March 2019

Response to FRC Consultation on a Revised U.K. Stewardship Code

I. An introduction to Vanguard's philosophy and long-term orientation

Vanguard welcomes the opportunity to respond to the Financial Reporting Council's (FRC) consultation on the revised U.K. Stewardship Code ('the Code'). Vanguard[1] is one of the world's leading asset managers offering a wide selection of low-cost mutual funds, exchange traded funds (ETFs), and related investment services to individuals, financial professionals, and institutional investors. As at year end 2018, Vanguard's global assets under management (AUM) were approximately £3.6 trillion. Our structure as a prominent index-fund investor and asset manager (with approximately 75% of Vanguard's global AUM being indexed mandates) provides us with a specific perspective, and underpins our long-term orientation regarding investor stewardship practices.

As a global investment manager, Vanguard provides investment products and services to individual investors, financial professionals, and corporate institutional investors. Vanguard invests on behalf of more than 20 million people across 170 countries, each of whom has entrusted us to protect their assets and create sustainable, long-term value as they save for their important financial goals, such as retirement, education savings, or purchasing a home. This is a humbling responsibility and has been our exclusive priority for more than 40 years. Our duty to our end investors is embedded in our corporate DNA and underscores everything we do. Our values of integrity, focus, and stewardship support Vanguard's mission "*to take a stand for all investors, to treat them fairly, and to give them the best chance for investment success."*

We view investment stewardship as a natural extension of Vanguard's culture, commitment to clients, and our fiduciary duty to act in investors' best interest. Our clients depend on us to be good stewards of their assets, and we depend on corporate boards to prudently oversee the companies in which our funds invest—some 13,000 companies globally. Through investment stewardship, we work to ensure that these companies—and the markets at large—operate with a similar long-term mindset. Our Investment Stewardship team seeks to improve the corporate governance policies and practices across our equity holdings, representing our clients' investments through industry advocacy, company engagement, and proxy voting. All of our activities are grounded upon four governance principles:

1. ***Board composition.*** Good governance begins with a great board of directors. Our primary interest is to ensure that boards are deliberately composed, and that the individuals who represent the interests of all shareholders are independent, committed, capable, diverse, and appropriately experienced. A board's diversity should be considered holistically, including diversity of skills and expertise, as well as gender, age, race, ethnicity, and other personal characteristics. These qualities will, we believe, enhance a board's debate, decision making, and collective capabilities.
2. ***Oversight of strategy and risk.*** Boards are responsible for consulting on and overseeing the company's strategic direction and progress toward its objectives, to which directors should be keenly attuned. Boards are also responsible for effective

[1] The Vanguard Group, Inc. is owned by Vanguard's U.S. domiciled mutual funds, which in turn are owned by fund investors. Together with its affiliates, "Vanguard" operates in the U.S., Europe, Asia, Australia and the Americas.

oversight of the risks most relevant to each company. We believe company boards should apply a thorough, integrated, and thoughtful approach to identifying, quantifying, mitigating, and disclosing risks that have the potential to affect shareholder value over the long term. These can range from business and operational risks to environmental and societal risks.

3. ***Executive compensation.*** We believe that performance-linked remuneration policies and practices are fundamental drivers of the sustainable, long-term value for a company's investors. The board plays a central role in determining appropriate executive pay that incentivises performance relative to peers and competitors.
4. ***Governance structures.*** We believe in the importance of governance structures that empower shareholders and enable accountability of the board and management. We believe that shareholders should be able to hold directors accountable as needed through appropriate governance and bylaw provisions.

II. Vanguard perspectives on the proposed Code

As a leading equity investor in the U.K. and in more than 60 other countries around the world, Vanguard welcomes the opportunity to provide input into the revision of the Code. We thank the FRC for its attention to the important and complex topic, and support efforts to solicit feedback from the industry. The nuanced nature of corporate governance and inextricably linked investor stewardship warrants careful attention. It also has implications for many investors across the investment value chain—most especially those invested for their retirement and long-term financial security. Below we have outlined our perspectives on investment stewardship and feedback on select aspects of the Code. *(References to specific sections of the revised Code are noted in parentheses.)* This discussion includes suggestions for:

- Strengthening alignment between the definition of stewardship and investors' fiduciary duties;
- Refining the Code to better account for index-tracking investment strategies;
- Clarifying the Code's discussion of material ESG risks; and
- Reassessing the disclosure, reporting, and assessment timetable with consideration for implementation by signatories.

