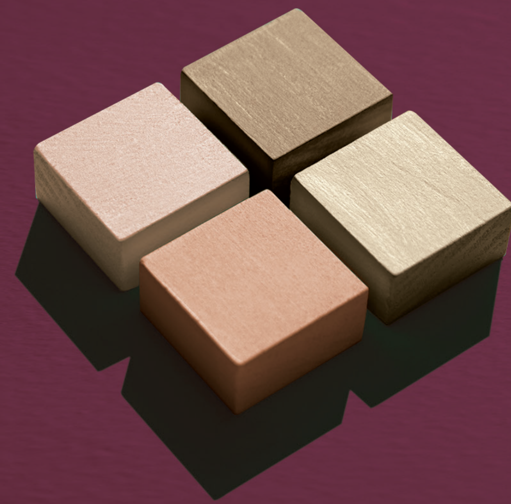
# Vanguard Investment Stewardship Policy Insights

**Highlighting Vanguard's views on executive compensation**



May 2022

## Executive summary


- On behalf of the Vanguard funds, we advocate for well-structured executive compensation plans that drive relative pay and performance alignment, are fair to long-term shareholders, and are flexible through uncertain times.
- We look for compensation programs that drive sustainable value for a company's investors in a way that links pay with performance relative to peers. To do so, compensation plans must be rigorously designed with thoroughly disclosed rationale.
- Vanguard does not expect nonfinancial metrics (such as ESG metrics) to be a standard component of all compensation plans. When compensation committees choose to include nonfinancial metrics, we look for the same qualities we do with more traditional metrics, such as rigor, disclosure, and alignment with key strategic goals and/or material risks.


Vanguard's Investment Stewardship team is responsible for engagement with portfolio companies and proxy voting at the direction of the boards of our internally managed global equity funds, including Vanguard index funds. Investment stewardship activities, including proxy voting, for Vanguard's externally managed active funds are supported by those funds' external advisors. See the back page for additional context.

### Our compensation philosophy endures

Executive compensation is one of the fundamental principles of Vanguard's Investment Stewardship program. We believe that well-structured, transparent, performance-linked executive compensation policies and practices are fundamental drivers of sustainable, long-term value. We encourage portfolio companies to adopt pay plans that incentivize outperformance versus industry peers over the long term, aligning executive compensation outcomes with shareholder outcomes.

This Insights highlights our main compensation principles and key parts of our executive compensation analysis process, and we discuss the rise of nonfinancial metrics—often referred to as environmental, social, and governance (ESG) metrics—in executive compensation plans to share our perspectives on best practices.

### Vanguard's expectations for compensation plans and metrics

Vanguard does not believe there is a one-size-fits-all approach to executive compensation. We expect, however, that all metrics—financial and nonfinancial—within an executive compensation plan should be rigorously designed, thoroughly disclosed, and tied to long-term performance goals related to strategic objectives or material risks. With the following best practices in mind, compensation committees may be better able to design pay programs that result in more aligned pay and performance outcomes.

- **Rigorous design.** We believe that compensation metrics should be designed with an end goal to help align executive pay with performance. The Vanguard funds look for plans in which variable compensation makes up most of the executives' total pay and is measured with a long-term focus beyond the next quarter. We expect boards to set targets to ensure that the metrics are rigorous and incentivize long-term value creation and that boards disclose performance toward these targets. We prefer the use of quantitative metrics, but in cases where qualitative ones are used, we expect disclosure about how the metrics will be assessed.

- **Thorough disclosure.** Investors need to be able to evaluate whether incentives tied to metrics can actually drive company performance and are not needlessly excessive. To assess this, we expect robust disclosures to ensure that investors can better understand a compensation committee's decisions. For example, why has a particular metric been introduced at this point? Disclosure should include how the chosen metrics align with the company's strategy and address a material risk or business opportunity. For example, companies could use third-party assessments or materiality frameworks, such as the SASB Materiality Map, to show why a particular metric is relevant. Disclosure may also include alternative metrics the board considered (but did not adopt) and any third parties the company worked with in developing the plan, such as compensation consultants.

- **Variable pay.** Although we are not necessarily prescriptive on the type of metric used, its weighting, or whether it belongs in the short- or long-term plan, the metric must appropriately incentivize long-term value creation as well as align with the company's strategy and/or address a material risk.

