March 2023

2023 UK Corporate governance and responsible investment policy

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Introduction

This document sets out what we consider to be corporate governance best practice. It explains our expectations with respect to topics we believe are essential for an efficient governance framework, and for building a sustainable business model. When developing our policies, we not only look at local market regulatory expectations, but also broader global guidelines and principles, such as those provided by the United Nations Global Compact, OECD guidelines and ILO conventions and recommendations. We expect all companies to closely align with our principles, or to engage with us when exceptional circumstances prevent them from doing so.

Although there is no 'one-size-fits-all' solution to building a sustainable business model, we look for companies we invest in to demonstrate that sustainability is effectively integrated into their long-term strategy and their daily operations. Companies should aim to minimise any negative impacts their businesses have on the environment, while innovating to find better solutions. Their strategies should include ways to make a positive impact on society, embrace the value of their workforce and supply chains and deliver positive long-term returns to shareholders.

We publicly disclose our voting decisions, including the rationale for votes against management. This data is now accessible one day after the shareholder meeting, here.

Company board

The board of directors is responsible for the management and long-term success of the company, taking into account its best interests and stakeholders. It should always act as a steward of stakeholders' interests.

The board sets out strategy and direction, ensuring that the necessary resources are available to enable their implementation and that appropriate risk management and internal controls are in place. It is also responsible for ensuring the integrity of accounting and reporting, and the effectiveness of internal control systems. Environmental, social and governance (ESG) considerations should be embedded in the operations of the business, and performance in these areas should be reported annually. Lastly, the board is ultimately accountable to investors and other stakeholders and should make sure its decisions are effectively communicated to them.

Board leadership

We believe that having the right board composition is an essential element of a company's success. We expect each director on the board to fully exercise their duties and promote the long-term success of the company.

We expect a board's decisions and actions to demonstrate leadership in managing the company's responsibilities to all of its stakeholders and to limit any negative impact of its operations on the environment.

As such, LGIM will usually hold the board chair accountable for failing to meet our minimum expectations under key policies to protect our planet and to safeguard society as a whole. For more information on key environmental and social focus areas please see below and our website.

The board chair and chief executive officer (CEO)

The responsibilities of the chair include leading the board, setting the agenda for board meetings, and ensuring directors receive accurate and timely meeting information. Under their direction, there should be a good flow of information between the board and its committees. The chair is also responsible for leading the appointment process for the CEO.

The chair should be able to challenge the executive directors and encourage the non-executive directors to actively participate in board discussions. It is the chair's role to regularly assess whether the board members have the adequate skills and commitment and are sufficiently diverse to make a positive contribution.

By contrast, the CEO has responsibility for executing the strategy agreed by the board and leading the business.

Given the importance of the role, we expect the chair to be independent.

We would therefore not expect a retiring CEO to take on the role of board chair. These two roles involve different responsibilities and a different approach to board relations and the company. Additionally, we have concerns that a hands-on CEO may find it difficult to become a hands-off chair.

Where a company would find the presence of the former CEO on the board beneficial in times of transition, our preference would be that the CEO is used as a consultant rather than as a formal board member. Either way, their services should not be necessary for more than a year.

There are also some instances where a company may, for a short period, be governed by an executive chair. This tends to be when the company is undergoing a shift in its structure, management or is under severe stress. In such circumstances, we expect companies to commit to separating the roles within a short, pre-set timetable. In addition, we would expect a deputy chair to be appointed to ensure that no person has unfettered decision-making powers.

The case of the combined chair and CEO

Although UK-listed companies generally do not adopt such a board structure, it is important to provide guidance on our views.

We believe that the roles of chair and CEO are substantially different and require distinctly different skills and experience. Therefore, we expect the roles to be separated. This division of responsibilities ensures that a single individual does not have unfettered powers of decision-making at the head of the company, thereby securing a proper balance of authority and responsibility on the board.