Investment stewardship, fiduciary duty, and scope of the Code

At Vanguard, our long standing mission[2] is client focused. That means integrity is foundational to our character as an organization—our loyalties lie with our clients, and we're built from the ground up to do the right thing for those in whose interests we serve. For this reason, Vanguard welcomes the addition of signatory purpose, objectives, and governance to the Code *(Principles A and B).* Our long-term perspective and disciplined approach to investing puts our investment stewardship approach squarely in the interests of clients, and the sustainable value of their investments. This is how we at Vanguard define our stewardship responsibilities, and we encourage the FRC and the future Audit, Reporting and Governance Authority (ARGA) to maintain a similarly central focus on end investors, savers, and beneficiaries *(Defining stewardship).* We believe that extending the definition of stewardship beyond the interests of end investors has the potential to conflict with the fiduciary duties of fund managers, which is already deeply embedded in Vanguard's stewardship approach. For this reason, we suggest that the revised Code make explicit

[2] As referenced on page 1, Vanguard is a mission driven organisation whose mission is "to take a stand for all investors, to treat them fairly, and to give them the best chance for investment success."

reference to fiduciary duty, given the critical importance of this concept to signatories and our duty to fund investors.

Vanguard is a predominately index-oriented investor—one that has committed to accurately and efficiently track indices in order to provide our clients with broad and deliberate market exposure. We pursue our investment stewardship responsibilities in three key ways: advocating, engaging, and voting funds' equity holdings. By nature of our indexed style of investment, these activities take place once an investment has been made by a Vanguard fund. The revised Code contemplates a broader scope of stewardship to incorporate activities across the investment process of an actively managed fund, including asset evaluation, investment decision making, and divestment *(Principles E and F).* It also extends the definition of stewardship to other asset classes beyond equities *(Provisions 1 and 23).* We believe this well-intentioned shift presents unique challenges for index tracking funds. For this reason, the Code should provide sufficient flexibility within its scope, the definition of stewardship, and the guidance provided *(for example, within Provision 9[3])*. We believe this will help to ensure the Code sets expectations with consideration for all investment styles, and that compliance can be demonstrated by all signatories.

Stewardship by index investors

We believe that Vanguard brings a uniquely constructive and long-term view to investment stewardship and sustainability matters. Over the last several decades, investors have increasingly turned to index mutual funds as a low-cost and diversified way to invest for a secure financial future. An index fund typically owns its stocks for as long as a company is included in the benchmark. By nature of this approach, index fund managers don't sell out of a stock because they don't like it, and they don't buy more of a stock because they do. Because we do not control the composition of the benchmarks our clients seek to track, a Vanguard fund's votes and voice are the most important levers we have to protect our clients' investments and help them grow over time. We are encouraged that, in turn, the concept of "long-termism" is being embraced by more and more public companies, markets, and policymakers around the world who have a growing appreciation for the perspective and value of an index fund. They know that Vanguard's index funds are—in every sense of the word—*invested* in their long-term success, since the funds are practically permanent owners wherever they are invested.

As a long-term oriented investor, Vanguard works to ensure that the companies in our portfolios continue to generate sustainable value; in other words, are set up for success tomorrow, next year, and for long into the future. We approach the integration of various sustainability factors, including environmental, societal, and governance (ESG) topics, by focusing on their materiality and relevance for individual companies, and in turn their potential to impact the long-term value of our clients' investments. That's why Vanguard doesn't approach sustainability by singling out one particular topic across our broad fund investments; rather, our stewardship approach focuses on enduring corporate governance themes (noted above) and allow for needed flexibility at the investee company level. After all, if a company's business practices or products put people's health or safety at risk, they may also present long-term financial risks to investors.

