KNOW-HOW

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CORPORATE

GERMAN CORPORATE GOVERNANCE CODE 2022

The Government Commission on the German Corporate Governance Code ("**Government Commission**") presented the new version of the German Corporate Governance Code ("**GCGC 2022**") on 17 May 2022. The GCGC 2022 was submitted to the Federal Ministry of Justice for review and published in advance on the Government Commission's website. The GCGC 2022 will enter into force on publication in the electronic Federal Gazette.

Sustainability as focal point

As was already apparent in the draft of the GCGC 2022 from January, the key changes to the Code take into account the growing importance of environmental, social and corporate governance issues ("**ESG**" for short). Listed companies are expected to incorporate social and environmental sustainability into their corporate strategy and planning, placing greater responsibility on management and supervisory boards for these issues. The Explanatory Memorandum to the GCGC 2022 states that companies can use the UN's "17 sustainable development goals (SDGs) to transform our world" as a guide when interpreting the concept of sustainability.[1]

In addition to an emphasis on ESG, the GCGC 2022 contains adjustments necessitated by the Second German Act on Equal Participation of Men and Women in Management Positions and the German Act Strengthening Financial Market Integrity. These adjustments include in particular new recommendations on the internal control system and risk management system, on the audit committee and on cooperation with the auditor.

The new provisions in detail

The key changes to the GCGC from its previous version of 16 December 2019 are as follows:

- **Social and environmental factors in corporate management**: The revised Code's focus on ESG is already apparent from the second paragraph of the preamble, according to which the management board and supervisory board must take social and environmental factors into account "in the enterprise's best interests":

"Social and environmental factors influence the performance of the enterprise, and its activities have an impact on people and the environment. The Management Board and Supervisory Board take this into account in the enterprise's best interests when performing their management and supervisory duties."

Furthermore, this focus is clearly reflected in the new **recommendation A.1**:

> *"The Management Board **shall** systematically identify and assess the risks and opportunities for the enterprise associated with social and environmental factors, as well as the environmental and social impacts of the enterprise's activities. In addition to long-term economic goals, the corporate strategy shall also give appropriate consideration to ecological and social goals. Corporate planning shall comprise appropriate financial and sustainability-related objectives."*

- **Sustainability as part of supervisory board's monitoring task**: The revised Code's focus on ESG is also reflected in recommendations that only concern the supervisory board. The final version of the GCGC 2022 no longer contains the recommendations geared specifically to the supervisory board's monitoring of sustainability issues, as included in the consultation draft (recommendation A.6). By way of a supplement to **principle 6**, however, the final version does generally state that the supervisory board's monitoring and advisory tasks also cover sustainability issues. The addition made in the consultation draft to **recommendation C.1** has been retained. This states that supervisory boards must in future also have expertise on sustainability issues relevant for the enterprise in question.

- **Qualification matrix for the supervisory board**: A new addition in the final version of the GCGC 2022 is that the implementation status of the specified objectives for the composition of the supervisory board and the competence profile is to be published in a qualification matrix in the corporate governance statement (**recommendation C.1, sentence 4**).

- **Internal control system and risk management system**: **Principle 4** on the appropriateness and effectiveness of the internal control system and risk management system now includes a sentence about internal monitoring:

  > *"Internal monitoring is essential to ensure that the internal control system and the risk management system are appropriate and effective."*

  It is the Government Commission's view that this internal monitoring falls under the remit of internal auditing (cf. Explanatory Memorandum on A.5). The Explanatory Memorandum points out that voluntary external audits, e.g. according to the IDW PS 980, 981 and 982 audit standards, can be used to corroborate the statements made on the appropriateness and effectiveness of the systems. The management board would thus also enable the audit committee to make the assessment required of it, so that "*external audits would be required from time to time*" (cf. Explanatory Memorandum on A.5).

  According to the new **recommendation A.3**, the internal control system and risk management system must in future also cover sustainability-related objectives:

  > *"Unless already required by law, the internal control system and risk management system **shall** also cover sustainability-related objectives. This **shall** include processes and systems for collecting and processing sustainability-related data."*

  The new **recommendation A.5** stipulates that the internal control system and risk management system are to be described in the management report:

  > *"The management report **shall** describe the main characteristics of the internal control system and risk management system as a whole, and provide comment upon the appropriateness and effectiveness of these systems."*

- **Compliance management system**: The current recommendation A.2 on the compliance management system has been deleted, but – unlike in the consultation draft – has been replaced by additional wording in principle 5:

  > *"The internal control system and risk management system also comprise a compliance management system aligned to the enterprise's risk situation."*

  The deletion was rightly criticised during the consultation process. Given the great legal and practical importance of compliance management systems, this change would have sent the wrong signal.

- **Minimum gender participation**: Principle 9 has been adapted in line with the legal situation that has existed since the introduction of the Second German Act on Equal Participation of Men and Women in Management Positions and now reads:

"The Supervisory Board ensures that the statutory minimum gender participation on the Management Board is complied with or defines target values for the share of women on the Management Board within the framework of the statutory requirements."