Where companies have historically combined the positions of CEO and chair and have chosen to keep this structure, we expect a strong, senior independent director or deputy chair to be appointed and for a meaningful explanation and justification to be provided in annual disclosures.

Any decision to combine these roles should be subject to a shareholder vote for approval, given that these are key board risk functions.

From 2020, we took a stronger stance on combined roles, as we believe it can have a negative impact on culture, board discussions, remuneration and shareholder rights. Accordingly, we will vote against the election or re-election of any individual holding such a combined role.

Senior independent director

The senior independent director plays an essential role on the board and should lead the succession process for the chair and appraise their performance. Additionally, they should meet investors regularly to stay well informed of any concerns.

They can be a key contact for investors, especially when the normal channels of the chair, CEO or chief financial officer have failed to address concerns or are not the appropriate avenues.

We expect senior independent directors to be fully independent non-executive directors. This is of particular importance when the company has a combined chair and CEO.

Please see our website for an article on the role of the senior independent director.

Non-executive directors

We expect non-executive directors to use their skills and experience to constructively contribute to board discussions and help develop proposals on strategy. They are expected to oversee management performance and provide a constructive challenge at board meetings.

Given the responsibility the role entails, non-executive directors must make sure they have sufficient time to perform their duties. We expect non-executive directors to take this into account when they take on outside board roles. Please refer to our section below - board mandates.

Non-executive directors should continually update their skills and knowledge and agree on their specific training and developmental needs, which should include all aspects of social, environmental, ethical and reputational risks faced by the business.

Structure and operation

Independence

Independence is essential to ensure the board exercises oversight and consistently acts in the best interests of the company and its stakeholders.

We support the criteria set out in the UK Corporate Governance Code to assess the independence of directors.

We recognise that non-independent, non-executive directors can offer significant skills and sector knowledge, and this can add value to the board discussions. Therefore, subject to board and committee balance being maintained, we will support the retention of a non-independent, non-executive director (for instance, beyond the recommended nine years). However, the benefits to the board of retaining this director and the expected duration of their service should be explained to shareholders. We do not expect this person to be a formal member of the audit or remuneration committees, instead they may attend meetings by invitation.

In relation to the chair's independence, in line with the UK Corporate Governance Code 2018, we expect companies to comply with the nine-year rule. In exceptional circumstances, where a chair is expected to remain beyond nine years, we would encourage early engagement with shareholders with an explanation to avoid a vote against their re-election.

Diversity

We believe a diverse mix of skills, experience and perspectives is essential for a board to function and perform optimally. Several studies have demonstrated that a good level of diversity can improve business decision-making, minimise risks, improve the sustainability of profit growth and therefore maximise long-term returns for investors.

When recruiting members, a board should be looking at diversity in a holistic way and consider the intersectionality of different characteristics. For example, a board should be cognisant of all aspects of diversity that appropriately represent a company's demography of operations and customers, including, for instance, gender, age, nationality, ethnicity, sexual orientation, disability, neurodiversity and socio-economic factors as well as background and experience. Consideration should also be given to the geographies in which the business operates, its future strategic international expansion plans and its consumer base. We would expect a company's diversity and inclusion policy to reflect this information at a minimum for both the board and senior management, and for there to be a broad focus on an inclusive culture, which is a key enabler for greater diversity.

To provide investors with a comprehensive understanding of their diversity strategy, we expect companies to be transparent on the procedures used to find new board members, executives and senior managers, and on how that process ensures a diverse board and senior executive pipeline. We expect all companies to disclose a breakdown of board directors, executive directors, managers and employees at a minimum by geography, main skill set, gender and ethnicity, and to provide information on the gender pay gap and the initiatives in place and actions the company is taking to close any stated gap.

In 2019, the government consulted on the expectations for companies to report on their ethnicity pay gap, and LGIM responded to the consultation, supporting the expectation for companies to understand their data in this area of diversity and to start to report on it. As such, we encourage companies to start capturing relevant data that will enable them to disclose their ethnicity pay gap.

