

Attn.

**Herrn Ministerialrat
Professor Dr. Ulrich Seibert**
Bundesministerium der Justiz und für Verbraucherschutz
Mohrenstraße 37
10117 Berlin
Germany

Via email: Seibert-UI@bmjv.bund.de

30 November 2018

Statement on the draft Act on the Transposition of the amended Shareholder Rights Directive (EU) 2017/828

Dear Professor Seibert,

We welcome the opportunity to provide our comments on the consultation regarding the draft bill of the implementation of the amended Shareholder Rights Directive (“Referentenentwurf eines Gesetzes zur Umsetzung der zweiten Aktionärsrechterichtlinie”, ARUG II, the “Directive”) in Germany.

Hermes EOS is one of the world’s leading stewardship specialists, advising on over \$450 billion on behalf of over 40 international institutional investors. Its purpose is to assist institutional investors¹ and asset managers in protecting and creating long-term value in their investments and managing their risks, by engaging with companies and policy-makers on environmental, social, governance, strategic and financial issues. As part of our public policy work, we respond to consultations on behalf of our clients. However, the views expressed in this communication do not necessarily represent the views of all clients. We acknowledge the distinct features of the German corporate governance system, in particular the dual board structure and codetermination.

We see the Directive as a significant opportunity to deliver positive outcomes for various stakeholders, but only if due regard is paid to its spirit and purpose, technical obstacles are overcome, and sufficient safeguards are put in place to ensure the desired actions and outcomes are achieved. We are supportive of the provisions in the draft bill, but in this response present two additional provisions for the Ministry’s consideration that we believe are needed to help make the Directive work best for Germany:

- 1. Reporting requirements on engagement implementation for institutional investors and asset managers**
- 2. Binding vote on remuneration policy**

Reporting requirements on engagement implementation for institutional investors and asset managers

We welcome the Ministry’s suggested amendments of the Stock Corporation Act (AktG) with regard to the new transparency obligations for institutional investors and asset managers, in particular regarding engagement policies. We believe engagement and stewardship, when done effectively, is the strongest

¹ In this letter we use the term ‘institutional investor’ as it is used in the Directive: i.e. referring to asset owners such as pension funds and insurance companies and not including asset managers.

tool under the amended Directive for achieving its ultimate aim of improving the long-term financial and non-financial performance of companies.

We believe that raising the standard of engagement to achieve impactful, purposeful, and effective stewardship delivers benefits for investors, their ultimate beneficiaries, the companies themselves and other stakeholder groups, plus society and the environment as a whole. The benefits of effective stewardship are supported by independent research².

To help to ensure engagement is effective, the bill must pay due regard to the spirit and purpose of the Directive and emphasise how stewardship is conducted in practice – i.e. the requirements on reporting on the implementation of stewardship activities rather than the policy itself. This is significant, as disclosure requirements under existing stewardship codes typically focus on the latter, which has resulted in stewardship activity of limited quality and effectiveness.

To drive effective engagement, institutional investors and asset managers should report explicitly on how they fulfil their stewardship responsibilities, including the type of company interaction undertaken, the seniority of investor staff involved and the company representatives engaged, the specific issues covered, whether and how there has been collaboration with other investors and stakeholders, and, under certain circumstances, how an engagement has been escalated. We believe investors should report on how stewardship activities help their organisation and specific funds to deliver on their purpose and contribute to the long-term sustainability of the assets under stewardship.

Transparency is required to ensure both action and accountability. By focusing on the implementation of policy, reporting under the law is more likely to drive positive behavioural change, awareness and insight along the investment chain and among key stakeholder groups including government. This will drive continuous improvement in stewardship practice.

Hermes EOS has supported the introduction of stewardship codes and their effective implementation for almost a decade. From our experience, regular public reporting, or at least reporting to clients/beneficiaries, on engagement should generally include the following information:

Investee companies:

- Voting behaviour at all shareholder meetings:
 - votes in favour of, against and abstaining on the management recommendation;
 - votes against management by issue;
 - support for shareholder resolutions;
 - rationale for the most significant vote decisions;
 - engagement around the votes; and
 - differences with the recommendation of the chosen proxy research provider, if any;

With regard to companies engaged:

- The process for selection of companies for engagement;
- the number of companies engaged;
- seniority of company representatives typically engaged (e.g. investor relations, subject specialists, CEO/CFO, other management board member and supervisory board);
- issues addressed through engagement;
- progress made against predefined engagement objectives; and
- resource that is dedicated to engagement (and, if separate, its interaction with fund managers).

