# Our engagement efforts and proxy voting: An update

***For the 12 months ended June 30, 2016***

Vanguard's core purpose is "to take a stand for all investors, to treat them fairly, and to give them the best chance for investment success." This means more than offering smart investments, trustworthy guidance, and low fees. It also means working with the companies held by Vanguard funds to make sure that our investors' interests remain paramount.

We take this responsibility seriously. As one of the world's largest investment managers, we recognize that our voice carries considerable weight. Because the funds' holdings tend to be long term in nature (in the case of index funds, we're essentially permanent shareholders), it's crucial that we demand the highest standards of stewardship from the companies in which our funds invest.

Consequently, we are making our voice heard loudly and clearly in corporate boardrooms. Our advocacy encompasses a range of issues, including corporate governance, executive compensation and succession planning, board composition and effectiveness, oversight of strategy and relevant risks, and communication with shareholders. We also exert our influence as fiduciaries in a very important way when each Vanguard fund casts its proxy votes at companies' shareholder meetings.

Below, we explain our approach to advocating for effective governance of portfolio companies through engagement and proxy voting. A record of how Vanguard mutual funds voted during the 12 months ended June 30 is also available.

## Engagement with companies

Although proxy voting at shareholder meetings is important, it's only one component of our corporate governance program. We believe that engaging in direct discussions with the leaders and directors of the companies in which the Vanguard funds invest is a particularly effective way for us to advocate for our views. During our conversations with corporate leaders and board members, we strive to provide constructive input that will better position companies to deliver sustainable value over the long term for all investors.

During the past 12 months, we conducted over 800 engagements with the management or directors at companies of different types and sizes, encompassing nearly $1 trillion in Vanguard fund assets. Our engagement volume represents an increase of 19% over the previous 12-month period and 67% over the past three years. Though we engage with companies for a variety of reasons, we are most likely to engage because we are preparing to vote at the shareholder meeting, an event has occurred at the company that could affect stock value, or our research has uncovered a specific governance concern that is not on the ballot.

Here is a summary of those engagements, categorized by industry sector and market capitalization:

| Sector | % of engagements |
|---|---|

| | |
|---|---|
| Consumer discretionary / consumer staples | 24% |
| Energy | 11% |
| Financials | 21% |
| Health care | 14% |
| Industrials | 7% |
| Materials | 5% |
| Technology | 13% |
| Telecommunications | 1% |
| Utilities | 4% |
| **Market capitalization** | |
| Under $1 billion | 22% |
| $1 billion—$10 billion | 40% |
| $10 billion—$50 billion | 26% |
| Over $50 billion | 12% |

Our engagement efforts include conference calls or in-person meetings with executives and/or directors, formal letters requesting change, and participation in broader initiatives advocating for change. Direct conversations with company managers and directors were the primary form of engagement.

At a broader level, Vanguard Chairman & CEO Bill McNabb has spoken before multiple industry groups promoting engagement with shareholders. In addition, he joined a coalition of prominent corporate and asset management CEOs in signing on to the Commonsense Corporate Governance Principles. These principles, issued in July 2016, outline a comprehensive list of governance recommendations for corporate boards and management teams, as well as asset managers, to follow. The principles address issues including board composition and governance, board responsibilities, shareholder rights, transparency, succession planning, executive compensation, and responsibilities of asset managers such as Vanguard. Executives from prominent manufacturing, finance, and asset management firms joined Mr. McNabb in signing on to the principles.

Also, senior Corporate Governance leaders have supported research and forums at academic institutions and associations promoting shareholder rights and discussing various environmental, social, and governance (ESG) issues. And our Corporate Governance staff has engaged in thought leadership roundtables, participated in conferences, and contributed to publications encouraging effective shareholder engagement and promoting ESG best practices among companies, investment managers, and service providers.

We believe it's important to provide investors and directors with the resources to make these conversations productive. Accordingly, we have actively communicated our views on company engagement best practices to

boards of directors through a variety of channels. And we continue to support initiatives such as the Shareholder Director Exchange (SDX) and the Conference Board's Guidelines for Investor Engagement. Vanguard has also become a signatory to the Principles for Responsible Investment, and our first public report to the PRI is scheduled for spring 2017.