Companies should ensure that candidates with appropriate skills and qualities are sought through the widest possible means, such as the use of recruitment consultants, public advertisements and the leverage of other relationships in the industry. Companies should also be prepared to look outside the usual pool of candidates to include those from less traditional 'corporate board' backgrounds. They should be willing to recruit those without previous board experience, as robust induction programmes and incumbent members with sufficient previous board experience in aggregate will be able to support less experienced directors. This approach will benefit the board's cognitive diversity and also help to expand the talent pool.

For the UK market, we support the initiative for women to make up at a minimum one-third (or 33%) of board directors at FTSE 350 companies, with 30% of executive committees at FTSE 100 companies also being female. In addition, we support the work and targets set out by the 30% Club, as well as the FTSE Women Leaders Review, which has set a goal of 40% by 2025 for FTSE 350 companies, and is seeking for women to hold at least one of the most senior roles of chief executive officer, board chair, senior independent director, or chief financial officer within the same timeframe.

We will continue to apply voting sanctions to those FTSE 350 companies that do not have a minimum of 33% women on their boards. From 2022, we started to apply voting sanctions to the FTSE 100 companies that do not have at least one woman on their executive committee, with the expectation that a minimum of 33% is reached over time.

For smaller companies outside of the FTSE 350, our policy has been to require at least one woman on the board. However, we have more recently signalled that our expectation is for these smaller companies to also reach a minimum of 33% over time. Therefore, from 2023, we expect the board to comprise at least 25% women, rising to 33% by 2024.

As the diversity conversation has broadened beyond gender, we expect companies to start to collect and understand their data on ethnicity and other diversity characteristics, throughout all levels of the organisation.

To this end, and in line with the Parker Review, we expect all FTSE 100 companies to have at least one ethnically diverse board member and, where companies do not meet this minimum expectation, voting sanctions will apply. Smaller companies are also encouraged to consider the Parker Review targets when refreshing their boards, and we expect all FTSE 250 companies to have at least one person from an ethnic background on their board by 2024, or face voting sanctions from 2025.

While we continue to push for companies to meet the targets set out above, we have also responded to and supported the consultation from the Financial Conduct Authority (FCA) that proposed on a comply or explain basis that UK-listed company boards should comprise at least 40% women, and that at least one of the senior board positions (chair, chief executive officer (CEO), chief financial officer (CFO) or senior independent director (SID)) should be held by a woman. UK companies need to be considering this target now, to avoid having to provide explanations in their disclosures as to why they have not met it.

Succession planning

Succession planning is a vital component of an efficient board. It helps to avoid the dangers of 'group think' and ensures continuity and that individuals with the right skills sit on the board.

We expect companies to put in place a formal and transparent procedure for the appointment of new directors. The external board evaluation exercise should assist in this task. We expect the nomination committee, together with the board, to consider setting short, medium and long-term plans to ensure there is an orderly replacement of board members and senior executives. The plans should map out potential successors in the short term for unexpected departures, in the medium term to replace directors who reach their tenure limits, and in the longer term to take account of future skills and diversity requirements.

We encourage companies to publish as much of this information as possible in their annual disclosures.

In addition, we would expect to see a skills matrix linked to the strategy of the company and an explanation of how newly appointed directors would fit into the matrix and the minimum time commitment needed for them to fulfil the role.

Re-election of directors

To ensure the successful composition and functioning of the board, it is essential that shareholders have the ability to effectively exercise their voting rights by holding directors accountable on an annual basis.

To help us make an informed decision on director elections, it would be useful for companies to disclose the minimum annual time commitment required from each director.

In addition to the biographical details of each director, we also encourage the disclosure of the attributes and skills that the director brings to the board, and how these fit with the combined skill set of other directors and the long-term strategy of the business.

