

Conversation with Vanguard about Its Perspectives on Governance

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Understanding the views of major shareholders becomes critical as companies head into the proxy season. We are fortunate to get insights from Glenn Booraem, Principal & Fund Controller at Vanguard and head of their governance program, about Vanguard's perspectives on key governance issues and engagement with their portfolio companies.

Davis Polk: We understand that Vanguard sent letters out to many of the portfolio companies that you hold investments in this year. How did you decide who to send letters to, what was the subject matter and primary objectives of those communications, and what has been the response like from the companies that received them?

Glenn: Communicating our views and concerns directly to the companies in which we invest has been a central component of our engagement strategy for many years. To this end, over the past few months, our Chairman and CEO, Bill McNabb, sent letters to the chairmen of more than 900 of the companies held in our funds. These letters sought to accomplish two objectives. First, we wanted to ensure that the companies in which we had the most significant ownership stakes and those that comprised a substantial proportion of our portfolios understood very clearly our views on corporate governance and executive compensation matters. In addition, we wanted to ensure that they knew how to get in touch with us to discuss these matters if need be. The last couple of times we've conducted broad outreach like this, we've included our governance and compensation principles [[Our views on corporate governance | Vanguard](#) & [Our views on executive compensation | Vanguard](#)] with the mailing; they have consistently served as a great catalyst for ongoing discussion. Second, for a subset of the recipients (about 350), we made specific requests for changes in their governance practices or further engagement regarding compensation. On the governance front, we asked companies, where applicable, to consider (a) providing for the annual election of all directors (i.e., board declassification), (b) adopting a majority voting standard – in some form – for the election of directors, and/or (c) providing the right for 25% of the outstanding shares to call a special meeting.

Thus far, we've been pleased with the responsiveness of many of the recipients. In a number of cases, companies have either adopted the changes we requested or committed to put proposals to effect those changes on the ballot at their upcoming meetings. And even in those instances where companies have yet to implement changes, we've had the opportunity to engage directly with them and exchange views on these issues.

Davis Polk: In your view, how has shareholder engagement evolved over the years? For example, what percentage of portfolio companies did Vanguard engage with in 2013? If the level of engagement continues to increase as it has in the past few years, how will investors like Vanguard handle the demands on their time?

Glenn: Engagement is definitely on the rise. We believe more and more companies are realizing the benefits of talking directly to their investors – both active and passive – on a more proactive basis. Historically, the vast majority of "engagement" was purely reactive – in response to a particular event, such as a proxy contest, or an adverse recommendation from a proxy advisor. More recently, companies and investors alike have figured out that maintaining an ongoing dialogue provides for a meaningful exchange of perspectives on emerging issues and sets the stage for more productive discussions when issues arise.

In the past year, we've met (either in-person or virtually) with more than 700 companies, and we expect that that number will continue to grow. For us, the key to managing these growing volumes is ensuring that we conduct our engagement discussions as efficiently as possible. To this end, we benefit from recurring discussions with companies because we're not starting from scratch every time. Once we build a foundation of understanding, our subsequent discussions can

focus more on incremental changes in our respective views and focus on emerging issues.

Davis Polk: How often are directors becoming part of the discussions with Vanguard? Do you think there are particular issues that mandate having a discussion with independent directors rather than company representatives?

Glenn: Directors are definitely involved in our discussions more frequently than in the past, and we view that as a positive development. That said, we don't believe that it's critical for directors to be involved in every engagement. Typically, we're most interested in speaking with directors when we have specific questions or concerns regarding governance and/or compensation matters within the purview of the board's key committees. It's also increasingly common for the board to be involved in the discussion of the process for recommending (or opposing) a merger or other transaction. We believe the recently announced SDX Protocol (sdxprotocol.com) establishes a meaningful framework for shareholder-director engagement.

Davis Polk: How often do these dialogues happen at in-person meetings and when do you think those are necessary? Do they ever include other investors at the same time? When do you decide that you need to proactively reach out to a company for engagement?

Glenn: Our discussions are still predominantly virtual (teleconference or videoconference) but we're always happy to host face-to-face meetings where it's possible. There's definitely incremental benefit to meeting in person if the logistics permit.

Thus far, we've tended to engage companies primarily on a one-to-one basis, but there's growing interest in the area of "collective engagement," especially coming from the UK. This is an area where US investors have trod lightly to avoid the possibility of creating a securities law "group," but one where we will continue to evaluate options to do what's in the best interests of our fund shareholders.

Our decision whether and how to engage with particular companies is driven by a number of factors, including, among others, the significance of our ownership stake, the consistency of their governance and compensation practices with our principles, and the extent of our past dialogue with and voting history at the company.

Davis Polk: What are some of the key governance issues that Vanguard is focused on in the coming proxy season that companies should be aware of?

Glenn: The key issues on which we concentrate our efforts year over year tend to be pretty consistent and derive directly from our governance and compensation principles. We believe that a level of consistency in our views over time – appropriately adjusted as events dictate – gives companies a reasonable target on which to focus over time. On the governance front, this gets to the handful of structural provisions – a declassified board, a majority voting standard for the election of directors, and some provision for shareholders to initiate action independent of the board (e.g., call special meetings) – that we believe provide for the right balance of rights and responsibilities among shareowners, the board and management.

One area about which we want to deepen our understanding both through disclosure and our discussions is how boards are thinking about their composition and effectiveness. What complement of skills, experiences, background and competencies does the board see as critical to its success? How do those factors translate into the board recruitment, evaluation, succession and refreshment process? How does the board consider diversity along multiple dimensions? We believe that all of these perspectives are important to ensure that shareholders are represented by the best possible directors, and gaining more insight into boards' thinking and process in these areas is a priority for us.

Davis Polk: Activist investors are constantly in the news these days. How does Vanguard interact with those activists who may be seeking major strategic or business changes at their target companies?

Glenn: When we're presented with options for a company we own – regardless of the proponent – our primary objective is understanding the competing visions for the company – whether those are different strategic directions, different leadership or a potential transaction – and determining which of those visions best supports our interests as long term investors. In these instances, we spend time with both the activists and the company to assess all available information in considering our vote. We're inherently neither pro-management or pro-activist – we want to identify the course of action that's most beneficial to investors over the long term. By virtue of our substantial index fund holdings, we're practically permanent holders of most stocks, so our interest is in sustainable value creation, not short term financial engineering that drives a temporary pop in the stock price.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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