

Engaging with Vanguard



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Key Takeaways

Vanguard's three major proxy voting policy updates for 2022 – on board composition, diversity and overboarding - reflect nuanced evolutions of its existing approach but with important distinctions regarding expectations around disclosure and practices

In a year in which companies are already seeing an increase in the number and support for Environmental & Social shareholder proposals, Vanguard's approach places continued emphasis on assessing proponents' alignment with long-term shareholder interests as well as company disclosures and arguments against proposals' demands

Engagement discussions and board skill/experience disclosures remain the primary channels through which Vanguard ascertains board effectiveness and the strength of board oversight of relevant topics

Approach to Stewardship and Engagement

Allie Rutherford: You joined Vanguard's investment stewardship group in early 2020. It has certainly been an interesting two years in the market during that time. Can you share what has changed and what remains the same with respect to Vanguard's approach to stewardship during your tenure?

John Galloway: By way of context, the team I lead is responsible for investment stewardship activities for Vanguard's internally managed equity funds, which are principally index funds. Vanguard's active funds are managed by a couple dozen external managers, and those managers have responsibility for both investment management and investment stewardship for those funds. When I speak about Vanguard's approach to Investment Stewardship, I'm referring specifically to our internally managed equity funds.

The stewardship program at Vanguard is constantly evolving in response to new data, developing market dynamics, regulatory requirements, investor expectations, and our view of what creates (and can erode) shareholder value. At the same time, our program remains constant in our purpose to look after long-term shareholder value and to apply principles that have been in place for years.

Our core beliefs about the importance of corporate governance have not changed, nor has the focus on maximizing shareholder value over time. Companies should take comfort in our program's focus on long-term shareholder value and consistent grounding in core governance principles – our views should never be a surprise to company leaders and you will always be able to understand how we approach an issue.

When it comes to our team, we have added new capabilities and resources in response to the rapid growth and complexity in stewardship topics and the many shareholder proposals we now evaluate. The breadth and nuance of these topics requires more company-specific engagement and policy research and development to understand the nexus between issues up for vote and long-term shareholder value. But even as topics evolve, our focus on protecting shareholder value for the investors in our funds has not changed.

Allie: Can you characterize how you are approaching engagement this proxy season?

John: We aim to be consistent in our approach and we value constructive long-term engagement. We are not going to talk to every portfolio company every quarter; we are not on the speed dial of companies' IR teams. Because of the structure of our index funds, our long-term perspective requires us to think both 3-5 years and 3-5 decades in terms of a company's long-term business model and sustainable value proposition. For that reason, engagement is really important to Vanguard. We look for candid conversations that get to the core questions underneath a shareholder or management proposal to understand the linkage to shareholder value.

Both the topics we focus on in engagement, and our decision whether or not to meet with a company, are deliberate and research-driven. We evaluate a range of factors, including the Vanguard funds' exposure to the company, evidence of governance concerns or risks to shareholder returns, as well as the outcomes of prior engagements. Purpose, impact, and timeliness of the discussion are always key considerations. While we are open to meeting with a range of company leaders, we prefer to speak with independent board directors, particularly regarding issues related to board composition and oversight. It is important to note that while we may decline an engagement if we do not see a need to talk to the company in the moment, we want to hear from companies if circumstances change.

Proxy Voting Policy Updates

Allie: Vanguard made several updates to its proxy voting policies this year, including asking for greater disclosure around board composition, expectations of enhanced board diversity across a wider universe

of companies, and a request for greater disclosure on oversight of board commitments and clarity on NEO board service. Can you give us insight into what drove those changes?

John: The updates we made to our policies this year are nuanced, but we feel they are important for companies to understand. The first is on board composition: we are asking companies to provide an explanation of what they think is the appropriate composition of the board, including representation by gender, race, and ethnicity. We hope to see companies articulate a vision of board composition that is reflective of what they think will promote and protect long-term shareholder value, inclusive of employees, customers, communities, and suppliers. A skills matrix that includes this information is a helpful tool, and one that we hope to see companies implement and disclose.