Board effectiveness

Board tenure

The regular refreshment of a board ensures that its members remain independent from management and third parties, that different perspectives feed into board discussions, and that skill sets remain relevant. A regularly refreshed board is more likely to be willing and able to question established practices, avoids group think, exercises more efficient oversight of management and stays ahead of market changes.

We would expect all companies to put in place an individual non-executive director term limit of a maximum of nine years. Exceptionally, we may approve an extension to a director’s tenure by another three-year term, to 12 years; however, we would expect the director to step off the audit or remuneration committees. We would also encourage early engagement with us to provide an explanation.

Board mandates

We believe it is important for executive directors to seek external board appointments as this will help broaden their skills and knowledge, enabling them to provide more input to board discussions. However, when taking up outside appointments, they should be mindful of the time commitment required to exercise their duties on multiple boards.

This is because, as the number of companies a director serves on increases, so does the risk that they may become less effective. This risk increases further depending on the role and time commitment needed due to the size and complexity of the company itself. A director has a duty of care to ensure they have sufficient time to contribute effectively to each directorship.

We do not expect non-executive directors to hold more than five non-executive directorship roles in total. We may also take into consideration the number of board roles held at private companies. We consider a board chair role to count as two mandates due to the extra complexity, oversight and time commitment of this role. A practising executive director should not hold more than one non-executive director role with an unrelated listed company.

Board meetings and attendance

Regular board meetings are vital for the board to effectively perform its duties.

We believe the chair should hold separate meetings with the non-executive directors to discuss the performance of the executives. In addition, the non-executives should have at least one meeting during the year without the chair present.

Directors’ attendance at board meetings is a vital part of their role to ensure contributions to board decisions and fiduciary duties to investors are fulfilled. We therefore expect companies to allow investors to assess directors’ attendance at board and committee meetings by publishing attendance records in their annual disclosures.

We expect directors to have attended no less than 75% of the board and committee meetings held during the year. Where a director does not attend a board or committee meeting, the company should report to investors the reason for non-attendance.

Board size

We believe companies should put in place a board that is appropriate for the size and complexity of the business. It is essential that the size of the board does not compromise a genuine and thorough exchange of ideas and efficient decision-making.

Board effectiveness reviews – internal and external

The evaluation of directors is an essential way to improve board effectiveness. It is also a way for investors to determine from the outside the quality of debate and interaction between board members.

We expect an internal board evaluation to take place annually. This evaluation should be led by the board chair, with assistance from the company secretary.

External reviewers can also bring different perspectives on the functioning of the board, as well as experience of how other boards operate. We expect an external evaluation of the board to take place at least every three years. This should be performed by an independent third party to avoid conflicts of interest. The board should approve the appointment of the reviewer and agree the scope of the evaluation at the outset. The board should receive and discuss the findings at the conclusion of the review. We expect the reviewer to follow the Code of Practice for reviewers set by the Chartered Governance Institute. The reviewer should not be used for more than six consecutive years.

In the interests of transparency, we expect the process and general outcomes of such evaluations to be published in the company's annual disclosures, as well as any progress made on the outcomes of previous board evaluations. Any potential conflict of interest with external reviewers should also be disclosed.

Non-executive director induction

The chair of the nomination committee is responsible for ensuring that incoming non-executive directors receive a comprehensive induction to the company on joining the board and that training is available on an ongoing basis. This will allow new directors to contribute to board meetings as soon as possible.

We support the view that companies should hold regular briefings or presentations to the board from divisional directors to ensure that members are kept informed on all aspects of the business. The company secretary can also assist non-executive directors with important training.

Directors should be encouraged to continually update their skills and knowledge and should agree on their specific training and developmental needs, which should include all aspects of social, environmental, ethical and reputational risks faced by the business. One way to remain up to date is to regularly meet with investors, along with other relevant board members, to gain knowledge and to hear various perspectives.

LGIM holds an annual event, usually in Q4, for non-executive directors, covering a number of ESG topics of interest. We also regularly publish thought leadership pieces and blogs on relevant topics related to corporate governance, stewardship and responsible investment, which can be accessed through our website and the LGIM.blog.

