Vanguard response to the UK Corporate Governance Code Review

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Financial Reporting Council

125 London Wall, Barbican, London EC2Y 5AS

Submitted via email to: codereview@frc.org.uk

Vanguard[1] welcomes the opportunity to provide feedback on the Financial Reporting Council's (FRC) Draft revised UK Corporate Governance Code (Code). Vanguard has a long history of supporting regulatory reforms designed to strengthen financial markets and protect investors, consistent with our core purpose: To take a stand for all investors, to treat them fairly, and to give them the best chance for investment success.

We are proud to serve UK investors, and we continue to invest in our commitments to the UK market and UK investors. Since opening our London office in 2009, Vanguard has worked to lower the cost of investing for individuals, and to encourage them to adopt straightforward investment principles, including setting appropriate goals, having a balanced portfolio, and maintaining a long-term perspective. Vanguard's unique investor-owned structure sets us apart and enables us to put investors first.[2] The interests of our more than 50 million investors around the world, who are saving for long-term goals such as retirement or a new home, are at the centre of everything we do. That is why we support vibrant public capital markets that are attractive to and accessible for companies and investors alike.

We support the FRC's ambition of the proposed reforms to address the policy issues asked by the Government in its response to the consultation, Restoring Trust in Audit and Corporate Governance; and we value the FRC's recognition of the need for flexibility, proportionality, and consideration of the particular circumstances of individual companies in a way that could enhance disclosure and investor confidence. We also appreciate the comply-or-explain nature of the Code, which enables companies to choose bespoke governance arrangements suitable to their circumstances in both the short- and long-term.

Vanguard's Investment Stewardship programme represents the interests of long-term investors through its stewardship of Vanguard's internally managed equity funds, which are predominantly equity index funds. Vanguard's Investment Stewardship programme looks for the companies that Vanguard's

[1] Vanguard is a leading global investment management organisation which offers a large selection of low-cost mutual funds, exchange-traded funds, investment advice and related services to individual investors, financial professionals, and institutional investors. We manage assets globally on behalf of tens of millions of investors and act as an investment advice to more than 400 funds worldwide.

[2] Vanguard is owned by the US-domiciled funds, which in turn are owned by their investors. Vanguard funds in Europe are also managed by Vanguard.

internally managed equity funds invest in to employ corporate governance practices that are in the best long-term interests of their shareholders. These practices are reflected in our funds' investment stewardship policies, organized around four areas of good corporate governance[3]:

1. Board composition and effectiveness,
2. Oversight of strategy and risk,
3. Executive remuneration, and
4. Shareholder rights.

Specific comments on the proposed amendments

Overall, Vanguard is supportive of the proposed changes to the Code. We support the FRC's objectives to focus on oversight of internal controls, strengthen the link between remuneration and corporate performance, and facilitate better engagements between issuers and investors.

We support three recommendations in particular:

- **Board effectiveness and evaluation:** We appreciate that the revised Code encourages boards to conduct annual evaluations of their makeup and performance, including factors such as performance, composition, and how effectively members work together. We believe that boards should regularly assess their performance to ensure they are high-functioning and serving as effective stewards of shareholder capital. Well-composed, effective boards can set in motion a virtuous cycle that enables long-term investment returns for investors in their company. We believe that good governance includes disclosure of a board's evaluation processes, as this information provides investors with visibility into how the board measures and looks to improve its own performance.
- **Director capacity:** We appreciate that the revised Code encourages companies to disclose their directors' significant director appointments in the annual report. Directors' ability to undertake their role effectively with respect to commitments to other organizations[4] is essential given the need for directors to serve as engaged, effective stewards of shareholders' capital. Disclosure of board policies and practices related to director capacity can help investors understand whether directors have sufficient capacity to serve on the board.
- **Engagement with shareholders:** We appreciate that the revised Code encourages companies to have open dialogues with their investors via shareholder engagement. Direct engagement with company leaders is a core part of Vanguard's Investment Stewardship programme, as it provides us with opportunities to understand how directors carry out their responsibilities on behalf of all shareholders. We appreciate the FRC highlighting the importance of boards of directors engaging with the shareholders on whose behalf they serve and disclosing insights from those discussions to all shareholders. However, we would caution that shareholder engagement, and related reporting, should be intentional and impactful, and not a "box-ticking" exercise that is not linked to thoughtful objectives. Outcome-based reporting of the impacts of a company's corporate governance practices might be challenging for companies to monitor and report on without additional guidance from the FRC about how to best implement certain governance

[3] Global investment stewardship principles (vanguard.com)

[4] UK Corporate Governance Code Consultation document https://www.frc.org.uk/getattachment/a92c8f2d-d119-4c4b-b45f-660696af7a6c/Corporate-Governance-Code-consultation-document.pdf

practices. We would welcome further clarification from the FRC about meaningful disclosure of both process and outcomes related to governance activity.

We also highlight areas for further consideration for the FRC, aligned to the proposed amendments:

- **Sustainability matters:** We observe the revised Code encourages companies to consider how sustainability is addressed in a company's business model, strategy, and disclosure. Regarding the proposed sustainability-related revisions (including audit committee requirements and descriptions of how sustainability impacts a company's business strategy in the annual report), we believe that boards should focus on sustainability-related matters that are material to long-term investment returns.
    - **Audit committee:** Regarding the audit committee requirements on sustainability matters, we believe that audit committees should remain focused on matters that are material to long-term investment returns at their particular company, including material sustainability-related matters, without the potential distraction of reviewing sustainability information that is not material to long-term investment returns.
    - **Annual report disclosure:** Regarding the revisions related to sustainability reporting in the annual report, we believe that this reporting should ultimately describe how these factors may impact long-term investment returns. Vanguard views corporate disclosures—including disclosures pertaining to sustainability —through the lens of materiality to the firm's long-term investment returns, and we focus on the risks that are most relevant to particular companies, while acknowledging that those risks might evolve over time. Disclosure and assessment of material risks, including sustainability risks, is important for price discovery and long-term shareholder returns.
- **Remuneration's alignment with strategy:** We also note that the proposed changes to the Code encourage companies to align remuneration outcomes with company performance. We strongly believe that remuneration outcomes should be aligned with successful delivery of a company's long-term strategy and long-term investment returns. However, the proposed Code recommendation which suggests adopting environmental, social and governance objectives in remuneration policies gives us some pause. We look for companies to incorporate metrics in executive remuneration plans, including any metrics on sustainability-related matters, that are material to the company in question and the successful execution of the company's strategy for creating value for shareholders. As such, we suggest the FRC further consider how to frame its request for the inclusion of environmental, social and governance objectives in remuneration plan to ensure that remuneration metrics are fully aligned with long-term investment returns at the company in question.

Vanguard's Investment Stewardship programme has a clear mandate: to safeguard and promote long-term investment returns at the companies in which Vanguard's internally managed equity funds invest. We carry out this mandate by engaging with leaders of the companies in which the funds invest, voting on proxy ballots at company shareholder meetings, and sharing our perspectives on corporate governance practices associated with long-term investment returns in published materials and relevant forums. The UK Corporate Governance Code remains an important input in our analysis of UK public companies' corporate governance practices, and we appreciate the opportunity to share our perspectives on the proposed changes to the Code. We would welcome a response or a dialogue on our views, and we thank you for the opportunity to share our perspectives on these important matters.

Sincerely,

[redacted]