

AN OUNCE OF PREVENTION

Why adopting corporate governance guidelines makes a difference



As one of the world's largest institutional investors, Vanguard promotes strong corporate governance practices by the companies in which we invest as a means of enhancing shareholder value. While the votes we cast at shareholder meetings are perhaps the most visible outcome of our views on specific governance matters, they represent only a subset of our activities that advocate for positive change. In some respects, the ballot is a blunt instrument, and we have found that we are frequently able to accomplish as much through dialogue with companies as through our votes.

That said, we hold fairly categorical views on certain governance matters. For example, we believe firmly that all of a company's directors should be subject to annual election by a majority vote, and that an appropriate proportion of

shareholders should be able to call a special meeting. In that context, we have consistently supported board declassification proposals.

On the other hand, we are likely to vote against proposals regarding majority voting for directors and shareholders' ability to call special meetings because those proposals are typically too prescriptive (for example, ignoring what we view as acceptable alternatives to a majority vote bylaw) or too loosely framed (for example, failing to specify an exact percentage of shareholders required to call a special meeting). When voting against these proposals, in virtually all instances we meet with company officials to make clear our support for the governance principle behind the proposal, as distinct from the proposal itself.

Frequently, company officials tell us there isn't a problem to fix; financial performance is strong, the board is not entrenched and is elected by a staggering majority, and management is accountable. Our view is that the best time to ensure that solid governance practices are in place is when seas are calm. An ounce of prevention is worth a pound of intervention, to borrow loosely from Benjamin Franklin. This is an important notion for a number of reasons.

» **First, while we never expect to need our life preservers, we'd be foolish to leave port without them.** We typically invest with the presumption that there is a well-functioning board and give substantial deference to the board in leading the affairs of the enterprise — setting direction, administering compensation and negotiating transactions. That said, if we find ourselves in a position where we believe action is warranted, we expect to be able to exercise our ownership rights without impediment.

» **Second, once the water starts rising, it's too late to look for your life vest.** We view the adoption of best-practice governance structures — a declassified board and simple majority voting, among others — as hallmarks of an accountable and responsive board. It's highly unlikely that a board that failed to adopt such provisions in good times will do it when the going gets rough.

» **Finally, storm preparation should not be read as an indictment of the captain and the crew.** Even at a high-performing company, the current board and leadership team will not be at the helm forever. We believe that enabling shareholders to protect their interests by effecting change is a fundamental right.

“WE ARE FREQUENTLY ABLE TO ACCOMPLISH AS MUCH THROUGH DIALOGUE WITH COMPANIES AS THROUGH OUR PROXY VOTES.”

As long-term investors, we have learned that an ongoing discussion of these issues can be more effective than a simple thumbs-up or thumbs-down on a proxy proposal. When we engage companies on these issues, we do so regardless of whether a proposal is on the ballot for the current year. While we will eventually vote on these issues, the discussion outside of the voting process is crucial. The productive discourse we have with companies ensures that our voice — and the voice of our fund investors — is heard. ■

Vanguard invests more than \$800 billion in stocks, including those of about 1,800 NYSE-listed companies. Nearly 40 Vanguard ETFs are listed on NYSE Arca, including VANGUARD TOTAL WORLD STOCK ETF (NYSE Arca: VT).