

Corporate Governance – Supervision and Application

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“Corporate Governance of Public Interest Entities in Georgia: What’s Next?”

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- I. Stock exchanges
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A Three examples

- I. 'Money makes the world go round' – sometimes in the wrong direction: Deutsche Börse AG – 2004/2005
- II. 'Crime and punishment': VW-Scandal 2015 – ongoing
- III. 'And lead us not into temptation': 'Company A' 2015 – ongoing

Example I: Deutsche Börse AG

1) Change in shareholder structure is sometimes painful

a. Before IPO (2000):

- 7 % regional exchanges
- 10 % brokers
- 83 % German banks

b. A few years after IPO (2005):

- Over 40 % international investors (especially funds)
- Only 10 % German investors (banks, investment companies)

Example I: Deutsche Börse AG

- 2) Big changes to the shareholders' structure causes revolt
- a. **Attempt to take over London Stock Exchange (LSE)** by the Deutsche Börse (Dec 2004 / Jan 2005)
 - b. **Objection from large foreign investors.** Demands for
 - 'Payout' from redemption of shares
 - Resignation of supervisory board
 - c. **Deutsche Börse backs down**
 - Take-over bid is withdrawn (March 2005)
 - Dividend payouts (EUR 75 m 2005) and redemption of own shares (for ca. EUR 2 bn 2005-2008)
 - CEO steps down and around half of supervisory board members (including chairman) resign during 2005

Example II: VW 2015 – ongoing

- 1) From 2005 / 2006: **VW manipulates software** for diesel emission controls in several car models
- 2) 3 Sep 2015: US Environmental Protection Agency (EPA) issues a **Notice of Violation** against VW. The German public is not informed. No ad-hoc announcement is made to stock exchanges or their supervisory authorities
- 3) 19 – 20 Sep:
 - **VW publicly admits** software manipulation
 - CEO Martin Winterkorn resigns
- 4) Oct 2015:
 - **VW informs its customers** via website
 - First private prosecutions
 - **Numerous changes in VW's supervisory board** with new board member for compliance (former judge of Federal Constitutional Court)
- 5) March 2016:
 - Growing suspicion that **Winterkorn** knew of manipulation well before Sep. 2015 but **kept quiet**
 - VW Group of America boss, Michael Horn, resigns and is later sentenced in US to 7 years' imprisonment

Example II: VW 2015 – ongoing

- **278 main shareholders bring charges** against VW for damages of EUR 3.2 bn (others follow suit: 1,400 by Sep. 2016)

6) April 2016:

- VW reports loss of EUR 1.6 bn (mainly due to provisions of EUR 16 bn)

7) June 2016:

- Federal Financial Supervisory Authority (**BaFin**) makes a **criminal complaint to the public prosecutor's office** in Braunschweig due to **suspicion of market manipulation**
- First payouts in USA: 'settlement' of over EUR 14.7 bn
- Ca. 800,000 cars are re-called

8) Jan 2017

- **Former VW chairman seriously incriminates Winterkorn**

9) June 2018:

- Public prosecutor's office in Braunschweig sentences VW to a fine of EUR 1 bn

10) End of
July 2018:

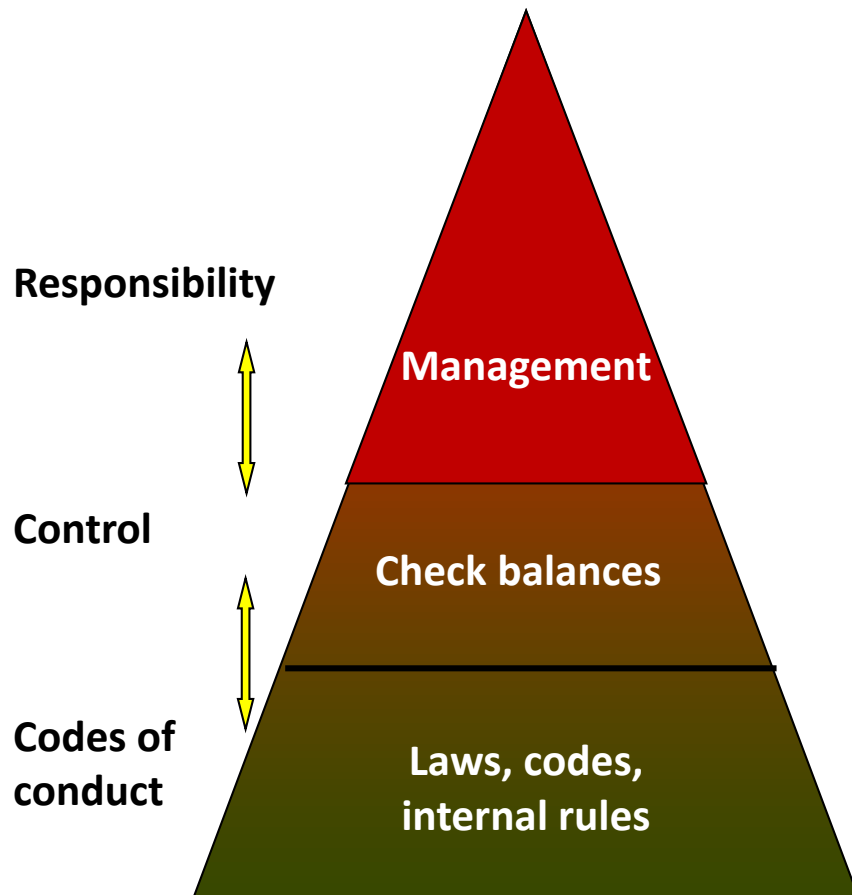
- It becomes known that VW employees warned of possible consequences of manipulation long before it was discovered

Example III: 'Company A' 2015 – ongoing

- 1) New CEO in April 2015
- 2) Agreement between CEO and staff committee of the board of Company A:
 - a. **Option programme** to buy EUR 4.5 m in company shares until end of December 2015; thereafter, if a certain increase in profits is achieved per year, after 5 years CEO receives same number of co-performance shares 'for free'
 - b. **CEO exercises the option mid December 2015**
 - c. Company announces Directors' Dealings accordingly
- 3) **As early as mid 2015 talks with a foreign competitor** regarding creation of a joint holding company
- 4) Feb 2016:
 - a. Non-disclosure agreement is made with competitor company
 - b. Both companies publish ad-hoc to announce the planned deal
- 5) Feb 2017: **public prosecutor begins investigation** against CEO on suspicion of violation of **insider trading rules** (but no investigation of chairman of non-executive board for aiding and abetting!)
- 6) 31 Dec 2017: CEO resigns