On gender diversity, as market views have evolved and we have seen boards make progress, we continue to adjust our expectations. We are looking for boards to take a thoughtful, intentional approach to enhancing board diversity, rather than being only responsive to investor expectations. This is a topic where we are balancing our belief that there are real risks in not having a board with a mix of characteristics with a desire to avoid unintentionally appearing to set quotas. While we will continue to prioritize direct engagement on board composition with larger companies, if a smaller company in our portfolio does not appear to have a diverse board, we are going to ask questions about their board's composition. We believe this is table stakes for good governance at companies of all sizes.

Lastly, we updated our policy on director capacity and board commitments. We have raised this issue for some time with companies and based on the reduction in total board commitments across directors, it shows that companies have become more attentive to overboarding. We recognize there are reasonable exceptions when a company may determine that having a particular board member is important despite apparent overboarding concerns, such as when a board member brings unique knowledge or experience. In these cases, we ask the board to describe its strategy and take accountability for its policies on commitments.

Therefore, we are encouraging boards to adopt director capacity policies, to disclose them, and do some self-policing. We have always taken a case-by-case approach and asked companies and directors to explain the nuances of their situations. We are now asking both companies to be proactive in their policies and disclosure so that we can spend our engagements on other important issues.

We also clarified our policy on Named Executive Officers (NEOs) serving on boards. We used to say if you were an NEO we think you should serve on no more than two company boards, and our policy implicitly assumed an NEO served on their own company's board (which we know is rarely the case outside of the CEO). Part of the feedback we received from companies was that the policy was frustrating because we were limiting a great pool of executives to serve on boards, including those who bring diversity of experiences and backgrounds. We made the decision to update this policy and we hope the change is viewed positively. That said, we continue to encourage boards to cast a wider net and deepen their pool of director candidates as a way to avoid the need to overboard directors.

Allie: Will large companies be held to higher standards for progress on board diversity?

John: It is a case-by-case assessment. We are now requesting that companies explain what their strategy is. If a company says they do not believe they need to advance diversity as part of their board composition strategy, we will address that as it comes along. However, we want companies to be forthcoming about their board diversity plans and processes.

Vanguard does not expect companies to turn over their board membership overnight. We are interested in understanding how boards are working to develop a pipeline that could include a wider set of skills or experiences, but we also need to see progress on diversity characteristics that are in alignment with local regulations or market norms. A lack of gender diversity is a significant red flag related to a board's attentiveness to this issue given the years-long focus on the risks associated with not having a diverse board.

Allie: Has your policy on climate risk evolved this year?

John: We have clarified our approach to climate risk oversight. Based on feedback from portfolio companies, we found our prior description of our approach was not specific enough about the areas of risk oversight we are focused on. We are being clearer that our focus is on situations where (a) there is a failure to disclose the board's oversight or (b) where we have found significant gaps in oversight at companies in high emitting sectors.

Companies may see this approach differs from other investors. Given that we represent the investors in Vanguard's equity index funds, we do not seek to dictate a company's climate strategy (or any aspect of their strategy). On the topic of climate risk, where it is material, what we are looking for is clarity on the board's assessment of the risks and opportunities the company faces, a well-disclosed plan or strategy that is set in the context of the Paris agreement to address those risks, and updates on progress against that plan over time. That is what we believe is in the best interests of shareholders.

Board Composition and Effectiveness

Allie: You have said that boards are central to how Vanguard thinks about governance. How do you assess board quality?

John: Board composition and effectiveness is where we spend a significant amount of our time because it informs everything. It is also an evolving area where we are seeing demands and expectations on directors continue to increase. We are very aware that it is challenging for Vanguard to assess the composition and effectiveness of any board given that we operate, by design, at a distance. We start with a study of the backgrounds and experiences evident on the board, but in some ways, that is like reading a collection of resumes. You can see that they have *x*, *y*, and *z* experiences, but you may not know how strong that experience is, or how relevant it is in the context of the company's needs and opportunities.