The revised Code makes explicit reference to *material* ESG risk *(Principle E)*, an important distinction in light of investors' fiduciary duties. However, we suggest that a revised Code provide additional examples of material risks, in addition to its current reference to climate

[3] We believe many examples offered in the draft guidance for Provision 9 are applicable in relation to actively managed investment strategies. We would encourage revisions to include indicative examples of how other styles of investment, such as index strategies, may "integrate ESG."

change. (For example, cyber and data security risk, supply chain risk, human capital risk, etc.) Relevant risks can vary depending on a company's industry, geography, and other factors. Investors look to company boards to oversee the strategic and risk implications of ESG topics. Where these risks may pose a long-term concern to a company, Vanguard engages with company leaders, encouraging them to uphold their responsibilities on their shareholders' behalf.

At the heart of sustainability are good corporate governance practices and, importantly, the responsibilities of boards of directors. Investors look to boards to understand and oversee material risks that may affect the company over the long term. In turn, companies should disclose these risks in a way that is clear and useful to investors. Vanguard believes that investors benefit when the market can appropriately price significant risks to the long-term sustainability of a company's business. That's why we place such great emphasis on the disclosure of a variety of risks, including competitive forces, regulation, government action, consumer demand and preferences, and social and environmental considerations.

There are many efforts underway to develop reporting frameworks suitable for both companies and investors, including the Taskforce on Climate-related Financial Disclosure (TCFD) and the Sustainability Accounting Standards Board (SASB). Vanguard is engaged in these efforts, and hopes to see the market coalesce around best practices that support accurate valuation over time—a critical priority for ensuring that investors are appropriately compensated for the risks they assume in the markets. Though some companies have embraced appropriate disclosure and reporting on important and material risk topics, adoption is not yet consistent. While this is not an explicit output of the revised Code, Vanguard encourages the FRC, the future ARGA, and their industry counterparts to prioritise relevant corporate disclosures which, in addition to supporting more accurate valuation in the markets, are inextricably linked with the ability of long-term investors to conduct effective stewardship.

Signatory reporting and assessment

We understand that our clients want to know how their funds are advocating, engaging, and voting on their behalf. Over the last several years, Vanguard has pursued a more holistic approach to reporting and communicating about our stewardship activities—outlining our beliefs, describing our activities, and demonstrating our impact through case studies, statistics, and topical updates. Each and every day we work to advance our Investment Stewardship programme, and we pledge to continue providing a meaningful window into our stewardship activities to keep clients, portfolio companies, regulators, and policymakers informed. We believe our current and planned approaches to reporting will align with the thematic expectations of the Code *(Becoming a signatory; Reporting and assessment).*

However, as the FRC and the future ARGA formulate more specific recommendations for *Activities and Outcomes Reporting* by signatories, it is important to recognize that more rigorous reporting expectations will create additional obligations for firms *(Reporting and assessment).* In some cases, revised requirements may exceed the current practices of investors and require operational changes and/or changes to existing reporting and disclosure practices. For these reasons, the Code should contemplate a more extended timetable for signatories to (a) publicize their new statements and (b) have their reports publicly assessed by the future ARGA *(Becoming a signatory; Reporting and assessment).* In addition, the FRC and future ARGA have not yet developed or communicated a framework for assessing and evaluating firm reports, nor have signatories had the opportunity to obtain feedback on any revised reports. For these reasons we believe a more considerate and collaborative timeline would be sensible, and would align reporting expectations with existing practices in the market (e.g., allowing ample time for firms to compile data and elevate reports after the proxy and calendar years).

Therefore, we suggest that:

- Asset managers and asset owners are provided at least six months from the new Code's date of publication (anticipated in 2019) to submit a new *Policy Statement*;
- An initial *Activities and Outcomes Report* is due for submission—reflecting a full year of 2020 stewardship activities—by end of first quarter 2021[4];
- The first *Activities and Outcomes Report* undergoes an iterative review with the new ARGA[5] over the course of 2021, including consideration of first-year reporting and disclosure assessments, before assessments are publicised in subsequent years; and
- Public assessments of signatories commence after the 2021 reporting cycle (beginning in 2022).