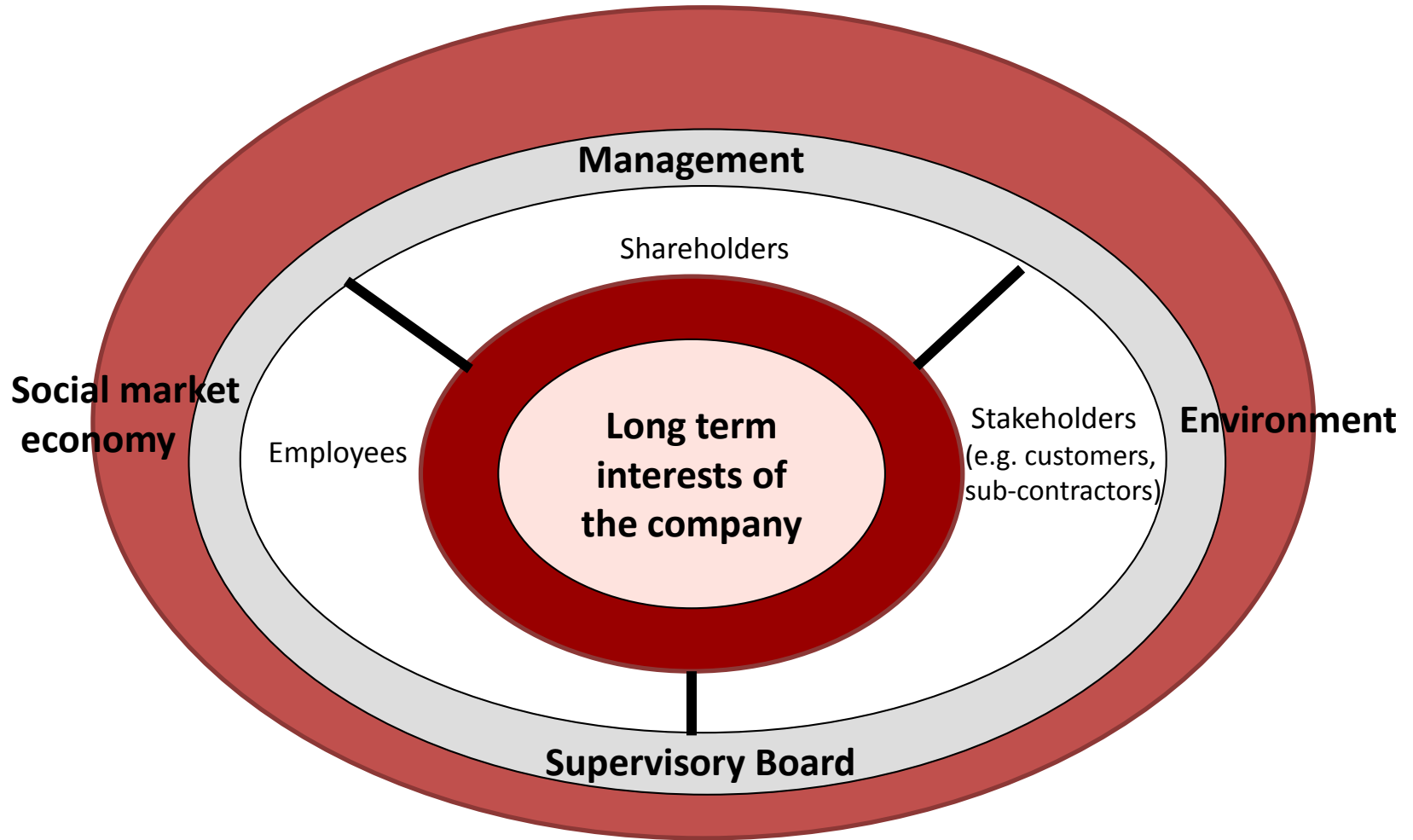
B Corporate Governance: What went wrong in these companies?

I. Corporate Governance structure



- Professional and socially competent management board (executive-directors)
- Independent, professional and socially competent supervisory board (non-executive directors)
- Prevention of exorbitant incentives
- Publication of conflicting interests
- Participation of management board (executive directors) in success **and** risk
- Audit independent from management board
- Direct communication
- Corporate Responsibility Committee
- E.g. Companies Act, Securities Trading Act, MAR, MiFID I and II, DTR
- Corporate Governance Codes
- Statutes
- Mission statement, business principles
- Compliance rules

Corporate Governance principles



II. Breaking the rules

- Example 1: Breach of general Corporate Governance principles (short-term distribution of profits vs. long-term interests of the company)
→ suspicion of violating **'acting in concert'** rules
- Example 2: Breach of supervision obligations and communication
→ suspicion of **market manipulation**
- Example 3: Allegation of 'wheeling and dealing'
→ suspicion of **insider trading**

