

August 31, 2017

### **Perspectives on Today's Letters from Vanguard**

Earlier today, Vanguard published several items of importance to public companies: an [open letter to public company directors from Vanguard's Chairman and CEO, F. William \("Bill"\) McNabb III](#), a [letter from Vanguard's Investment Stewardship Officer, Glenn Booraem](#), and an associated [2017 Annual Report on Vanguard's Investment Stewardship activities](#). These follow [Vanguard's strong op-ed](#) in The Wall Street Journal from earlier in the summer responding to misguided suggestions from academia that index funds such as Vanguard should be silenced and deprived of their voting rights in order to further empower active managers and activist hedge funds who are under significant pressure to obtain returns.

In a welcome development, Vanguard re-emphasized their commitment to bringing a long-term perspective to public companies, rejecting a myopic focus solely on short-term results, and recognized that their status as one of the largest investors in any given public company, whether through their index funds or through their active equity managers (most of whom Vanguard notes hold their positions longer than peer averages), gives them heightened influence and even responsibility for promoting responsible stewardship actively focused on the long-term. In addition, Vanguard proactively outlined the four pillars underlying its evaluation of corporate governance practices:

(1) The Board, as Vanguard considers the board to be “one of a company’s most critical strategic assets” and looks for a “high-functioning, well-composed, independent, diverse, and experienced board with effective ongoing evaluation practice,” on the principle that “Good governance starts with a great Board.” (Vanguard will especially be focusing on gender diversity over the coming years);

(2) Governance structures, with Vanguard supporting “provisions and structures that empower shareholders and protect their rights”;

(3) Appropriate compensation, seeking “pay that incentivizes relative outperformance over the long-term”;

(4) Risk oversight, as Vanguard believes “Directors are shareholders’ eyes and ears on risk” and that “Shareholders rely on a strong board to oversee the strategy for realizing opportunities and mitigating risks.” (Vanguard expects boards and management teams to provide “Effective, integrated, and ongoing oversight of relevant industry- and company-specific risks” and, on the disclosure front, believes

*If your address changes or if you do not wish to continue receiving these memos, please send an e-mail to [Publications@wlrk.com](mailto:Publications@wlrk.com) or call 212-403-1443*

in “materiality-driven, sector specific disclosures” and encourages companies to “embrace the disclosure of sustainability risks that bear on a company’s long-term value creation prospects.”)

Aside from these pillars (the assessment of which will be company-specific), Vanguard remains a firm believer in the value of engagement, seeking to “build relationships with boards and management teams that transcend a transactional focus on any specific issue or vote” and supporting the view expressed by a CEO who engaged with Vanguard that, “You can’t wait to build a relationship until you need it.” Vanguard will continue to value director involvement in engagement in appropriate cases (such as with respect to CEO compensation, board composition/succession and affirming alignment between strategy and governance practices) while recognizing that management primarily has “ownership of the message on corporate strategy and performance.” As public companies consider strengthening their relationships with Vanguard, it’s advisable to keep in mind that a classical “governance roadshow” promoting a check-the-box approach to governance without a two-way dialogue is a missed opportunity to demonstrate to Vanguard that the company’s strategic choices, board and management priorities and *substantive* approach to governance deserves their support.

With respect to activist and academic-sponsored attacks on the major index funds’ ability to participate in contested situations, Vanguard’s commitment to prioritizing responsible and long-term oriented investment stewardship is clear, having refused to outsource voting decisions to proxy advisory firms, doubled their internal team’s size since 2015, developed an intensive sector-based approach to analysis, engagement and voting and accessed the investment talent across Vanguard’s Investment Management Group and the 30 other investment firms managing Vanguard’s active portfolios.

We stand in strong agreement with Vanguard’s view that “The suggestion that index funds relinquish their voting rights is irresponsible and ill-informed” as “Any proposal to concentrate voting power in the hands of active managers (who represent a steadily declining ownership stake)...would reduce board and management accountability, promote short-termism by silencing the longest term voices and distort the incentives for investors and companies.”

Martin Lipton  
Sabastian V. Niles