January 2019

Response to German Corporate Governance Code Consultation

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

Vanguard welcomes the opportunity to respond to the Commission's consultation on the draft German Corporate Governance 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 €4.3 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 corporate governance practices.

As a global investment manager, Vanguard provides investment products and services to individual investors, financial professionals, and corporate institutional investors—each of whom relies on Vanguard to support their long-term financial goals. Vanguard invests on behalf of more than 20 million people across 170 countries; our duty to those end investors is embedded in our corporate DNA and underscores everything we do. Our values of integrity, focus, and stewardship support Vanguard's core purpose "*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 core purpose and duty to clients. Our end investors 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. Our focus is on ensuring long-term, sustainable value creation by issuers—our funds' portfolio companies. Our Investment Stewardship team seeks to improve the corporate governance practices throughout our portfolios, representing Vanguard fund shareholders' interest through industry advocacy, company engagement, and proxy voting. All of our activities are grounded upon four pillars:

- **Board composition.** Good governance begins with a great Board[2]. 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.
- **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 oversight of the risks most relevant to each company. We believe 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.

[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.
[2] In this consultation Vanguard's references to the "Board", "Boards", "Boards of directors", "Board members", and "directors" are each in reference to the Supervisory Board unless otherwise noted.

- **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.
- **Governance structures.** We believe in the importance of governance structures that empower shareholders and ensure accountability of the Board and management. We believe that shareholders should be able to hold directors accountable as needed through certain governance and bylaw provisions.

II. Vanguard perspectives on the draft Code

As a large equity investor in Germany, where the Vanguard funds have invested approximately €40 billion on behalf of our clients, we welcome the opportunity to provide input into the revision of the Code. We thank the Commission for its attention to the important and complex topic, and support efforts to solicit feedback from investors. The nuanced nature of corporate governance matters warrants careful attention and has implications for many investors across the investment value chain—most especially those invested for their retirement and long-term financial security, like Vanguard's clients. Below we have outlined our perspectives on good governance and feedback on select aspects of the Code.

Structure and focus

We support the reorganisation of the Code into high-level principles and recommendations. We believe this change facilitates greater clarity of purpose, enhancing both readability and usability of the Code. We also support the emphasis on an 'apply or explain' approach, which encourages companies to communicate how they apply the high-level principles through enhanced transparency and disclosure. Importantly, the proposed revisions will provide investors with greater insight into the governance norms across the market, as well as the practices applied within individual companies.

Incorporation of environmental and societal factors

Vanguard approaches the integration of various sustainability factors, including environmental and societal risks, by focusing on material and relevant topics that we believe have the potential to impact the long-term value of our clients' investments. We expect that companies are built and managed to be sustainable businesses. Where environmental or societal risks may pose a material risk to a company, we engage with company leaders to uphold our responsibilities as fiduciaries and seek to protect the value of our shareholders' investments. 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.

For these reasons, we welcome the inclusion of language in the Foreword to the Code that emphasises the role of a company in its community. Vanguard's priority is to understand through company disclosures how these considerations are overseen by Boards and what related risks may exist for investors. We would support a clear expectation that Boards oversee material environmental and social risks as they would any other material matters. We would also support the inclusion of disclosure guidance in the revised Code, drawing a greater link between the Code's general principles around transparency and encouraging companies to disclose their approach to investors. In particular, we seek consistent, comparable, decision-useful disclosure, both historical and forward-looking, around material environmental and social risks.

Shareholder engagement

Vanguard frequently engages with portfolio company executives and independent directors to share our corporate governance principles and learn about company corporate governance practices. We characterise our approach as "quiet diplomacy focused on results"—providing constructive input that will, in our view, better position companies to deliver sustainable value over the long term for all investors.

Engagement between companies and their shareholders continues to be important, and we support the Code's continued reference to this best practice. In particular, the availability of Board members for shareholder engagement—including the Board Chair—was an important development in the 2017 revision of the Code. Since then, we have regrettably continued to observe reticence from some German companies when requesting direct engagement with Board members and Chairs. The latter is most common when Vanguard seeks engagement about Board oversight of strategy and risk matters—a frequent topic of discussion with Boards in many other markets, and one of our aforementioned four pillars of good governance.

To support progress in engagement practices, we believe the Commission should bring greater precision to its language in Recommendation A.2, further normalising shareholder engagement with Board Chairs and other Board members about relevant topics of interest. Additional Code enhancements could include:

- Extend the guidance within A.2 to include Chairs of key Board committees (i.e., Remuneration Committees, Nominations/Governance Committees and Audit Committees). We would welcome the opportunity to engage with these additional members of the Board about their committee responsibilities, including executive pay practices, composition and diversity among Board directors, risk oversight, and long-term oriented corporate governance practices.
- Providing examples of those topics which members of the Board, including the Chair, may discuss with shareholders. This should incorporate explicit reference to the Board's oversight of company strategy and risk and disclosure of such practices. We believe Boards—now more than ever before—must incorporate this oversight into their corporate governance remits, and more actively communicate with shareholders about their practices through engagement and broad investor disclosure.

Individual attendance disclosure

We welcome the expansion of Recommendation A.14 to encourage company disclosure of individual Board member meeting attendance. As a foundational matter, meeting attendance is critical for a Board member to effectively contribute and fulfil their important oversight responsibilities. We believe shareholders (many of whom are similarly discharging their fiduciary and stewardship responsibilities) will be better served by this enhanced disclosure, which will support higher quality engagement with companies and voting decisions on individual Board members.

