Getting to know you:
Sharing practical governance viewpoints
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I'd like to thank Charles Elson, Ann Mulé, and their colleagues at the University of Delaware's Weinberg Center for Corporate Governance for providing this very important forum for sharing ideas. We at Vanguard consider ourselves fortunate to be friends and neighbors with the University of Delaware for many different reasons. I'll mention just two:

- One is the Weinberg Center itself. It has a well-earned reputation for disciplined and rigorous thought and debate around corporate governance. It's a reputation for fair-mindedness that is consistent whether you're talking to people in the corporate board world, or the investment world, or the legal profession, or academia. All of those points of view converge here at the University, and it's telling that they are all represented here this morning.
- The second reason we love the University of Delaware is much more selfish. And it's because this school has produced many great Vanguard crew members. Yes, as we speak there are Blue Hens running around our Malvern campus—and we are very fortunate to have them. They have made great contributions to our company and to our clients over the decades. Some have even come to work on our Corporate Governance team, and have helped to shape the way we think about these matters in broad strokes, and on a case-by-case basis.

So, it is a true pleasure to be here with all of you this morning.

I want to begin my remarks with a premise… it's a simple belief that I have. And that is: Corporate governance should not be a mystery.

- For corporate boards, it should not be a mystery the way large investors vote their shares.

- And for investors, it should not be a mystery the way corporate boards govern their companies.

I believe we're moving in a direction where there is less mystery on both sides, but each side has still has some work to do in how they tell their respective stories. So let me begin by telling you a little bit about Vanguard's story, and our perspective, and I'll start with an anecdote that I believe is illustrative of some of the headwinds that we all face in our efforts to improve governance:

"We didn't think that you cared"

A couple of years ago, we engaged with a very large firm on the West Coast. We had some specific concerns about a proposal that was coming to a vote. . . and we told them so.

The proposal failed, and it was embarrassing for the firm. They responded by reaching out for feedback from all their largest shareholders—or so they said. They didn't call their largest independent shareholder—Vanguard—nor did they apparently take into account the very specific feedback we had already provided.

In subsequent conversations with them (once we finally got to the board), they told us, essentially, "You guys run index funds. We didn't think that you cared."

Well, we do care. We care a great deal. [Interesting postscript… Now that this company knows we care, they've taken substantive action in response to input from us and others…]

A word about Vanguard

Let me pause for a moment to give you some additional context for Vanguard's point of view.

- Today we are the largest mutual fund firm in the world. We have $3 trillion in assets under management. We have 160 funds in the U.S., and an additional 120 in markets outside the U.S. In the U.S., we have nearly **$1.5 trillion in index equities—** and an additional **$330B in actively managed equity funds**.

- What that all means is that Vanguard investors collectively own:
  - about **5%** of every publicly traded company in the United States
  - and about **1%** of nearly every public company outside of the U.S.
- And, remember, as indexers, we are **permanent shareholders.** To borrow a phrase from Warren Buffet: Our favorite holding period is forever.
  - We're going to hold your stock when you hit your quarterly earnings target. And we'll hold it when you don't.
  - We're going to hold your stock if we like you. And if we don't.
  - We're going to hold your stock when everyone else is piling in. And when everyone else is running for the exits.

That is *precisely* why we care so much about good governance. Vanguard funds hold companies in perpetuity, and we want to see our investments grow over the long-term. We're not interested in managing the companies that we invest in. We can't and we won't. But we do want to provide oversight and input on the board of directors. And we count on boards to oversee management.

Vanguard's Corporate Governance Principles

That perspective informs our approach to Corporate Governance. So let me share, at the very highest level, our principles on Governance:

1) Independent oversight…. And more broadly, appropriate board composition, which is the topic of our panel today. It is the single most important factor in good governance. Let's face it. We're in a representative democracy. We empower a group of people to oversee our interests as shareholders and hire and fire the CEO, and have a say in strategy, and risk oversight, and compensation, and so forth. We as shareholders are not there, and they need to be our eyes and ears. And who they are and how they interact and what skills they bring to the table are critical from a long term value standpoint. Every other protective measure exists in case we don't get the right people in the room. I'll touch on this a theme a bit more throughout my remarks, and of course our panel will tackle it as well.

2) Accountability. Management should be accountable to the board. The board should be accountable to shareholders.