Practical examples of effective signatory onboarding and revision processes already exist in the market, including for new signatories to the Principles for Responsible Investment (PRI) which has onboarded more than 1,900 signatories and implemented public signatory reporting globally.[6] We believe a more sensible approach—coincident with these meaningful revisions—would support the Code's objectives of supporting best practice stewardship practices in the U.K. and globally, and encouraging quality reporting by signatories.

III. Concluding remarks

We once again thank the FRC for its work to support effective investment stewardship practices. We believe that when investors conduct stewardship practices thoughtfully and with a long-term orientation, end investors benefit. That's why Vanguard's investment stewardship efforts are closely linked with our mission and commitment to clients. Ultimately, through stewardship, we encourage companies to prioritize issues that bear on long-term, sustainable value creation—in the U.K. and in investible markets around the world.

We welcome the opportunity to engage further with the FRC and the future ARGA to discuss our views on this important topic. Any questions about Vanguard's perspectives, or requests for additional information, can be addressed to Adrienne Monley, Head of Investment Stewardship—Europe (adrienne_monley@vanguard.com) or Richard Withers, Head of Government Relations—Europe (richard.withers@vanguard.co.uk).

[4] In order to reflect a full year's stewardship activities in a comprehensive report, signatories will require adequate time to prepare the report. Under the revised Code's draft timetable, signatories are asked to submit their first *Activities and Outcomes Report* before the end of the very calendar year upon which they are reporting, in addition to providing an initial report in the same year they had their *Policy Statement* tiered. The above suggestion aligns with a sensible timetable utilised by the Principles for Responsible Investment (PRI) for its signatory onboarding process.
[5] The PRI's new signatory onboarding process includes an opportunity to receive private feedback on first-year Transparency Reports, before such reports are published the following year. We suggest a similar approach for the new Code.
[6] The PRI requests reports by signatories at the end of the first quarter each year; reports reflect activities for the prior calendar year. (e.g., A March 2019 report reflects the 2018 calendar year.)

IV. Appendix—Additional notes and related resources

Consolidating Provision 27 (and related guidance) with Provisions 19, 21, and 23

We note that Provision 27 addresses engagement with bond holdings separately from provisions 19 and 21 (which similarly discuss engagement activities) and from Provision 23 (which similarly sets forth expectations about exercising ownership rights across different asset classes). To simplify the Provisions and their related guidance, we would suggest consolidation and simplification to support clarity of expectations. For example, Provision 27 may serve as additional guidance under Provision 19, 21, or 23, rather than remain a standalone item.

Enhancing guidance for Provision 26

We note that the guidance for Provision 26, regarding disclosure of voting records, can be further clarified. Below we offer commentary for the three circumstances outlined in the draft guidance:

- ***There is a vote against the board***—Guidance should clarify whether the intent is to be inclusive of (a) a vote against any board director, or (b) a vote against a management recommendation.
- ***A vote is withheld***—Guidance should clarify the intended meaning behind the term 'withheld', which may be defined differently depending on the context in which it is used. For example, in the U.S. a shareholder may 'withhold' a vote for a director; however, the terminology depends on the voting system used by the company.
- ***The vote is not in line with voting policy***—Guidance should clarify if the intent is to seek disclosures about policy exceptions (i.e., votes are cast in a manner contrary to the investor's stated voting policy).

Related resources

Vanguard as published numerous materials describing our stewardship approach, activities, and outcomes. For additional insight into investment stewardship at Vanguard, explore the following representative selection:

2019 Semiannual Engagement Update:
https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019-semiannual-engagement-update.pdf

2018 Annual Report:
https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2018_investment_stewardship_annual_report.pdf

Former Chairman Bill McNabb's 2017 letter to public companies:
https://about.vanguard.com/investment-stewardship/governance-letter-to-companies.pdf