be separate from other board committees.
- 3.3 **Therefore, we would encourage the Commission to recognise the essential role played by a separate remuneration committee on the board and consider introducing such a recommendation.** We would also expect all shareholder representatives who are members of this committee to be independent.

Say on pay resolutions (Principle 23)

- 3.4 We note the approach taken by the Commission to introduce a mandatory annual advisory vote on the remuneration policy and remuneration report of the management board. Whilst we find an annual advisory vote on the remuneration policy helps ensure shareholders are given the ability to hold companies to account on executive pay, **we would encourage the Commission to require a less frequent voting cycle (e.g. every three years) for the mandatory vote on the remuneration policy.**
- 3.5 The second Shareholder Rights Directive⁶ requires a vote on the remuneration policy at least every four years. We believe that requiring the vote on the pay policy to be subject to annual voting would run counter with a policy of asking companies to focus on the long-term. By setting a longer voting cycle, companies would have to commit to a longer approach on pay. For instance, in the UK, there is an advisory annual vote on the remuneration report and a binding vote every three years on the remuneration policy. This binding vote was introduced in 2013 and whilst it is still early to make a full assessment of its benefits, we find this

⁵ <http://www.lgim.com/files/document-library/capabilities/board-effectiveness-reviews-jan-16.pdf>

⁶ Directive (EU) 2017/828 of 17 May 2017 amending Directive 2007/36/EC, Article 9a: "Member States shall ensure that companies submit the remuneration policy to a vote by the general meeting at every material change and in any case at least every four years."

encourages companies to adopt a longer term approach to pay as they are committed to apply the policy for a longer period of time.

Remuneration cap (recommendation D.2)

- 3.6 We entrust the board and remuneration committee to ensure that executive pay is set at an appropriate level to drive positive corporate behaviour and performance. In doing so, they should consider the wider impact of executive pay, for instance upon the general workforce, public perception, the economic climate, and government bodies. They should also take into account the sector and the size of the company.
- 3.7 We note recommendation D.2 which sets out that the amount of remuneration shall be capped by annual maximum expense levels in aggregate and as regards variable remuneration components. We find this method does not help investors appropriately assess the quantum of the various pay elements composing executive directors' pay schemes.
- 3.8 **LGIM would like to see a recommendation to disclose a cap for variable remuneration and certain fixed elements of remuneration such as pension and benefits. This cap should be disclosed for each individual management board member and calculated as a percentage of fixed pay or a number of shares.**

Variable remuneration (recommendation D.9)

- 3.9 LGIM believes that a company should motivate and reward executive performance by granting long-term incentives to align their interests with those of long-term investors. We have been engaging with companies globally for many years on this topic and continue to encourage the simplification and transparency of executive pay schemes, and their alignment with long-term company performance.
- 3.10 We understand the Commission's approach to long-term variable remuneration, aimed at implementing strategic initiatives. LGIM believes this recommendation would benefit from added clarity. **We would like to see the Code recommend that metrics set under long-term variable remuneration are assessed on a period of three years as a minimum.**
- 3.11 In order for investors to assess the appropriateness of the variable remuneration arrangements, we would also expect the Code to encourage the disclosure of performance targets so that stakeholders can effectively assess whether remuneration is challenging management and incentivising outperformance. Where targets are commercially sensitive to the business, LGIM expects these to be disclosed retrospectively, within a year after payment. If this is not possible, an explanation of why the target continues to be commercially sensitive is expected.

Award of performance-related remuneration to supervisory board members (recommendation D.20)

- 3.12 We find that the award of performance-related remuneration to supervisory board members is not an appropriate incentive. We believe it can potentially impair judgment and affect behaviours by encouraging focus on shorter-term performance.
- 3.13 We expect supervisory board members to exercise independent oversight to monitor and challenge the actions of management and help drive the long-term vision for the company. Their independence is essential for the supervisory board to be efficient in its missions.
- 3.14 **LGIM discourages the grant of remuneration other than fixed fees to supervisory board members as we find this can impair the independence of their judgment.** Fixed fees can be delivered in cash or shares; however they should not be linked to a performance element.

- 3.15 Please note that we have recently strengthened our global voting policy and will from 2019 systematically oppose any performance-related remuneration award made to non-executive directors (supervisory board members).

4 Facilitate better board-investor dialogue (recommendation A.2)

- 4.1 LGIM considers a core feature of good governance and long term stewardship is the supervisory board's ability to engage with shareholders. As an investor assessing companies from the outside looking inwards, understanding the perception of directors is very important to better comprehend the company's performance and long-term strategy.
- 4.2 Whilst we support recommendation A.2 on the availability of the supervisory board chair to discuss supervisory board-related issues with investors, we believe this recommendation could be strengthened.**
- 4.3 We have observed an increase in access to the board of German companies, however we find that supervisory board chairs generally remain cautious in their dialogue with investors. Therefore, we would encourage the Commission to encourage further dialogue between supervisory board members and investors. **We would recommend that appropriate guidelines are put in place to increase direct meetings between board directors and investors and enhance long term stewardship.** LGIM has published a thought piece on board-investor dialogue⁷ which provides more information on what good engagement looks like.
- 4.4 In addition, the supervisory board chair should not be the only point of contact for investors. **We indeed would like to see a recommendation that the chairs of the board committees are available to discuss supervisory board-related matters with investors.** This can be especially useful when investors have concerns which they believe have not been properly considered by the chair of the supervisory board or supervisory board as a whole. We would also like to reemphasise the importance of the role played by the LID, who, as mentioned above, is an important point of contact with principal investors.

⁷ <http://www.lgim.com/files/document-library/capabilities/lgim-guide-to-board-investor-dialogue.pdf>