Hermes Equity Ownership Services

Hermes Corporate Governance Principles
Germany

General Endorsement of German Corporate Governance Code

We generally endorse the recommendations of the German Corporate Governance Code ('the Code') in its version of May 2010 and encourage companies to comply with the Code. Any cases of non-compliance with either recommendations or suggestions should be explained in full. However, the Code does not cover all issues that we regard as important. In our German Regional Principles we therefore cover additional issues, emphasise certain points or set out our preferred approach where required. The following guidance is intended to assist German companies and their boards in understanding our views on these issues.

Shareholder Participation in Corporate Decision-Making

We encourage German companies to involve shareholders through an appropriate forum in decisions concerning fundamental corporate changes, such as major acquisitions, dispositions or takeovers - even in situations where this is not required by German law or encouraged by the Code. Companies should also ensure adequate shareholder involvement in key corporate governance decisions, such as the nomination of candidates for election to the supervisory board, and provide shareholders with the opportunity to express their views on the company's remuneration policy under the law concerning the appropriateness of management board remuneration.

Supervisory Board

Election/Re-Election of Members of the Supervisory Board

The election and re-election of supervisory board members is the principal mechanism for shareholders to appoint their proxies and hold them to account. To ensure individual accountability, it is international best practice that members of the supervisory board are (re-)elected individually. The Code recommendation that elections to the supervisory board shall be made on an individual basis (5.4.3.) should therefore be followed without exception.

We believe that the election/re-election of members of the supervisory board should normally occur on the same date and for the same length of tenure. However, we note that occasionally there may be good reasons for (re-)election on different dates and for different periods, and these should be disclosed to shareholders. Going forward, we would welcome a recommendation in the Code to the effect that appointments of supervisory board members should not normally be for periods of more than three years. However, we recognise that occasionally there may be good reasons for longer appointment periods and will consider this issue pragmatically. As such, if it is intended to make appointments for longer periods, companies should explain the reasons for doing so well in advance of the shareholder meeting.

Consequences of a Substantial Vote against Discharge

We believe that there should be practical consequences in cases where shareholders do not strongly support the discharge of a supervisory board member. If a member of the supervisory board has lost the confidence of a significant percentage of shareholders, he or she should at least not be chairman or vice-chairman of the supervisory board or be a member of any of its committees. A supervisory board member who was not convincingly discharged during his or her tenure should generally not be proposed to shareholders for re-election.

Removal of Members of the Supervisory Board

The right to remove the shareholder-elected members of the supervisory board, though rarely used and rightly regarded as a last resort, acts as an important reminder to them that they are ultimately accountable to the shareholders. However, to be effective, the possibility of being removed must be realistic. As such, it should be possible for a simple majority of shareholders represented at a shareholder meeting to remove members of the supervisory board. Requiring a qualified majority for the removal of members of the supervisory board, as § 103 I of the German Stock Corporation Act does, may insulate the members of the supervisory board from the shareholders and thus render them less accountable. For this reason, we encourage German companies to provide in their articles of association for the removal of members of the supervisory board at a shareholder meeting by a simple majority of shareholders. Going forward, this practice could be recommended or at least suggested in the German Corporate Governance Code.

Chairman of the Supervisory Board – Cooling-off period

It used to be widespread practice in Germany that the chairman of the management board became chairman of the supervisory board after retiring from day-to-day management. There may, of course, be good arguments for appointing a successful former chairman of the management board to the supervisory board, not least that he or she will have an in-depth knowledge of the company. However, we note that the roles of chairman of the supervisory board and chairman of the management board, as well as the competencies, knowledge and experience required for them, are very different. As such, in addition to significant conflicts of interest that may arise, the two roles simply require very different personalities and mindsets. We have therefore believed for a long time that as a general rule the chairman of the management board should not become supervisory board chairman (for similar reasons he should also not become a member of the audit committee). This way conflicts of interest are prevented which may otherwise arise where a chairman of the supervisory board has to lead a review of decisions taken during, or issues that fall into, his or her tenure on the management board. Instead a successful former chairman of the management board could be proposed for election as an ordinary member of the supervisory board.