Stakeholder engagement

We believe companies should be managed taking account of the interests of their stakeholders on material issues. Understanding and taking account of key stakeholders' views will allow boards to create better alignment between the company and its stakeholders' interests. We expect companies to report in their annual disclosures how engagement with key stakeholders has fed into board discussions.

Employee voice

We believe investors should be able to hold directors accountable for their consideration of employee views.

We encourage companies to set up a structure that is most appropriate for their requirements. The UK Corporate Governance Code provides three alternatives approaches to consider:

- To appoint a worker director who sits at board meetings and is allowed to speak and provide feedback. FirstGroup plc is one example
- To establish a formal workforce advisory panel
- To appoint a non-executive director as a designated point of contact for workers

Companies should select the method(s) most appropriate to their own business.

Some factors we have observed that can be conducive to a good process:

- The selection of a method that builds trust within the company, is valued by all employees and encourages participation
- A clear mechanism for all staff to feed into the process, regardless of whether that is through regular meetings with their designated workforce member/non-executive director/employee director or via email
- Clear action plans for issues that affect employees and distribute these to all staff via newsletter or email. A dedicated page on the intranet, with its existence made known to all staff. Open and transparent communication is important to get employee buy-in to the process. 'Town Halls' should supplement written communication
- A feedback mechanism for employees
- Employee engagement and staff turnover should be tracked over time and published in the company's annual disclosures
- Exit interviews should be carried out by human resources, the output reviewed by the workforce representative, and any recurring themes should be investigated and reported to the board

We believe that sharing views internally can lead to innovation, problem solving and raised productivity, as studies show that there is a positive correlation between employee engagement and performance.

Companies should disclose in their annual disclosures the process adopted, examples of positive outcomes, improvements in employee engagement scores, as well as what percentage of employees consider the company a great place to work and the level of staff turnover over the past few years. Greater public disclosure will increase awareness, improve practices, and can lead to greater productivity and long-term performance for all companies in the market.

Employee directors – the board should determine if this model serves the interests of all of its stakeholders. However, if there is evidence, such as strikes or lawsuits that suggest the employee voice is not being heard, and this persists over a prolonged period, in addition to engagement with the company, we may take voting action by supporting any shareholder-led resolution calling for action.

Investor dialogue

We believe that engagement constitutes a vital risk-mitigation tool for the board. Engagement with investors should be a two-way discussion. Board directors should aim to use engagement meetings with investors as an opportunity to explain company decisions and to make sure they are well understood by the market. Such meetings should also be an opportunity to listen to investors, use their experience and act on their feedback.

Our position on board-investor dialogue is available on our website.

Culture

Culture has become an increasingly discussed topic in recent years among businesses, investors and even regulators. Its measurement and assessment is an exercise we expect the board to undertake.

Companies should maintain the highest standards of conduct towards all stakeholders. The board should promote behaviour and values that demonstrate integrity and respect.

Company boards should disclose information that helps investors understand their culture. Investors need reassurance that the CEO and management are really driving the cultural message and setting the tone from the top, and that this is regularly discussed and challenged by the board, which should monitor how the cultural message is filtering down to the rest of the organisation.

We expect companies to disclose information including:

- How they measure culture and how that relates to the business strategy
- How their mission statement and values are communicated and reinforced
- Any key performance indicators that are linked to culture

LGIM may vote against the re-election of directors who we believe have not demonstrated good business conduct. E.g., harassment, fraud, etc.

Board committees

Board committees ensure that specific directors are responsible for key board functions. We expect all listed companies to put in place three separate board committees, responsible for the core functions of audit, nomination and remuneration.

To enable investors to assess their effectiveness, we expect the role, composition and activities of all board committees to be published in the annual disclosure documents.

