Vanguard Investment Stewardship Insights

Voting insight: Proposals to approve the supervisory boards' actions at German automakers

May 2022

Company: Mercedes-Benz Group AG (Mercedes)

Meeting date: 29 April 2022

Proposal: Item 4—Approve discharge of supervisory board for fiscal year 2021

Company: Bayerische Motoren Werke AG (BMW)

Meeting date: 11 May 2022

Proposal: Item 4—Approve discharge of supervisory board for fiscal year 2021

Company: Volkswagen AG (Volkswagen)

Meeting date: 12 May 2022

Proposal: Items 4.1 through 4.23—Approve discharge of supervisory board members for fiscal year 2021

How the funds voted

The Vanguard funds[1] recently voted on proposals to approve the discharge of supervisory board members at the annual meetings of Germany's three leading automakers: Mercedes, BMW, and Volkswagen. The funds supported the proposal at Mercedes. The funds considered, but did not support, the proposals at BMW and Volkswagen.

In Germany, companies are required to have a two-tiered board structure consisting of a management board, which is responsible for the day-to-day operations of the company, and a supervisory board, which performs oversight, contributes to strategy, and appoints or removes members of the management board. The supervisory board is designed to give stakeholders, including shareholders and employees, a voice in how a company is run. The supervisory board is also responsible for monitoring the company's compliance with legal, regulatory, and corporate governance requirements.

German law allows shareholders to cast annual votes to ratify the actions of both the management board and the supervisory board in the previous fiscal year. Since these votes are retrospective, shareholder support (or lack thereof) can be interpreted as how much confidence shareholders have in a company's governance.

In recent years, Mercedes, BMW, and Volkswagen have been involved in regulatory proceedings that alleged the automakers had breached European Union (EU) antitrust rules by colluding to restrict competition in the development of emissions-cleaning technology in their vehicles. The fallout exposed material legal, reputational, and regulatory risks to their businesses and resulted in financial penalties for BMW and Volkswagen but not Mercedes. The Vanguard funds' votes reflect our assessment of how each company responded to the crisis as well as our level of confidence in their current governance structures, including board composition and the oversight of risk. In the case of BMW, the meeting agenda included a "bundled" discharge proposal covering the supervisory board as

1 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 holdings, 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.

a single entity. Therefore, we were unable to consider voting against specific individuals who we considered accountable for risk oversight failures.

Vanguard's principles and policies

Good governance starts with a company's board of directors. A board should serve as an independent body to oversee material risks to shareholder value. On behalf of the Vanguard funds, our Investment Stewardship team regularly reviews the extent to which company boards identify, mitigate, and disclose material risks. We also analyze board structures to assess their functional ability to independently oversee management. Strong board structures and clear, decision-useful disclosure of material risks help demonstrate sound governance practices and assist both companies and investors in making better decisions to safeguard long-term shareholder value.

Following applicable market standards, laws, and regulations, when a German company experiences governance failures, the Vanguard funds may hold the supervisory board or management board members accountable by not supporting proposals to ratify the boards' actions. Vanguard may also use the discharge vote to express general governance or oversight concerns or address instances where the board has failed to respond to shareholders' concerns repeatedly, either expressed through voting activity or via engagement.

Analysis and voting rationale

Vanguard has regularly engaged with board members and company leaders from each of the three automakers. Our recent discussions have focused on a range of governance topics, including board composition and risk oversight. Our engagements and subsequent research and analysis ultimately informed how we voted, which is outlined in the following sections.

In all three cases, due to various factors including the nature of the governance concerns, in addition to turnover and current tenure within the management teams, the Vanguard funds' voting decisions focused on accountability at the supervisory board level, choosing to support the discharge of the management boards.

Mercedes-Benz Group AG

Vanguard has engaged regularly with Mercedes's company leaders, including discussions directly with the chair of the supervisory board. In our recent conversations, we sought to better understand the company's governance policies and practices and how the supervisory board oversees risk.

Unlike its peers, Mercedes avoided being fined over the EU's antitrust ruling, having self-reported its misconduct to the authorities. In addition, the company thus far has shown a good deal of transparency in its handling of the scandal, including publishing the findings of independent investigations. We believe this demonstrates the efficacy of its internal controls and compliance procedures.

Importantly, Mercedes maintains a majority independent supervisory board with no obvious deficiencies in terms of its composition. This helps provide confidence to investors who may be concerned about their representation at the board level.

We continue to monitor developments related to ongoing investigations. However, given our assessment of the board's oversight procedures, structure and level of independence, and the company's disclosures in relation to the antitrust scandal, the Vanguard funds supported the proposal to discharge the supervisory board.

Bayerische Motoren Werke AG

Vanguard has engaged with representatives from BMW on a number of occasions in recent years.

The company has a majority independent supervisory board. However, we have observed areas of concern including insufficient key committee independence. We also noted that in 2015, the company's former CEO, Norbert Reithofer, transitioned directly to the role of supervisory board chair, which is not in line with market best practice. Typically, when a senior executive of a German public company steps down, a period of at least two years is expected before they can be appointed to the supervisory board. This is to help ensure independence in the supervisory board's oversight role, which is fundamental to the effective functioning of a two-tier governance structure.

Furthermore, with respect to the EU's antitrust ruling, the supervisory board chair, Mr. Reithofer, held the position of CEO at BMW during the entire period in which the misconduct took place. Therefore, as a result of these considerations, the EU's antitrust ruling, and fines incurred by the company, the Vanguard funds did not support the proposal to ratify the actions of supervisory board members.

Volkswagen AG

Vanguard's history of engagement with Volkswagen goes back several years. In 2021, we met with the company twice, including a call with the supervisory board chair. During this meeting, we discussed a range of important governance topics such as board composition and independence. We also covered the supervisory board's oversight of climate-related risk, corporate culture, and compliance matters in light of the ongoing scrutiny around the company's disclosures and internal controls.

In our assessment, the composition of Volkswagen's supervisory board does not adhere to core principles of good governance. According to our analysis, the current board does not include any independent members. Despite the representation of large shareholders on the board, this is insufficient in terms of both market practice and Vanguard's views on board composition and effectiveness. When we raised this concern with Volkswagen representatives, they disagreed with our definition of independence. While acknowledging the issue, they indicated that addressing it would not be a near-term consideration. As such, our concerns in this area remain unresolved.

When considering the other legal and regulatory issues experienced by Volkswagen in recent years beyond the EU's antitrust ruling, the cost of governance failures to the company—and therefore to its shareholders—has been substantial. While Volkswagen has taken some steps to improve its corporate culture and move beyond these negative events, the company appears unwilling to consider the kind of governance reforms required at supervisory board level to bring it into line with market norms. Without these measures, we will continue to be cautious about the company's oversight procedures and the supervisory board's commitment and ability to effectively mitigate material risk. For this reason, in continuation of the approach taken at previous annual meetings, the Vanguard funds decided not to support proposals to ratify the actions of supervisory board members.

What we look for from boards on these matters

Vanguard looks for the companies in which we invest to maintain governance structures that facilitate effective risk oversight. We believe there are clear links between the strength of these structures and the likelihood, frequency, and severity of governance failures.

On behalf of our investors, Vanguard will continue to engage with Mercedes, BMW, and Volkswagen in order to communicate our views on the standard of corporate governance practices at these significant holdings.

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.

2209856_052022

Vanguard®