- **Discretionary adjustments.** Adjustments to a pay plan outside the preselected targets and thresholds could indicate that the plan's structure is not effective enough to drive outcomes, which may lead to a company overpaying for underperformance. Any discretionary adjustment to a plan or metric should be accompanied by thorough disclosure so investors can properly understand the compensation committee's decision-making process and any guardrails that have been established alongside the metric. With this rationale in mind, Vanguard looks for pay plans that sufficiently explain significant discretionary changes to compensation outcomes.

- **Relative performance metrics.** To better incentivize outperformance of peers, Vanguard encourages the inclusion of a relative performance metric, such as but not limited to relative total shareholder return. These metrics may help align executive pay during both good and poor market conditions by protecting against outsized (or undersized) payments to executives. Relative metrics can be used alongside appropriate absolute metrics (such as net sales, operation income, or return on investment). With that said, we believe that the compensation committee is in the best position to determine the appropriate set of metrics given the company's strategic direction and industry conditions.
- **Metric materiality.** Vanguard expects compensation metrics to relate to material issues, including those subject to regulatory scrutiny, and to be measurable, reportable, and clearly linked to a company's strategy and risk mitigation efforts. When a metric does not meet these criteria, we engage with boards to understand how the metric incentivizes long-term value creation and whether it is appropriate to include within the compensation plan.

### ESG metrics in compensation plans

Over the last few years, the global pandemic, the material risks of climate change, economic uncertainty, and a heightened awareness of inequality, worker rights, and other social injustice issues have prompted boards to consider a wider range of metrics in pay plans to emphasize the risks and opportunities these matters pose to company strategy.

Nonfinancial metrics related to safety, risk management, and customer experience (Net Promoter Scores, for example) have long been used in compensation plans. In our more recent engagements, we have heard from portfolio company board members about how they are incorporating or looking to incorporate environmental and social metrics related to topics such as climate change risk management, workforce diversity, and human capital matters. We have also seen shareholder proposals requesting that boards incorporate these metrics into compensation plans. The approach to incorporating them varies by sector, industry, and region. In the energy sector, for example, efforts are under way to link compensation to reductions in greenhouse gas emissions and overall net zero commitments. Companies are also using environmental and social metrics in compensation plans to align executive incentives with their commitments to diversity, equity, and inclusion.

### Ensuring that ESG metrics are appropriate

Vanguard does not expect ESG metrics to be in every company's compensation program. Taking the step to include nonfinancial metrics in compensation frameworks should be done with the same rigor as for financial metrics; they should not be included for signal value only, and they should clearly be linked to the delivery of long-term shareholder value. Investors will want to understand the composition of these metrics and progress toward these stated goals, just as they do with more traditional financial metrics.

We look for boards to adhere to best practices, like the ones listed above, when incorporating any metric into pay plans. Investors need to be able to evaluate whether incentives tied to nonfinancial metrics are ultimately tied to company performance and drive the intended outcomes. As ever, companies can and should disclose environmental and social metrics and targets that are material to the long-term strategy and value of their business, but a board does not necessarily need to include all such metrics in compensation plans. Poorly structured ESG metrics that are misaligned with a company's strategy and/or material risk could result in overly inflated pay relative to performance.

We believe that these compensation practices will help investors evaluate executive compensation programs and assess whether the construction and inclusion of ESG metrics in pay plans are implemented in the best interests of long-term shareholders. You can read more about our views on executive compensation in our Global investment stewardship principles document.

Vanguard publishes Investment Stewardship Policy and Voting Insights to promote good corporate governance practices and to provide public companies and investors with our perspectives on important governance topics and key votes. This is part of our growing effort to enhance disclosure of Vanguard's investment stewardship voting and engagement activities. We aim to provide additional clarity on Vanguard's stance on governance matters beyond what a policy document or a single vote can do. Insights should be viewed in conjunction with the most recent region- and country-specific voting policies.

The funds for which Vanguard acts as investment advisor (Vanguard-advised funds) retain the authority to vote proxies that the funds receive. To facilitate the funds' proxy voting, the boards of the Vanguard-advised funds have adopted Proxy Voting Procedures and Policies that reflect the fund boards' instructions governing proxy voting. The boards of the funds that are advised by managers not affiliated with Vanguard (external managers) have delegated the authority to vote proxies related to the funds' portfolio securities to their respective investment advisor(s). Each external manager votes such proxies in accordance with its own proxy voting policies and procedures, which are reviewed and approved by the fund board annually. The Vanguard Group Inc. has not been delegated proxy voting authority on behalf of the Vanguard-advised funds.

2194814_052022



Vanguard®