# Voting and engagement in practice

Here are some recent examples of how our engagement and informed voting have influenced positive change:

**Encouraging change in board membership.** At a real estate company, every director failed to receive the majority of shareholder support at the previous shareholder meeting. However, all still retained their board seats. We have particular concerns about so-called zombie directors remaining on boards after receiving less than majority support in director elections, and we had conveyed these views numerous times with board members and management. At the same time, the company drew the attention of an activist investor who was also seeking significant board turnover. After blocking the attempted proxy contest, the company left shareholders with only their existing nominees for election at their 2016 annual meeting. Our Corporate Governance team pursued repeated dialogue with the company and the dissidents, encouraging proactive change to board membership and the resignation of directors who had not, in fact, been re-elected by a majority of shareholders. Although the proxy contest did not move forward, we expect to firmly pursue an engagement and, if necessary, voting approach to further emphasize the need for change to the company's future slates of directors.

**Changing board composition and executive compensation.** The first time we engaged with a large consumer products firm, we stressed the need to incorporate performance-based vesting, not just time-based vesting, to long-term executive incentive awards. We also discussed board composition and the company's plans for rotating in new board members to serve long-term strategic needs. Finally, we encouraged the board to develop a shareholder engagement program that actively seeks input and demonstrates meaningful changes over time. Six months later, the company disclosed meaningful changes to incentive compensation that directors attributed directly to our discussions with them. The company also added several new board members and senior executives aligned with its long-term strategic needs.

**Deepening discussions on climate change risks.** We engaged a large oil and gas company to discuss shareholder proposals on environmental issues to understand how the company assesses and manages some of its greatest risks, particularly those related to climate change. We also met with other company shareholders who shared concerns that the company lagged its peers in risk assessment, disclosure, and response to emissions and other environmental matters. Ultimately, the company received a high-profile climate change proposal that had already been approved at several peer companies with management support. After analyzing the issues underlying the proposal, we have encouraged company management to make specific improvements in how it assesses the severity of these risks, communicates to shareholders about the risks, and works with key stakeholder groups to improve its practices.

**Pressing for better understanding of risks in supply chains**. Upon seeing a number of ESG-related shareholder resolutions on the ballot for a large food producer, we sought to better understand the company's approach to environmental risks and labor practices and its plans for improvement. We learned of the company's already robust engagement with key stakeholders and interest groups, its recent improvements to risk management and independent audits of farmers, and its development of a third-party advisory panel of

experts. The company also described its process for elevating environmental concerns to the board of directors. Our team requested further enhancements to the charter of an existing committee, which we believed would better ensure consistent reviews of these issues and improve accountability. Our team also encouraged the company to improve its public disclosures and communication about the board's role in overseeing such risks and the progress already under way. We believe these developments will deservedly improve the company's reputation in the investment community and with the general public.

**Increasing attention to environmental risk.** We have been meeting with a large energy company to discuss its response to pipeline spills, recent litigation, and violations of environmental regulations. We have been concerned with whether environmental risks were receiving appropriate attention from the board, and we questioned how shareholders and stakeholders could effectively assess such risks when the quality of the company's disclosure lagged that of its peers. After we encouraged the establishment of a board committee to oversee environmental risk, the board amended its bylaws and disclosed the role of the new committee on its website and in this year's proxy statement.

# Proxy voting

Voting at companies' shareholder meetings is an important aspect of our role as a fiduciary acting in the long-term interests of our investors. To that end, our governance analysts evaluate proxy proposals in the context of guidelinesadopted by each of our funds' boards of trustees. These guidelines reflect our long-standing views on what we believe are the optimal governance structures that strike the appropriate balance among the rights and responsibilities of owners, managers, and directors.

In the past 12 months, Vanguard funds voted by proxy at approximately 16,700 company meetings covering nearly 160,000 items. These included director elections, auditor ratifications, compensation plans, mergers and acquisitions, and other management and shareholder proposals.

On average, Vanguard funds voted with management 92% of the time. Here is a summary of our activity:

| Global voting and engagement record | July 2015–June 2016 | July 2014–June 2015 |
|---|---|---|
| Number of shareholder meetings at which we voted | 16,740 | 12,785 |
| Number of countries in which we voted | 73 | 72 |
| % of proposals voting with management recommendations | 92 | 92 |
| Number of company engagements | 817 | 685 |

The following provides a more detailed discussion of the categories we voted on most frequently. Our voting record is summarized in the table at the bottom of this page.

**Director elections.** Board elections constitute one of the most critical areas of governance, because shareholders rely on directors to monitor management. Over the past 12 months, the funds supported 94% of

director nominees. The funds voted against the remainder primarily because of concerns about candidates' independence, their attendance, or actions taken by a committee on which they served. Less frequently, we withheld votes from directors who in our view failed to observe good governance practices or showed a disregard for shareholder interests.

