How Supervisory Board communication supports corporate risk mitigation

Growing "say-on-pay" discussion due to tight legislative framework

In the dualistic German system, legislation on external communication by Supervisory Boards is regarded as relatively tight. Corporate external communication lies primarily within the responsibility of the Executive Board. However, in some cases Supervisory Boards are even legally required to make public statements – such as in the annual Compliance Statement regarding the German Corporate Governance Code, as well as in the Supervisory Board Report at the Annual General Meeting. Furthermore, Supervisory Boards make official appearances in annual corporate governance statements and statements on public takeover offers.

The mere referral to legislative limitation is however no longer sufficient to international and institutional investors to refuse discourse between Supervisory Boards and investors. If American, British and French boards provide periodic answers on pressing matters to investors, why should German Supervisory Boards not follow in line?

The fact, that in a globalized capital market German Supervisory Boards can no longer hide behind alleged legislative boundaries was essential to a group of German industry representatives, when they found the "Developing Shareholder Communication" initiative. Within the scope of 'institutional adequacy', the initiative recommends in its "Guiding Principles for the Dialogue between Investor and Supervisory Board" to only communicate topics within the sole responsibility of the Supervisory Board[1]. These comprise of the composition and remuneration of Executive and Supervisory Board, organizational questions regarding Supervisory Board activities, as well as the selection of annual auditors. Ultimately, Supervisory Boards can only communicate on topics from within their sole area of competence.

If for instance an investor questions corporate strategy, the investor may only discuss the supervisory and supportive role of the Supervisory Board within the strategic process, or may discuss an assessment of the strategy implementation. The corporate strategy as such, including its development and implementation, however lies within the sole strategic and communicative responsibility of the Executive Board. Investors may face considerable difficulties when discussing the competences of individual Executive Board Members with the Supervisory Board. This may appear practical as part of an investor's risk evaluation, must however be futile as Supervisory Boards lack the sufficient rights to inform. The only lever in this field may be executive remuneration as part of an incentive and steering system, which the Supervisory Board may comment. This is one of the main reasons from which a growing discussion within the frame of "say-on-pay" regulations arose.

[1] "Guiding Principles for the Dialogue between Investor and Supervisory Board" published by the "Developing Shareholder Communication" initiative, as of July 5, 2016

Corporate governance focused by communication between Supervisory Board and capital market

Poor leadership, badly appointed top-management positions as well as defining an insufficient corporate strategy by the Executive Board are three of the gravest risks of listed companies [2]. Against this backdrop, it is understandable for institutional investors either preemptively, in case of reasonable suspicion of poor leadership, but also increasingly in general, to directly contact Supervisory Boards.

For German Supervisory Boards this resembles a revolutionary step, since it traditionally and by legislation rather remains in the background. When introducing Supervisory Boards in the 19th century however, the founding idea was to provide shareholders with a voice in public companies.

Conclusion

Institutional investors are held accountable for their actions and risk mitigation by their clients. Seeking direct contact to Supervisory Boards of companies the investor is heavily invested in, therefore seldom serves self-perpetuating purposes, and is rather part of the obligatory risk management. Increasingly, German Supervisory Boards answer to these requests, however often entering uncharted territory regarding the traditional division of roles between Supervisory and Executive Board. Therefore, it would be wise for Supervisory Boards to develop an own communication concept and to discuss its fundamental principles with the Executive Board. Otherwise this approach to risk mitigation from an investors perspective may quickly turn into a risk for all involved parties, including the company itself.

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[2] Prof. Dr. Marcus Labbé: "Der Aufsichtsrat in der Pflicht", exempt from a current study by Hochschule Augsburg on potential and operational risks, shown in the example of publicly listed companies regarding the Executive Board, HV Magazin 02/2017, p. 20/21.