Audit committee

The audit committee is responsible for:

- Monitoring the integrity of the financial statements of the company
- Appointing external auditors
- Monitoring their qualifications, independence, effectiveness and resource levels

This committee is also responsible for the overall risk management of the company to ensure that sound and robust internal controls are in place to appropriately manage the company's financial, operational and reputational risks.

As the audit committee plays a vital role in safeguarding investors' interests, we expect all companies to have an audit committee comprising only independent non-executive directors. The committee should have at least three members, with sufficient financial experience to provide oversight and accountability; as such, we expect the audit chair to have financial expertise, without which LGIM will vote against the re-election of the audit chair.

Non-independent directors may attend audit committee meetings by invitation, but they should not be members of the committee. The board chair should not be a member of this committee.

Members should have sufficient time to examine the company's financial statements and to liaise with internal and external auditors. The implementation of the government's proposals to improve the UK's audit, corporate reporting and corporate governance systems, will result in an additional time commitment from the audit committee to oversee the reporting and assurance requirements. Therefore, over the next few years, we expect FTSE 350 companies to increase the number of audit committee meetings they hold to four or more a year.

The chair of the audit committee should be available to answer investors' concerns on specific audit issues.

To provide further transparency, we would expect the auditor's report to provide information about potentially material issues that were raised by the auditor as a concern and subsequently dismissed by the board, and the reasons for any decisions.

Nomination committee

The nomination committee is responsible for overseeing all board and senior executive appointments, ensuring an orderly and successful board and executive succession process. The committee should ensure the board has the right composition, taking account of important governance considerations, such as skill sets, diversity, tenure and over-boarding.

The focus of the committee should not be restricted to the board, but must also seek to include alignment with the rest of the workforce in terms of human capital policies. The committee should work closely with the remuneration committee to ensure that appropriate service contracts are in place.

Given the key role of this committee in board composition matters, the majority of its members should be independent non-executive directors. The company board chair may be a member, or even chair, of the committee if they are considered independent. We assess the board chair's independence on an annual basis.

The committee chair should be answerable to investors if it is felt that appropriate succession plans are not in place or where there are concerns over the composition of the board.

Remuneration committee

The chair of the remuneration committee should have appropriate knowledge of the business to align the remuneration with its strategy. For this reason, the person appointed to the role of remuneration committee chair should have served as a member of the board for at least a year prior to their appointment as chair of the committee.

We expect remuneration committees to consist exclusively of independent non-executive directors. The company board chair can be a member of the committee if they are independent, but they should not chair the committee. We assess the chair's independence on an annual basis.

Non-independent directors may attend remuneration committee meetings by invitation, but should not be members of the committee.

We expect remuneration committees to set the remuneration policy for the executive directors, the chair and senior management.

Remuneration committees should:

- Seek independent advice. External advisers, consultants and internal employees advising the committee should be fully accountable to the committee. The committee should exercise its own independent judgement when considering any advice provided by third parties
- Consider carefully and be able to demonstrate how they have reviewed the pay and related policies of the workforce when setting pay for the executive team and be able to demonstrate how this is aligned with the culture of the company
- Challenge management if the company is paying less than the real living wage as set out by the Living Wage Foundation, or if the company is not offering all employees the chance to work a minimum of 15 hours per week. This represents the minimum a company should be doing to reduce income inequality and poverty within its workforce
- Give consideration to the views of the company's shareholders. Many institutional investors' pay policies are available on their websites. LGIM's pay policies are on our website and we communicate these policies with remuneration consultants annually, so that they can provide better advice to companies

We will vote against the election of individual board directors when we do not support remuneration for the second-consecutive year. We may also vote against individual directors where there are particularly contentious issues.