On the most significant engagements:

- Objectives of the engagements that are most material to the company or industry in which it operates and according to the geography;
- interaction type (e.g. meeting/call/statement at annual general meeting), seniority levels engaged and issues addressed;

² See, for example, Hoepner A., Oikonomou I., Sautner, Z., Starks, L.T., and X. Zhou (2018): ESG Shareholder Engagement and Downside Risk. Working Paper; Dimson, E., Karakas, O., and X. Li (2015): Active Ownership. Review of Financial Studies, 28(12), 3225-3268; Barko, T., Cremers, M., and L. Renneboog (2017): Activism on Corporate Social Responsibility. ECGI Working Paper No 509/2017; Principles for Responsible Investment (2018): ESG Engagement for Fixed Income Investors – Managing Risks, Enhancing Returns; Principles for Responsible Investment (2018): How ESG Engagement Creates Value For Investors and Companies

- engagement and collaboration with other investors and stakeholders;
- under certain circumstances, how the engagement has been escalated;
- the outcomes and progress against objectives; and
- monitoring of the company and its response.

Therefore, **Hermes EOS provides qualified support for the Ministry's proposal on the transparency obligations for institutional investors and asset managers regarding their engagement policies. This is subject to the bill or other appropriate guidance focusing on the actual practical implementation of the policies.**

We believe a stewardship code would be an effective supporting mechanism to deliver the full potential and objectives of the bill, by defining, on a comply-and-explain basis, key principles of reporting and transparency. A stewardship code is a flexible mechanism that can be adjusted, tightened or broadened over time, outside the formal legislative process, as best needed to make the Directive work for Germany.

From our experience, in addition to national authorities and supervisory bodies, support from local institutional investors, particularly the larger players in the market, will be vital in making stewardship regulation work. They will need to become early adopters, invest resources and challenge fund managers - thus providing market pressure - and deliver market-leading disclosure. Also, support from international investors will further drive the objectives and change sought by the Directive. There is however no established market pressure for institutional investors, underscoring the need for clarity on disclosure requirements.

We think a significant implementation risk remains in the absence of more detailed requirements or guidance, in particular a lack of enforcement and effective consequences for poor disclosure, poor compliance or poor explanations of non-compliance, which are vital if 'comply or explain' approaches are to change behaviour. Market pressure may not be not enough and international experience suggests that any code should be owned by a regulator with the powers and mechanisms to ensure appropriate implementation.

For further information on our thinking around the importance of the Directive and its implementation, please see our [viewpoint paper](#).

Binding vote on remuneration policy

The remuneration of management board members of German listed companies has been a contentious issue for some time. We believe that the complexity and lack of transparency of management board remuneration systems have made them difficult to understand and analyse, and benchmark against performance. Some of the flaws include the lack of clear alignment of payment with company performance; payments being made despite serious misconduct or missed targets; and inappropriate termination payments. In our view, enhanced say-on-pay rights for investors in the related sections of the Stock Corporation Act (AktG) will help tackle and address some of these issues.

We have been at the forefront of engaging with companies on their executive remuneration practices in major markets for more than a decade. As part of our stewardship activities, we have also developed specific "remuneration principles", which outline our expectations as to what sustainable, transparent, and simple remuneration systems for management boards should look like.³

More recently, in Germany we worked with other major stakeholders such as remuneration consultants, German institutional investors, DAX corporations, and other corporate governance experts to devise simple, sustainability-focused, best practice guidelines for management board remuneration at German listed companies. The resulting guiding principles across structure, reporting, and engagement outline best practice executive remuneration, including dialogue with investors.⁴

Enhanced shareholder rights regarding executive remuneration will only be a partial solution to some of the aforementioned flaws of executive remuneration systems. We think a more focused discussion on the structure, complexity, and opacity of executive remuneration systems would be beneficial. As such, a

³ The original remuneration principles jointly developed with other investors can be found here: <https://www.hermes-investment.com/wp-content/uploads/2017/09/Remuneration-Principles.pdf> Subsequently, we provided further explanation to our principles, published here: <https://www.hermes-investment.com/wp-content/uploads/2017/09/Remuneration-Principles-Clarifying-Expectations.pdf>

⁴ More on information on the working group as well as the resulting remuneration guidelines can be found here: <http://www.guidelines-executivecompensation.de>

stewardship code or revised Corporate Governance Code could make specific suggestions as to what sustainable, transparent, and simple remuneration systems should look like.

That said, **we urge the Ministry to consider proposing a *binding* rather than an advisory shareholder vote on a company's remuneration policy at least every *three* years, alongside a yearly advisory vote on the remuneration report.**

Even in the case of a binding shareholder vote on the remuneration policy, the ultimate and primary responsibility to design an appropriate remuneration system will remain with the supervisory board. Its members have the duty to present an appropriate and long-term oriented remuneration system to shareholders at the annual shareholder meeting.

We hope that our comments and suggestions are of assistance. If you would like to discuss our views in further detail, please do not hesitate to contact Andy Jones (andy.jones@hermes-investment.com, tel. +44 (0)20 7680 2248).

Yours sincerely,

Dr Hans-Christoph Hirt, Dr Michael Viehs and Andy Jones
Hermes EOS