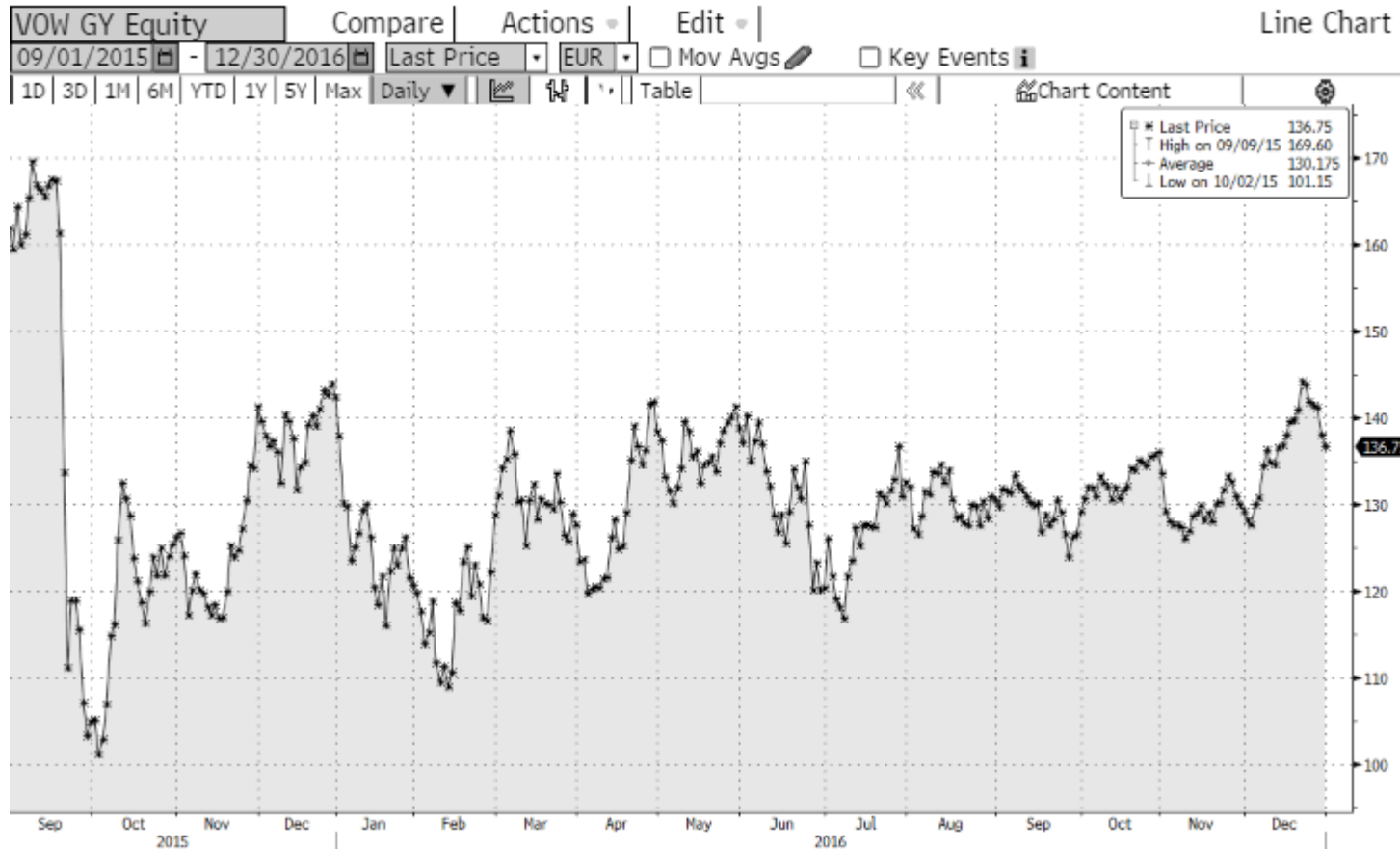
C Consequences for the capital market

Deutsche Börse share price - January 2004 to March 2009



C Consequences for the capital market

VW share price – September 2015 to December 2016



D What role do the 'authorities' play in general

I. Stock exchanges in the EU

- 1) Foremost neutral institutions, provide facilities for an 'orderly and fair' market, subject to market supervision
- 2) Have influence on the adherence to CG-rules only if
 - Their own rules (exchange regulations, terms and conditions) are violated
 - The integrity of the market (not the company) is endangered (own market surveillance department becomes active)
 - Administrative assistance is requested for and by supervisory authorities
- 3) Measures
 - Trading ban for market participants
 - Suspension of trading
 - Removal of financial instruments from trading
- 4) **However, stock exchanges do not oversee Corporate Governance Code**