A large voting opposition (more than 20%) to remuneration proposals should not be ignored. Remuneration committees should:

- Hold themselves accountable for the decisions taken that led to the high vote against executive remuneration
- Publish an explanation for the dissent, including what the board is doing to address shareholder concerns. This should be sent to the Investment Association for inclusion in the Public Register. An explanation should also be included in the remuneration committee chair's statement in the next annual report

Additional board committees

Companies may consider it appropriate to set up additional board committees to assist in discussions. These committees are useful where the board could benefit from an increased focus on an issue that is directly linked to its long-term success, or where the company operates in a high-risk sector. In particular, for companies where environmental and social (E&S) risks represent a material part of the business model, LGIM would recommend that a sustainability committee be established that includes board members.

Advisory committees

In other cases, boards may consider the need for direct access to independent and external advice and expertise from third parties or stakeholders. We are supportive of companies setting up advisory committees. This is a flexible option to obtain specific and relevant information to assist the board and management in their decision-making without having to affect the size and composition of the board.

Board responsiveness

Voting at company meetings is part of a shareholder's escalation strategy to signal concerns with aspects of governance. Where 20% or more of the votes have been cast against a board's recommended resolution, we expect the board to engage with shareholders to determine their reasons. The next annual report should provide information on the steps taken to address shareholder concerns.

A vote against a relevant director's re-election may be applied if a company has not provided information regarding the concerns expressed by shareholders that led to the high vote against, and any actions taken by the board to address shareholder concerns.

Audit, risk and internal controls

The board is responsible for determining and disclosing the company's approach to risk, its risk appetite, and monitoring the outcomes and controls in place for effective risk management.

It is also responsible to investors for presenting a true and fair view of the financial position of the company, and it should set out future capital management plans and its near-term financial prospects.

Processes and procedures should be established to ensure the independence and robustness of the internal and external audit functions.

Assessing the effectiveness of the resources available for the internal and external audit functions forms part of the board's responsibilities. We expect boards to report to investors in their annual disclosures their conclusions following this review, along with any noted areas of concern and actions taken to address such concerns.

Compliance with regulations

The audit and risk committee should ensure that all laws and applicable regulations are complied with, so as not to expose the company to the undue risk of fines, censorship and reputational damage. We will hold the audit committee chair responsible for failing to detect breaches in accounting practices. Where a company has failed to act in line with applicable laws such as the Modern Slavery Act or the Companies Act, we may not support the approval of the annual report and accounts.

Climate Risks

We expect companies for whom climate change is a material financial risk, to appropriately reflect these risks in the scenarios, assumptions and estimates used to prepare their financial accounts. Companies should ensure, through transparent disclosure, that there is consistency between their narrative on climate change and their accounting determinations. In addition to our ongoing targeted engagements relating to climate accounting topics, we will develop our work further in this area. This may lead to applying voting sanctions on companies that fall short of minimum expectations from 2024.

External audit

An external audit provides independent assurance of the financial statements of a company to its investors. The role of the auditor is to provide reasonable assurance that the financial statements give a true and fair view of the financial health of the company and that they have been prepared in accordance with the appropriate accounting standard. Any significant matters raised by the auditors ought to be fully explained by the board, including how these have been addressed.

The external auditors are also responsible for producing the auditor's report, which is a formal opinion and evaluation of the financial statements. We support and encourage the use of an extended audit report to provide investors with greater insight into the auditor's assessment of the accounts.

We believe the role of the external auditor should be put to tender on a regular basis, at least every 10 years, with the total tenure of the audit firm not exceeding 20 years. LGIM will not support the re-appointment of the external auditor if it has served as auditor for more than 20 consecutive years. Within this timeframe, we expect the lead audit partner to be subject to refreshment at least every five years.

We also expect companies to include an audit firm that is not one of the global top four firms in the tender process. The way the tender is carried out should be explained, covering whether it included a firm outside the global top four firms and why the final decision was taken.

The board is responsible for appointing the external auditor. The company is expected to clearly disclose the audit firm used, the partner who led the audit and the tenure of that firm. In addition, the audit committee should outline its criteria for how it has assessed the independence and quality of the audit and whether it is considered effective. Where the auditor is newly appointed, the audit committee should comment on whether the performance of the audit met its expectations as set out during the tender process.