This is where good disclosure and effective engagement matters; both disclosure and engagements inform our understanding of how the board itself thinks of its role acting on behalf of shareholders. We regularly ask boards about what skills, experiences, and characteristics they need, about their view on the right mix of director perspectives and how the board's meetings, committees, and processes ensure directors'

perspectives add value to the company. Directors and management teams can share this information with us in engagements, but they should also make progress to weave it into their disclosures.

We expect directors to be able to speak candidly (and credibly) about the board's independent oversight. In the case of compensation plans, for example, we have concerns when we hear directors rely heavily on compensation consultants as the rationale for plan design. Similarly, we have concerns if a director defers to company management when asked to discuss the board's role in risk oversight. We do not expect that a board will have an adversarial relationship with the CEO or company management, but we do expect they will demonstrate their independence, bring in external perspectives, and evidence their due diligence on material risks to shareholder value.

On a topic like cybersecurity, we do not believe that every board needs a cyber expert per se. But we would expect boards to ensure they have access to the appropriate external expertise so that they can develop an understanding of the topic and provide appropriate, independent oversight. This is an area where we are actively engaging with companies and asking them to disclose how their board is addressing any gaps in skills or expertise related to cyber (as we do with other material risks).

Allie: Does this board assessment change in an activist situation where it can be hard to assess the strengths of directors simply through their bios and other disclosures? Are you applying a new thinking on this in what we expect will be a relatively activism-heavy proxy season?

John: This is an area where we spend a lot of time and focus. Some of the more high-profile proxy fights we saw last year were enormously time-intensive and required significant research and many engagements from Vanguard with both the company and dissidents. That said, it is tremendously helpful to have that depth of engagement with various directors. I would expect that companies will want to make board members/nominees more available to speak to investors, in part because the activists are making their director nominees available to engage.

It is very important for us to hear not only from the activist investors regarding their case for change, but from companies too. Our analysis of each proxy contest is grounded in an assessment of the clarity of the company's response to an activist's argument for change, and that includes the company's explanation of why their nominees are the best candidates to promote and protect shareholder value. This is one of the areas that we are keeping an eye on, anticipating that activist and company behaviors may change as universal proxy takes effect later this year.

Executive Compensation

Allie: Given how many of Vanguard's engagement conversations focus on executive compensation in the proxy season, can you share what concerns or red flags you expect to focus on?

John: First, we really want to understand the board's role in overseeing and executing the compensation program. Second, we want to hear about the board's role in using discretion for pandemic-related adjustments. We were very understanding and flexible in the first two years of the pandemic, but where there is a departure of the executives' experience compared to shareholders, we need to better understand that

logic. Third, we know that some companies have gotten the impression that they need ESG metrics in their plans. To be clear, we are not asking for this. If companies believe ESG metrics are appropriate to align executive compensation with shareholder value, we ask that these metrics be measurable, clearly disclosed, and not detract from the alignment of the executive's goals and long-term shareholder value. Our view is that when these metrics are poorly constructed, they can be a boon to pay without any impact on shareholder value over time.

Environmental and Social Shareholder Proposals

Allie: With the myriad of Environmental and Social-related shareholder proposals going to vote this proxy season, and a number already passing, what can you share about how Vanguard will be evaluating proposals that address novel topics?

John: We are increasingly asking or encouraging companies to be more forthcoming and clear when there is a proposal that they do not believe is in the interests of shareholders. We have seen some companies rely on language in no-action requests or in proxy statements stating that a proposal is not necessary or is duplicative. What sometimes seems left unsaid are any reasons that the company believes the proposal would not create, or could put at risk, shareholder value.