II. Supervisory authorities of EU-states

- 1) Usually the main authority responsible in each country (FCA, BaFin, CONSOB, AMF etc.)
- 2) **Breaches of the law are punished by the authorities;** in the case of criminal proceedings the public prosecutor is called in (e.g. insider trading, market manipulation, money laundering)
- 3) Breaches of CG-rules (in a narrower sense →CG-codes) in general
 - In all significant financial centres of the EU the principles of the CG-code are seen as '**soft law**' (bridge between law and ethics)
 - As a 'soft law' the CG-code is only effectual indirectly and to a limited extent
 - However: meaning and application of CG-code in each financial centre in the EU differs

- 4) Corporate Governance Code in **Great Britain** (UK Corporate Governance Code and Stewardship Code)
- Is the door to a **'premium listing'** in the Main Market of LSE. Companies must be able to satisfy criteria of the CG-code (**'comply or explain'**); a 'sponsor' introduces the applicant in an eligibility letter to the FCA in its capacity as UK Listing Authority (UKLA)
 - Has less prescriptive requirements for the segment AIM
 - Requires disclosure of company's governance arrangements to be included in the **IPO prospectus** (overseen by the FCA)
 - In addition to listing process requires companies with shares listed in the Main market to issue a **yearly declaration of compliance**, usually in their annual report
 - Does not require FCA to actively check if a company reports after its admission to listing. **FCA only acts if it becomes aware a company has failed to report**

- 5) Corporate Governance Code in **Germany** ('Deutscher Corporate Governance Kodex')
- Is not included in the listing rules of the exchanges
 - Requires disclosure of company's governance arrangements in **IPO prospectus** (as in all financial centres in the EU)
 - Adopts the **legal obligation of the Companies Act** which states that all companies listed in the 'Regulated Market' issue a **yearly declaration** of compliance (as in GB)
 - Does not apply directly to companies listed on the Freiverkehr (Open Market)
 - **Does not call for direct monitoring** by either BaFin or any German state supervisory authority

- 6) Corporate Governance Code in **France** (code AFEP/MEDEF* de gouvernement d'entreprise; code monétaire et financier)
- As in Germany, but:
 - Autorité des Marchés Financiers (**AMF**) is obliged to compile a yearly **report on the general application of the governance rules** and to make recommendations for companies on how better to apply the code rules
 - Consequence: the companies listed in CAC 40 and SBF 120 adhere strictly to the CG-rules

* AFEP = Association française des entreprises privées
MEDEF = Mouvement des entreprises français

III. & IV. Corporate Governance Commissions & Auditors

Corporate Governance Commissions

In Great Britain, Germany and France: no obligation to monitor CG, only responsibility to further develop the code

Auditors

In the three states auditors check the declaration of compliance in the company's annual report in a similar manner:

- 1) Examination of declaration of compliance to see if it is **complete and (formally) applicable**
- 2) No examination to see if variations from CG-rules are described correctly in the declaration
- 3) If facts are established during the examination of the annual report, **auditors must report that the content of the declaration is incorrect**

E The role of investors

- I. Adherence to CG-rules is playing a growing part in the appraisal of market-listed companies, especially
 - 1) Pay structure ('say on pay')
 - 2) Risk exposure
 - 3) Conflict of interest
 - 4) Transparency
- II. Increased focus on 'soft' factors
 - 1) Environment
 - 2) Social engagement
 - 3) Sustainability
- III. Measures for (suspected) violations
 - 1) Sell shares
 - 2) Publicly announce concerns**
 - 3) Vote in the AGM against (individual) directors, refuse to grant discharge
 - 4) In particularly serious cases:
 - Call an extraordinary AGM
 - Claim for damages