**Compensation.** We dedicate considerable effort to ensuring that compensation programs align the interests of executives with those of shareholders. The funds' votes reflected our views on compensation as follows:

- The funds supported 96% of nonbinding compensation proposals (including "Say on Pay" in some markets). In the United States, the funds voted against proposals at 91 companies where there were significant concerns regarding the execution or design of executive compensation programs.
- The funds supported 88% of binding votes worldwide (and 84% in the United States) on equity compensation plans. The funds voted against plans that could generate potential voting dilution created by the number of shares authorized and/or the rate at which the company has been granting shares.
- The funds voted against 396 directors in the United States who served on compensation committees.

The funds were most likely to vote against compensation plans because of concerns about whether they properly incentivized long-term performance or could result in excessive dilution of current shareholders. We also engaged with companies to encourage positive change. We held direct discussions with more than two-thirds of the midsize and large U.S. companies where the funds voted against their "Say on Pay" compensation proposals. Many of those firms have since made improvements reflecting our feedback.

**Corporate proposals.** The funds voted in favor of 92% of proposed mergers and acquisitions, supporting them if our analysis showed they would contribute to long-term value. A number of other company proposals asked for authorization of new shares or technical amendments to governing documents. We supported approximately 96% of these proposals; the funds voted against 4% when the authorization of new shares would unreasonably dilute current shareholders' ownership stakes.

**Shareholder proposals.** Shareholders put forth proposals on issues ranging from governance provisions (such as proxy access) to calls for enhanced disclosure of certain risks. The funds were most likely to support changes that were consistent with our governance principles, such as annual elections for a board of directors. Vanguard funds sided with incumbent boards in 13 of the 19 U.S. proxy contests (68%) that went to a vote—a similar rate as in prior years.

The most significant category of shareholder proposals over the past year in the United States involved those seeking proxy access. Proxy access gives long-term shareholders the right to nominate directors on a company's proxy card. We consider it a meaningful tool that can promote accountability and protect shareholders' long-term interests. That said, it must also include safeguards to avoid potential abuse by investors who do not have a significant long-term interest in the company. Vanguard favors proxy access proposals that permit a group of shareholders who have held 3% of outstanding shares for at least three years to nominate directors, but we considered each proposal on a case-by-case basis. Based on our evaluation, the funds supported 53% of proxy access proposals (47 of 88), a 16% increase from the previous 12 months. We also engaged with more than 60 recipients of such proposals and urged them to adopt proxy access.

We analyzed proposals that sought additional reporting or corporate policy changes, including those regarding environmental risks, on a case-by-case basis—focusing on a sufficient linkage between the particulars of the

resolution and the impact on long term shareholder value. In many instances, we did not support proposals that, although directed at a specific risk, were unduly broad or prescriptive. That said, our lack of support for individual proposals must not be confused with awareness of and engagement on the underlying issues. We believe that the powerful combination of thoughtful company engagement and ultimate voting opportunity enables us to share nuanced concerns with boards and management teams and, where necessary, hold boards accountable for meaningful change.

Vanguard funds have ownership stakes in a growing number of companies outside the United States. Consequently, we are more frequently called on to evaluate and vote on shareholder proposals worldwide. Although our approach remains largely the same, we consider the various market differences with regard to board structure and accountability, as well as management's support of various proposals. Shareholder meetings outside the United States requiring our attention amounted to more than 12,000 in 72 countries in the latest 12-month period. Of that number, more than half involved shareholder meetings in China, where we have observed that shareholders are often controlling or sovereign.

For more information, please see Vanguard's responsible investment policyand Vanguard's view: Social concerns and investing.

# How Vanguard funds voted

**July 1, 2015–June 30, 2016**

| Management proposals | Number of proposals voted on | % of votes supporting management recommendations |
|---|---|---|
| Directors and board-related | 68,620 | 94% |
| Compensation | 15,195 | 92% |
| Capital structure change | 24,560 | 96% |
| Ratification of auditors and auditor-related | 10,365 | 98% |
| Mergers, acquisitions, and reorganizations | 6,930 | 92% |
| Anti-takeover-related | 315 | 91% |
| Routine business | 24,530 | 92% |
| **Shareholder proposals** | **Number of proposals voted on** | **% of votes supporting shareholder proposals** |
| Directors and board-related | 3,015 | 69% |
| Governance-related | 1,535 | 62% |
| Environmental and social issues | 315 | 4% |
| Compensation-related | 110 | 28% |