We do not believe that the recent introduction of a general, legally binding waiting period of two years for moving from the management to the supervisory board is helpful. Indeed, we would think that the mandatory waiting period will lead to valuable experience and relevant knowledge being

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lost from the supervisory board and thus its efficiency being weakened rather than strengthened. The financial crisis has shown that company specific knowledge and sector experience are of high importance for the overall efficiency of supervisory boards. In appropriate cases, we are therefore willing to support shareholder proposals for the election of suitable and successful executives to the supervisory board. This ought to be the exception and be fully explained to shareholders well ahead of the shareholder meeting at which approval is sought.

Composition of Committees
We welcome the Code's recommendations on supervisory board committees (5.3.1- 5.3.5). We believe that companies should generally establish three key committees: audit, nomination and remuneration and that these should consist of at least three members. We welcome the recently introduced recommendation that the chair of the audit committee should be independent and not a former member of the management board (5.3.2). Given the potential for conflicts of interest, we believe that as a general rule all members of the audit committee should be demonstrably independent directors with the necessary competencies, knowledge and experience. We also believe that the audit committee should not be chaired by a representative of a major shareholder.

Nomination Committees
We welcome the German Corporate Governance Code's recommendation regarding nomination committees (5.3.3). We believe that nomination committees should consist of a majority of independent members and should not be chaired by a representative of a major shareholder. We strongly encourage German companies to involve shareholders through appropriate mechanisms in key corporate governance decisions, such as the nomination of candidates for election to the supervisory board. Whilst we recognise that there are legal limits to this, there are a number of mechanisms, such as a consultation of shareholders with regards to the criteria that should be taken into consideration when assessing the composition of the supervisory board, which would seem to be compatible with the relevant German law.

Corporate Governance Committees
Companies which set up "Corporate Governance" or "Shareholder Relations" Committees to monitor business relations and transactions between them and companies controlled or associated with their major shareholders should ensure that the nature of such committees is reflected in their composition, terms of reference and reporting. Such committees are meant to be a corporate governance safeguard mechanism - principally for outside shareholders. They should thus be composed of demonstrably independent members, and also have terms of reference that ensure that business relations and transactions with all relevant entities related to major shareholders are monitored and reported in a meaningful way to outside shareholders. This should be done on an annual basis thereby giving outside shareholders an assurance that they have not been unduly disadvantaged through the influence of the major shareholders.

Employee Representation
It is of fundamental importance that the supervisory board is made up of members with an appropriate and diverse range of competencies, knowledge and experience to enable it to discharge its duties and responsibilities effectively. Employee representation at supervisory board level, a requirement under German legislation for most large listed companies, may compromise the principle that supervisory board members should generally be chosen on the basis of their ability to carry out their responsibilities and functions in a way that ensures the creation of long-term shareholder value. In our experience, a sufficient number of truly independent board members with relevant competencies, knowledge and experience are necessary to carry out this duty effectively. Supervisory board members should be accountable to the shareholders as a whole and not act for or be accountable to any specific interest group.

Employee representation at supervisory board level is also the main reason why supervisory boards tend to be very large. This may reduce efficiency and make it more difficult to ensure confidentiality. Finally, we note that the German system of co-determination provides only German employees with representation at board level and reserves a number of board seats for trade union officials. In our view both practices are difficult to justify. We understand that a number of the German companies that have converted their legal status to Societas Europaea (SE) in recent years have chosen to do so at least partly to address concerns related to the German system of co-determination. In the absence of sufficient political willingness to address the issues, we encourage companies to consider whether they could benefit from conversion to the SE legal form which would allow them to deal with a number of these concerns.