3) Shareholder voting rights that are consistent with economic interests. This means one share, one vote. No special share classes for added voting power.

4) Annual director elections and minimal anti-takeover devices. We believe that shareholders benefit when the market for corporate control functions freely.

5) Sensible compensation tied to performance. The majority of executive pay should be tied to long-term shareholder value.

And **6) Engagement.** I'd like to place my greatest emphasis on **engagement** today, because engagement serves as a touch point for all of our other core principles.

At Vanguard, we've been on a journey toward increased engagement over the past decade or so. Our peers in the mutual fund industry have as well. This is not poker. Our votes should not come as a surprise to companies and their boards.

Our outreach efforts began many years ago by simply posting our proxy voting guidelines on our website, then having ad hoc, issue-driven conversations with companies. A few years later, we began writing letters to companies from our CEO (my predecessor in the role, Jack Brennan), and proactively alerting companies to fact that we were a significant shareholder, and that we wanted them to be aware of our guidelines.

And as we've gone along, we've became more targeted in whom we mailed letters to, and more prescriptive in our language.

Last year, we sent out **923 letters (in total)** to companies across the U.S., **and 358 of those letters requested specific governance structure changes**. We said: We differ on these points. Here's our stance, and this is the direction we'd like to see your company move. We'd love to discuss these issues with you.

So far, about **80 companies have adopted substantive changes** (without having to go through a shareholder proposal). And we've had some very good conversations with other companies as well.

Engagement is bilateral, and comes in many forms.

It's important to remember that engagement is a two-way street. It's not just investors voicing concerns or publishing proxy guidelines. There are some great examples of boards being proactive and getting their messages out to investors. Sometimes it's event-driven. I'll share two examples from recent years.

- **Microsoft**, in a number of instances, has used videos from their directors to communicate the board's perspective on issues. Whether it's the lead independent director describing the board's role in overseeing strategy or the chair of the audit committee describing the board's perspective on risk management, these insights into the board's thinking provide helpful context for investors. This is a great example of one form of "one-to-many" engagement that is simple, underutilized, and very much appreciated by us as investors.

- Another example: When **Dell** announced its intention to go private, we met with the special committee of the Dell board that had to make the decision on shareholders' behalf to sell at a specific price. We listened to their perspective and their decision-making process and the things that they took into account… It put us in a better position to decide whether or not this was a good deal. The more opportunities we have to interact with directors in the normal course gives us an increasing level of insight.

Practical engagement around board composition

Sometimes engagement can mean just being crystal clear and transparent about your expectations—and about how you think through certain issues. This applies to board and investors. At the risk of embarrassing two of my fellow panelists, I'd like to highlight recent examples as it applies to board composition:

- First: on the board side: **Shelly Lazarus, who sits on the board of General Electric**. Last year, GE published a "skills matrix" that spelled out the types of expertise or perspectives that they seek for their board (i.e., these are the types of things we're looking for, and these are the people we believe embody them.) We're seeing an increasing number of companies offering this kind of perspective—and it's very helpful to investors.

- The second person I'll pick on is from the investor side: **Rakhi Kumar**, who leads Corporate Governance a**t State Street**. State Street recently came out with a framework for assessing board tenure. They've determined what the average board tenure is (in aggregate and at the individual level) and they said that companies that exceed certain targets (in aggregate or individually) have a greater potential to be voted against. It's a formula, to be sure…. And I know there is greater nuance to it than that… But more importantly…. It's a good data point for boards to be aware of… For example, if a board has a director that exceeds StateStreet's tolerance, it's conceivable that Vanguard and BlackRock and Fidelity might have similar questions about why, for example, a particular board member has served for 30 years, and whether he or she is sufficiently independent of management.

These are both great frameworks to raise important questions and have meaningful discussions between boards and investors. In the end, it helps facilitate a level of self-awareness for boards. It allows them to say, in essence: We realize that our board is comprised differently (or operates differently) than other firms in our business—and here's why.

There may be a good reason for a board to be an outlier. There may not be. But let's provide as much context as we can and invite the discussion. Because investors are going have these questions anyway, and in the absence of additional context, they may draw their own conclusions.

Thinking like an activist

The <u>outlier</u> concept extends beyond board composition, and gets into matters of business oversight and strategy. I believe that the best boards continuously and purposely work to understand where their companies might be different, or might be perceived as different.