E The role of investors

IV. A recent tendency demands investors pay attention to **not only rights but also obligations**

- 1) In GB: UK Stewardship Code of Sep 2012 expects a policy of '**responsible cooperation**' from institutional investors
- 2) In EU: Shareholders' Rights Directive 2017 expects '**strong, long-term and transparent engagement**' from (mainly large) investors

V. Numerous corporate governance brochures encourage in-depth **discussions between management (in particular), supervisory board and, especially, large investors**. But:

- 1) Risk of unequal treatment of investors
- 2) Risk of conflict for members of the supervisory board, who have an obligation of secrecy
- 3) Risk of breaching the (law based) division of tasks of management board and supervisory board (in a two-tier system)

Summary

- 1) **Increase of legally-regulated corporate governance rules** in the EU; applied by state supervisory authorities or public prosecutor's office
- 2) **Corporate governance rules** which are not legally regulated still **have a legal framework** (listing rules, Companies Act, etc.) within the duty to 'comply or explain' regime; supervision is, throughout, only formal
- 3) **Investors' rights** regarding compliance with corporate governance codes are increasingly opposed to their **duties**, especially with regard to responsible cooperation

And what will/should be the reaction of the relevant companies?

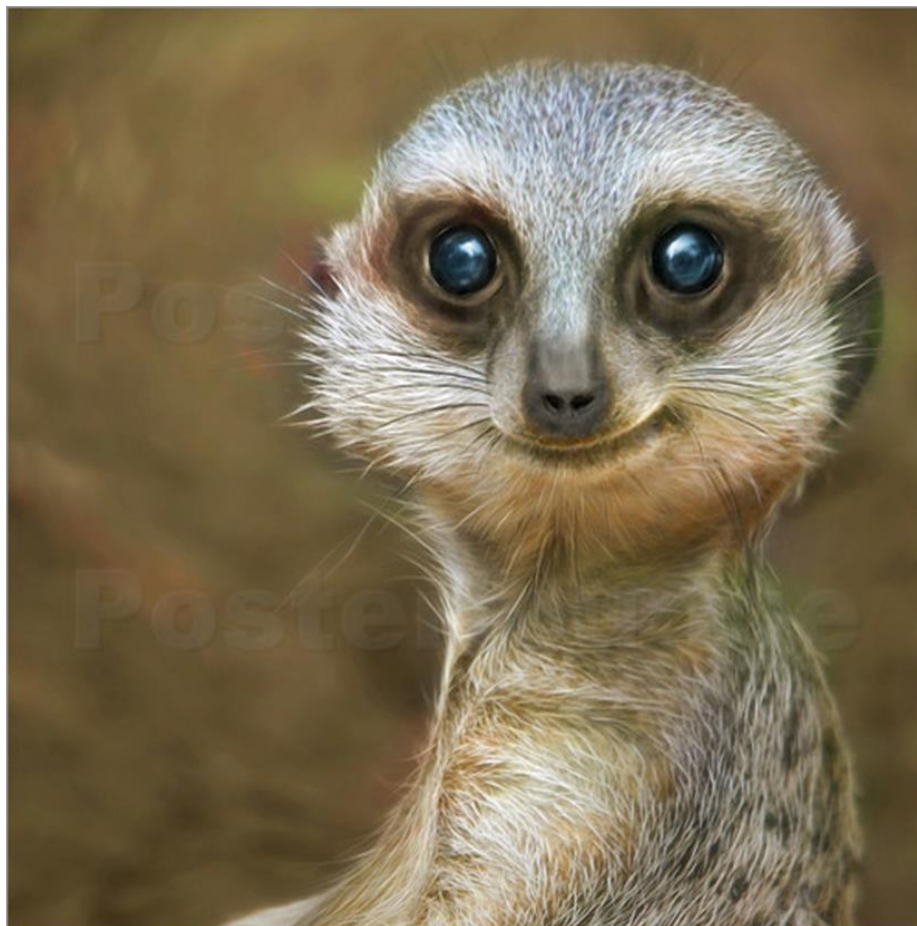
.... as an ostrich



... as a tiger



... or as a meerkat



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