- **Establishing an audit committee and cooperating with the external auditors:**

  The current recommendation D.3 on establishing an audit committee has been deleted. **Principle 14** has instead been expanded and now states that an audit committee must be established. This is based on the new section 107(4), sentence 1 German Stock Corporation Act introduced by the German Act Strengthening Financial Market Integrity, according to which the supervisory board of a listed company must establish an audit committee. In addition, the current recommendation D.11, according to which the audit committee is to evaluate the quality of the audit on a regular basis, is to be replaced by a new **recommendation D.10**:

  > *"The Audit Committee **shall** discuss the audit risk assessment, the audit strategy, audit planning and audit results with the external auditors. The Chair of the Audit Committee **shall** discuss the progress of the audit on a regular basis with the external auditors and report on this to the Committee. The Audit Committee **shall** consult with the external auditors on a regular basis without the Management Board."*

  Unlike the consultation draft, the final version no longer includes the recommendation that the chair of the audit committee is, on a regular basis, (i) to meet with the Chief Financial Officer and (ii) to participate in discussions regarding critical audit matters between the management board and the external auditors and report on these to the committee. In addition, the final version of the GCGC 2022 no longer contains the recommendation that the audit committee is also to arrange for external reviews of the internal audit system. The recommendation in the consultation draft – which was rightly criticised – that the audit committee is also to meet with the external auditors without the management board, was modified in recommendation D.10 of the final version (only) to the extent that "meet" was changed to "consult with". Recommendation D.10 supplements the new section 109(1), sentence 3 German Stock Corporation Act introduced by the German Act Strengthening Financial Market Integrity, according to which the management board will not participate in a meeting of the supervisory board if the external auditors are called in as experts, unless the supervisory board or the committee deems its participation necessary.

- **Qualifications of the financial experts on the audit committee:**

  The GCGC 2022 also contains a new **principle 15** on the qualifications of the members of the audit committee:

  > *"At least one member of the Audit Committee must have expertise in the field of accounting and at least one other member of the Audit Committee must have expertise in the field of auditing financial statements."*

  This reflects the requirement introduced by the German Act Strengthening Financial Market Integrity that at least two of the members of the supervisory board or audit committee must be financial experts (section 100(5), section 107(4), sentence 3 German Stock Corporation Act). **Recommendation D.3**, which follows principle 15 and is likewise largely new, provides that knowledge relating to sustainability reports and audits of such reports also falls under knowledge of and experience in the application of accounting principles, internal control and risk management systems and auditing financial statements. The chair of the audit committee must also be an expert either in accounting or in auditing financial statements, or both. The corporate governance statement must identify the relevant members of the audit committee and provide details of their expertise. Finally, as provided in the current recommendation D.3, the chair of the supervisory board may not chair the audit committee.

- **Report on the form of supervisory board meetings**: According to the new version of recommendation D.7, the supervisory board report must also state how many meetings of the supervisory board and the committees were held as physical meetings and how many as video conferences or conference calls. This was not part of the consultation draft.

Gleiss Lutz comments

Leaving aside the amendments triggered by the Second German Act on Equal Participation of Men and Women in Management Positions and the German Act Strengthening Financial Market Integrity, it is clear that the primary focus of the changes to the GCGC 2022 is sustainability. During the consultation process, there was some criticism of the importance given to this topic in the Code. The Government Commission has however responded to this by making only a few linguistic improvements in the final version. This is understandable given the ever-increasing importance of sustainability aspects for the work of the management board and supervisory board. All in all, the GCGC 2022 emphasises this rising importance, thereby addressing a concern of many institutional investors.

Those affected by the GCGC 2022 should review the amendments as soon as possible to ensure they will be ready to submit the next declaration of conformity. Companies that do not already comply with the new recommendations, in particular, can immediately initiate the necessary internal processes and have these implemented by the time the next declaration of conformity is submitted. It is especially important for the management board to review its corporate strategy in view of recommendation A.1 and its internal control and risk management systems in view of recommendation A.3. Recommendations C.1, sentence 2, and D.3 on the qualifications of members of the supervisory board or audit committee, as well as recommendation D.7 on supervisory board meetings, are particularly relevant for the supervisory board. The qualification matrix recently recommended in C.1, sentence 4, must also be developed for the corporate governance statement if no deviation from the provisions of the GCGC is to be declared.

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[1](1) No poverty, (2) zero hunger, (3) good health and well-being, (4) quality education, (5) gender equality, (6) clean water and sanitation, (7) affordable and clean energy, (8) decent work and economic growth, (9) industry, innovation and infrastructure, (10) reduced inequalities, (11) sustainable cities and communities, (12) responsible consumption and production, (13) climate action, (14) life below water, (15) life on land, (16) peace, justice and strong institutions, (17) partnerships for the goals. See https://sdgs.un.org/goals for further information.

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