Amendments to the German Stock Corporation Act

Draft law implementing the second Shareholder Rights Directive

By Simon M. Weiss

Introduction

In mid-October of this year, the Federal Ministry of Justice (*das Bundesjustizministerium- BMJV*) presented the long-awaited draft (*RefE*) of a law implementing the amending directive on shareholder rights (SRD II). The goal of the SRD II is to promote the exchange of information between listed companies and their shareholders and to improve opportunities for shareholders to participate in this exchange. Specifically, the 2nd ARRL concerns the following matters now addressed by the *RefE*: (a) the identification of shareholders (Know Your Shareholders), (b) transparency requirements for institutional investors, asset managers and proxy advisers, (c) related party transactions and (d) remuneration policy (Say on Pay).

Know your shareholders

The first set of provisions, referred to as Know Your Shareholders, mainly concerns two subjects: the rules for identifying shareholders, and the exchange of information between the company and its shareholders. In the future, through entities that function as intermediaries, such as custodian banks, investment undertakings and central depositories, a listed company will be able to obtain information on the identity of its shareholders, including their names, dates of birth, addresses and shares held. In addition, the exchange of information with shareholders will be improved as a result of a new requirement mandating that these intermediaries forward certain information from listed stock corporations domiciled in Germany, or in other EU member states, to shareholders or the next intermediary in the custody chain. Furthermore, intermediaries must immediately send a listed company all information received from its shareholders regarding the exercise of their rights. The *RefE* explicitly extends these rules to multitier custodian chains involving foreign intermediaries; →

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identification requests from companies and information about shareholders and their exercise of shareholder rights are to be routed through these as well. It is noteworthy that the *RefE* does not make use of the possibility provided in the SRD II to limit the identification requests to certain shareholding thresholds. Non-listed companies can opt-in to the regime by amending their articles of association to reflect these changes (opt-in).

New transparency requirements for institutional investors

The second set of changes involve new transparency requirements for institutional investors, asset managers and proxy advisers. In the future, institutional investors and asset managers must publish their engagement policy and report annually on its implementation. This includes information relating to the exercise of shareholder rights, the shareholders' voting behavior, and how conflicts of interest are being addressed. Deviations from these transparency requirements must be disclosed, and the principle behind such a deviation must be explained. The *RefE* also imposes a similar transparency obligation on proxy advisers, who will have to make a declaration of compliance with a code of conduct. This code of conduct will be tailored to proxy advisers and is primarily designed to prevent conflicts of interest – an appropriate regulation, as proxy advisers can exert considerable influence on a company, particularly when advising large institutional clients.

Handling of transactions between listed stock corporations and related parties

A third focal point is the handling of transactions between listed stock corporations and related parties. The SRD II introduces a new regime to protect minority shareholders of a listed company from the adverse effects of asset transfers to related parties – that is to say, significant shareholders, members of the management or other insiders. According to the guidelines, such transactions must be announced immediately after they are concluded and are to be subject to the approval of the supervisory board. However, those who expect these new regulations to result in far-reaching governance changes for German stock corporations as regards related party transactions are likely to be disappointed. First, the requirement of supervisory board approval only applies if the transaction exceeds 2.5% of the value of the company or group's total fixed and current assets, as calculated within the most recent annual financial statements (section 266 *HGB*). This is a relatively high threshold, likely to only be reached in absolutely exceptional cases for most companies. Second, the *RefE* makes use of all the exceptions provided for in the SRD II for transactions requiring supervisory board approval. Consequently, transactions with subsidiaries and transactions that have been approved by the Annual General Meeting (irrespective of the value of the transaction) will not require the approval of the supervisory board. However, transactions within a contract-based group (*Vertragskonzern*) – that is, a group of companies created by a profit transfer and control agreement between a controlling entity and a controlled entity – have been disregarded. This is because according to the *RefE*, German stock corporation law for such contract-based groups already provides a high level of protection for the other shareholders. "Transactions in the ordinary course of business and at arm's length conditions" are also exempt from the supervisory board approval requirement, provided that the company's articles of association do not stipulate otherwise. If no such stipulation in the articles of association exists, the company only needs to provide for an internal review procedure regarding the "customary market conditions" of the transaction. A mandatory fairness opinion by an external consultant – an option provided for in the 2nd ARRL – is not addressed in the *RefE*. Finally, procedural errors, such as those resulting from an incorrect valuation of the transaction or an undetected "related party" situation between the company and its counterparty, should not affect the effectiveness of the transaction. Thus, concerning the regulation of related party transactions, the *BMJV* is adopting an approach consistent with the valid argument that stock corporation law already encompasses sufficiently effective legal concepts to protect against harmful influences by related parties (such as the prohibition of hidden profit distribution, the general principle of equal treatment of shareholders, and strict liability of executive bodies with reversal of the burden of proof). However, in the currently ongoing consultation process, stakeholders committed to protecting minority shareholders may suggest a more vigorous approach to legislators.

Shareholder participation in remuneration of management boards and supervisory boards

The fourth, and most politically explosive, set of provisions in the regulations concerns shareholder participation in the remuneration of management boards and supervisory boards. Here, too, the *BMJV* takes an approach that tends →

to be favorable to companies and their management. In the future, a listed company will have to publish a remuneration policy that must be approved at least once every four years at its annual general meeting. In addition, a "clear and understandable" remuneration report on past payments must be presented at its annual shareholder meeting. This report must also be subject to a vote by the shareholders. Additional provisions require that, in the future, both the remuneration policy and the report must be published on the company's website, in accordance with its declaration of compliance with the German Corporate Governance Code. However, the mandatory annual general meeting vote regarding the remuneration report and remuneration policy is of an advisory nature (recommendation only), which is justified by the draft proposal on the basis that the European requirements should be incorporated into the dual competence structure of the management board and the supervisory board as gently as possible, pursuant to German corporate law. If the annual general meeting rejects the remuneration system for the management board, the supervisory board must review it; however, the final decision rests with the supervisory board alone. Against this backdrop, the statement in the *RefE* that the new regulations will lead to a "noticeable change in German law" is likely to be met with considerable doubt in the consultation process. Even so, the new regulations should certainly provide ample material for discussions on the subject of salary excesses.

Conclusion

In summary, publicly listed German companies' concern over an excessively far-reaching implementation of the European requirements can be largely dispelled for the time being. The implementation period runs until June 2019, and due to transitional provisions, the majority of the new regulations will only become relevant starting in the 2020 AGM season. Stock corporations, intermediaries and other addressees of the regulations are required to closely monitor the progress of the legislative process. <–

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