Management Board

Appointment Periods and Severance Payments
We generally favour contract periods for members of the management board of significantly less than the customary, legal maximum of five years. Five-year periods not only reduce the accountability of management board members but may also lead to significant liabilities for the company, if the appointment needs to be terminated before expiry of the contract. In this regard, we support the recommendation for a severance payment cap of the lower of the value of the remaining term of the contract or two years' compensation in respect of premature termination of contracts with management board members (4.2.3). We also welcome the severance payment cap that is recommended with regard to premature termination of contracts in change of control situations, though it seems to leave scope for generous payoffs. We find it difficult to support initial appointments to the management board for periods exceeding three years since they may prove very costly when they need to be terminated before expiry. The relevant suggestion of the Code, which states that for initial appointments the maximum period of five years should not be the rule (5.1.2.), does not adequately address this issue.

Remuneration

Supervisory Board: Performance Related Pay
We note that the German Corporate Governance Code recommends that members of the supervisory board receive fixed as well as performance-related compensation (5.4.7). Participation of supervisory board members in performance-related pay or incentive plans may align their financial interest too closely with those of management board members and senior executives rather than those of shareholders. However, we recognise that there are arguments in favour of medium to long-term performance related remuneration elements for supervisory board members. Such schemes should be designed to align the longer-term interests of supervisory board members with those of shareholders and should not compromise the monitoring and moderating functions of the supervisory board. Given the particular conflicts of interests that may arise, performance related remuneration should in no case be granted for the membership in audit, compliance and risk committees.

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We therefore encourage companies to explain fully the design of performance related remuneration plans for supervisory board members, in particular how it is ensured that these plans do not create conflicts of interest. To encourage a significant investment by supervisory board members in shares and thus to ensure a clear alignment of their interests with those of shareholders, variable remuneration should at least partly be paid in shares which would be held for at least four years.

Management Board: Remuneration Policy

Remuneration packages should be sufficient to attract, retain and motivate executives of a calibre required to run the company successfully over the long term. At the same time, remuneration should be structured in a way that provides senior executives with adequate incentives to maximise the company's value in the long term. The objective of any remuneration scheme should thus be to align the interests of executives with those of shareholders by linking a substantial part of their variable compensation to the company's performance over at least three years and to the underlying returns earned by shareholders over such period. To ensure such an alignment, performance metrics should also include market or sector relative measures. "Bonus-malus" systems with regard to longer-term, variable remuneration can help in aligning effectively the interests of executives with those of shareholders.

Flawed remuneration policies may encourage executives to take excessive risks in order to generate short-term profits and fail to align their interests with those of shareholders in the longer term. For companies in the financial sector in particular, we will therefore look for evidence that variable incentive structures reward sustainable profits and incorporate appropriate risk metrics and measure of the cost of capital involved in any deal-related activities.

Remuneration policies should be disclosed annually so that shareholders can assess whether the interests of senior management have been aligned with their own. Furthermore we encourage companies to prepare and publish detailed remuneration reports. Such reports provide a chance to articulate policies with regard to remuneration and explain how they support strategic objectives. As such, they can provide a useful basis for constructive dialogue between companies and shareholders.

Advisory Vote on Remuneration Policy

We have promoted advisory votes on remuneration policies in our German Corporate Governance Principles for some time. We therefore welcome the legal framework introduced by the law concerning the appropriateness of management board remuneration which facilitates such advisory votes. From our experience in other markets, regular constructive dialogue between the board and investors on remuneration and its role in long-term value creation is of great importance. An advisory vote can be an important part of this dialogue. It also provides shareholders with an opportunity to formally express their opinion regarding the design and implementation of a remuneration policy. We therefore encouraged German companies to enable shareholders to vote on their remuneration policies in 2010 and continue to encourage companies to provide shareholders with the opportunity to vote on their remuneration policy if they have not yet done so, if there have been significant changes to the remuneration policy or if there was a significant number of votes against the policy in the previous year.

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