Board evaluation

We believe that companies with well-composed, high-functioning Boards are more likely to create long-term value for their company shareholders. Board evaluations can promote these aims, often contemplating Board effectiveness, skills, diversity, and governance practices. We support the Code's reference to enhanced Board evaluations, which can serve to advance a company's corporate governance. Importantly, we encourage greater Board disclosure about the self-assessment and/or external evaluation process—as well as the broad findings of these processes—to encourage greater investor confidence in a well-constructed, thorough approach.

Board composition

One of Vanguard's aforementioned four pillars is focused on Board composition. At the core, we believe good governance begins with a great Board. A deliberately composed Board brings not only independence, appropriate experience (so as to bring valuable perspective to the director role), and the right capabilities (across the range of relevant skills for the company and industry), but also diversity of thought, background, experience, and tenure. Diversity in personal characteristics (such as gender, race, and age) also meaningfully contributes to the Board's ability to serve as an effective, engaged steward of their shareholders' interests. We applaud the Code's inclusion of diversity and independence as important considerations for Board composition.

Board election

Board elections serve as an important opportunity for shareholder voices to be heard, and Vanguard strongly prefers that shareholder representatives stand for election each year. With annual Board elections as our ultimate objective, we support the Code's recommendation (B.1) that Board terms for shareholder representatives should move from five years to three years. This change, though not yet fully aligned with our well-established global governance principles, takes a meaningful step towards alignment with international governance best practices.

We are also supportive of the additional recommendation (B.4) regarding disclosure about the term of Board membership, clarifying for investors the number of years to which a director is being elected. A related best practice is disclosure of each individual director's years served on the Board. Such disclosure about Board members would, we believe, support improved market clarity of Board tenure and composition.

Board independence

We welcome the addition to clarify those circumstances which may conflict Board members' independence (B.8). One of our core governance principles is to ensure that the Board members who represent the interests of all shareholders are independent (in mind set and freedom from conflicts), as well as capable and appropriately experienced. In support of this principle, we believe that further clarity should be provided around Board members with close family relationships to a controlling shareholder. In the instance of close family relationships, Board member independence and overall Board effectiveness can be compromised. For this reason, we also welcome the inclusion of Recommendation B.9, which establishes that companies should explain any exceptions to this guidance. In particular, providing rationale when a company classifies a Board member as independent where he or she does not meet the criteria for independence.

Further to our preference for independence in Board membership, Vanguard believes that a Board's key committees (i.e., the Remuneration, Audit, and Nomination/Governance Committees) should consist of independent directors. We understand there may be practical difficulties in achieving this aim, given the co-determination governance model in Germany. Nevertheless, we strongly believe as a fundamental governance matter that the Audit Committee should be comprised only of independent directors—in particular, those who are independent from the Management Board and a controlling shareholder. To support effective committee and full-Board governance practices, we also believe that the aforementioned key committees should be chaired by an independent Board member and that committee membership should be majority independent.

Remuneration

We advocate for executive pay arrangements that are constructed to incentivise relative outperformance over the long term. When shareholders do well, so should executives; and when shareholders don't do well, executives' pay should move in the same direction. Performance-linked policies should motivate management to focus on long-term value creation instead of short-term goals. The Board should ensure that the company's policies are appropriate compared with those of peers and the company's industry, and the details of any pay plan should be clearly disclosed to shareholders. We therefore welcome the Commission's focus on ensuring German company remuneration structures are transparent and reflect investors' expectations. In particular, we support:

- The emphasis on pay for performance;
- The use and disclosure of a peer group;
- The notion that long-term variable remuneration should comprise a significant proportion of the total remuneration; and
- The introduction of clawback provisions.

We believe a company's Board should play a central role in determining appropriate pay for its executives. For this reason, we are concerned that the Code's recommendations on remuneration (section D) do not allow for needed flexibility. Boards should have the ability to adopt remuneration systems that reflect their company's individual circumstances, stage in development, and long-term strategy. As a predominately indexed investor—whose funds can hold stocks not just for years, but for decades—we support remuneration plans which drive sustainable business practices and encourage executives to operate with the long-term in mind. Because of our uniquely long-term perspective, we also believe the Code should allow Boards to set multi-year targets within long-term remuneration plans, driving for performance over multiple—not only single—years. After engagement with thousands of companies over many years, our Investment Stewardship programme has learned the hazards of a one-size-fits-all approach to remuneration. Instead, we believe that appropriate flexibility for Boards to operate in their shareholders' best interest, along with high quality disclosure and investor engagement, will support optimal remuneration practices over the long term.

III. Concluding remarks

We once again thank the Commission for its work to support corporate governance best practices in Germany. Our investment stewardship process is iterative and ongoing, an approach that we believe supports the depth and breadth required to address an expanding array of important governance matters across our funds. Similarly, we believe company corporate governance practices should be deliberately iterative and that the greatest opportunity for progress in this space is continued advancement at both the individual company and broad market level. Only then will Boards and investors alike be able to address the ever-growing complexities that bear on long-term value.

We welcome the opportunity to engage further with the Commission and 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 or Richard Withers, Head of Government Relations—Europe.