Vanguard's sole focus is on long-term shareholder value. We have no other objectives. We know that inattentiveness to certain environmental and social issues creates risk to long-term shareholder value. There are many cases where we determine that shareholder proposals address material risks or mitigation of risks, and therefore, we support them. In any case, if a company recommends against supporting a shareholder proposal, we expect the company will explain why the proposal is not in the interests of long-term shareholders.

Other investors, and certain shareholder activists, may take a different approach and some companies will face pressure to take action. From Vanguard's perspective, if a company's board believes that tackling an 'E' or 'S' issue is not appropriate or in the best interests of shareholders, we want to know so that we can take their perspective into account as we do our case-by-case analysis.

Allie: Proposals seeking civil rights or racial equity audits are prevalent this year. What is Vanguard's view on these proposals?

John: We are very clear that when it comes to civil rights, discrimination, and racial equity, there are opportunities and risks to companies ranging from potential consequences for employee attraction and retention, to consumer demand, to potential regulatory and litigation challenges. If a company is not being attentive to diversity, equity and inclusion matters, we believe that there are associated risks. We are looking closely at the facts and circumstances at each company that receives a civil rights or racial equity audit proposal. The level of prescription in these proposals is something we also take into account in our assessment.

On the one hand, if we believe there are unmanaged risks related to civil rights or racial equity, it would be appropriate for shareholders to address those concerns with the board. On the other hand, we are not sure that in every instance investors are in a position to determine that a third-party audit is the right path for a company to take. What we ask companies to help us assess is 'is there a material risk?' and 'what steps are

you taking to address any risks?’ If a company and its board believes that the right answer to address its risks is to conduct an audit, we would be comfortable with that. If the company believes an audit is not the right answer, we look to understand their rationale as well as the case made by the shareholder proponent.

We observe that the examples of audits that proponents point to as successful examples relate to situations where a company’s risk had already materialized and where the audit was a helpful remedy because the company and board credibility on the topic was limited. We are not as clear on whether the same remedy applies as a proactive prescription for companies where the risks are not materialized and where the board and management do not support the audit approach. Again, it is important to note that Vanguard’s approach to all shareholder proposals is a case-by-case assessment of what we believe is in the interest of long-term shareholder value at the company in question. We are not looking to prescribe particular actions across our portfolio companies.

Allie: Following a year in which numerous shareholder proposals passed, many companies are grappling with how to navigate situations where they may not have been able to fully implement a proposal’s request. How should companies be thinking about shareholder proposals which passed, and how Vanguard will analyze companies’ responsiveness?

John: We are thinking critically about how we promote and protect long-term shareholder value. In the past, we have had concerns if a board was not responsive to shareholder feedback. Now there is a recognition that proposals are increasingly being put forth for a variety of reasons, some of which may not be tied directly to the creation of long-term value. As a result, proponents’ motivations and objectives, and the nature of their engagement with companies, are becoming a more important element of our assessment of proposals and company actions. That is one of the reasons it is becoming more important for companies to be forthcoming in sharing their perspective about why a proposal is or is not in the interests of long-term shareholders.

We have voted on a few shareholder proposals this year where our analysis led us to conclude the company and board had appropriately addressed the spirit of the proposal and the specifics the proponents were asking for did not seem additive to shareholder value. Companies have been willing to engage with us when we have questions on the nuance of proposals, and we continue to encourage that dialogue to help us understand their perspectives and assess where proposals are asking companies to take actions that may not support long-term shareholder value.

Allie: We have seen a number of non-investor groups sourcing shareholder proposals for proponents. How do you think about the influence of these organizations that are not investors?

John: This really speaks to the evolving nature of proposals and the marketplace in general. Our view is that companies need to be prepared to use different tactics to respond to these types of campaigns and proposals. We will use a similar approach and framework for evaluating these proposals, with the focus on truly understanding the case and relationship to long-term value. We do look at proponents’ ability to describe the link to shareholder value and we also look at their economic exposure to the company and alignment with long-term value creation.

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