And are those differences strengths or vulnerabilities? Some of this is a defensive mindset. Some of this is the continued evolution of the Board's role in strategy. In many companies, we're seeing the board's role move beyond the historical perspective of "review and concur" to become more engaged in setting the strategy.

That raises an important question: How does the board inform itself? If you want to, as a director, you can be fed a steady diet of management's perspective on issues. And in many instances, if left to your own devices, that's what you get. Management comes in, gives you a presentation, and tells you why this is the right strategy. If that's all you've got—shame on you.

Healthy and vibrant boards **think like an activist—**in the very best sense. They ask: Where should we be pushing harder or taking costs out? What are the blind spots of the management team? What are the blind spots on our board? And how do we correct that? Some boards bring in sell-side analysts that have a "sell" rating on the company to tell them what they are missing.

If all the board is listening to is management's perspective, they may be surprised when an activist shows up and says, "Hey, your cost structure is way out of line with your competitors."

A quick side note here on the topic of activist investors. The nature of activist investing has changed significantly since the 1980s. Today, we're seeing a greater trend toward *constructive* activists rather than destructive activists. Activists are not inherently good or bad. They often raise legitimate questions.

And when they raise legitimate questions and tie their business cases to long-term shareholder value—that gets our attention. There have been a number of cases where a board wasn't asking the right questions and eventually lost touch with how the company was being run, and how it was being perceived by investors. I'll share two instances where Vanguard has sided with activist campaigns in recent years.

- **Canadian Pacific Railway:** In 2012, activist Bill Ackman went in and identified some vulnerabilities in Canadian Pacific Railway. We agreed—as did many other large investors—that the company had been poorly run and governed. Ackman brought in an experienced CEO and a number of directors they thought could make a difference. It's been an activist success story—by and large.
- **Commonwealth REIT.** Another example of us supporting an activist: Earlier this year, Corvex and Related Companies waged a successful campaign to replace the entire board of Commonwealth REIT. This was a company with a track record of poor performance and poor governance, and they were ultimately held accountable. Commonwealth was using a third-party management firm, RMR that was run by family members of

Commonwealth leadership. RMR extracted value from the public company. They didn't operate it well, but they were paid well nonetheless. We supported wiping the slate clean. In the case of Commonwealth, we were the largest shareholder. We were important to Corvex's case, but at the end of the day, I don't think they needed us. 81 percent of Commonwealth shareholders voted to remove the company's board.

Looking ahead: The future of engagement

I'll close my remarks with a few thoughts addressed directly to board members of public companies:

We count on you to oversee the companies that our clients invest in. It's an important role. In the U.S. alone, Vanguard invests in the stock of some 3,800 publicly traded companies. We place a great deal of trust and confidence in you. And trust and confidence are built upon open communication. We want to continue to increase the levels of engagement we have with boards. We believe that directors—and investors—are both moving in the right direction on that front.

As we look ahead, I believe we can do more.

- One idea: We've recently been involved in an effort to create the **Shareholder-Director Exchange**, which provides a protocol and some tools and guidelines for institutional investors and directors to talk. It's a wonderful idea, and it has great promise. There's an open question on how best to measure the effectiveness of engagement on a wider scale. But from our perspective, every positive change that we can help to effect is a win for our investors.
- Another possible channel that I'm passionate about: The creation of standing **Shareholder Relations Committees** on public boards. It could be an incredibly effective way for boards to gather those outside perspectives I discussed earlier. Frankly, we're surprised that more boards don't solicit our views on general industry topics. For example, we have a very successful actively managed Health Care Fund. I would think that the directors of pharmaceutical firms or biotech firms would be interested in talking to our portfolio manager to hear her opinions and outlook for the industry. There is a

great opportunity for (non-material) dialogue between investor and director on that level as well.

You, as directors, have a great opportunity to tell us how you bring value to investors. We want to listen. When you post a video to the company's website… we will watch it! When you give a good explanation of an issue in your proxy statement… we're reading it very carefully. When you provide context . . . we are taking it in.

We are listening to your perspective. We want you to be aware of ours. We are your permanent investors. We care very deeply about the role that you play for our clients. And we thank you doing the job well.

Thank you for listening.