The fees for the external audit should be disclosed in the annual report. Where the external auditor provides non-audit services, these should be fully explained in the company's annual disclosures. We expect non-audit services provided to be incidental to the audit, with the primary purpose of improving the quality of the financial accounts. We do not expect excessive non-audit work to be conducted by the company's external auditor, as this will bring into question the independence of their judgement.

Non-audit-related services are not expected to exceed 50% of the value of the audit services in any given year. We believe auditor liability is an important and proportional approach to supporting a high-quality audit. We are not supportive of a fixed auditor liability or restrictions on that liability.

Recommendations arising from the external audit are to be overseen by the board and the audit committee and should be reported to investors when they are considered material by the board and/or the audit partner.

Our article on the audit tender process can be found here.

Internal audit

Companies should have an effective and sufficiently resourced internal audit system in place that is designed to take account of new and emerging risks that may affect their business objectives and identify the level of risk taken. The processes and procedures in place to manage such risks should be embedded in the risk-based control system for the company and summarised in the annual report. The audit committee should have responsibility for and oversight of the internal audit function.

Whistleblowing

We expect companies to establish a whistleblowing policy that is integrated into its code of conduct. The policy should be publicly disclosed and open to all employees including those within the supply chain. The whistleblowing reporting channels should be easily identified and independent from management, with a direct line to the audit committee to allow for appropriate oversight and independent escalation where necessary. Companies should ensure their policy safeguards the identity of any whistle-blower

and that they are protected from internal harassment. Companies should also report how the risks associated with bribery and other illegal behaviour are being monitored and addressed.

Cybersecurity

The vulnerability of a company's IT systems can lead to material financial impact and reputational damage. Therefore, we expect a risk-based approach to be taken to address the issue of cyber-security and data protection. It should be integrated into the control functions of the business and overseen from a strategic perspective by the board. It is the board's role to understand the infrastructure needed in the business to protect valuable information assets, key intellectual property and customer's confidential data. Therefore, accountability should not be delegated. Cybersecurity should be a regular board agenda item. Any data breach incident should be disclosed to customers and the market in a timely manner.

Remuneration

We are increasingly concerned about the misalignment of the level of executive pay versus company performance, and the current social sensitivities around income inequality.

To address the issue of income inequality, LGIM expects the remuneration committee to be mindful of the pay and benefits offered throughout the organisation. LGIM's minimum expectations on employee pay and wellbeing can be found below.

As a long-term and engaged investor, we trust company boards to ensure executive directors' pay is fair, balanced and aligned with the strategy and long-term growth and performance of the business. In line with LGIM's long-term investment horizon, we expect executive directors' pay to reflect financial performance, operational and strategic measures and to be achieved within a long-term, sustainable framework.

The remuneration committee chair's statement should explain:

- Why the outcome of the single figure is appropriate, taking account of the delivery of key performance indicators (KPIs), employee pay and shareholder experience in terms of value created
- Why the chosen remuneration award level is appropriate for the company. Any explanation should avoid as its main argument comparisons with peer median pay
- Details of engagements undertaken with all stakeholders referencing any meeting that has taken place with the workforce to explain how executive remuneration aligns with the wider company's pay policy. How engagement with shareholders has influenced the remuneration policy and outcomes
- Any application of discretion (up or down) during the year. We define discretion as any change that alters the monetary outcome. Where discretion results in remuneration increasing, disclosures should set out when downward discretion was previously applied. Finally, we expect disclosures to explain what the monetary outcome would have been had the discretion not been applied. This will help us reach our own judgement on the level of fairness.

We expect companies to consider our principles below when setting pay policies for their executive board.

Key principles

We apply a set of simple pay principles when looking at remuneration structures:

1. The structure of remuneration and the payments awarded should be fair, balanced and understandable. This means fair in terms of what the company has achieved; balanced in terms of the amount paid to the executive, employees and investors; and understandable for the recipient, the board and investors.
2. Awards should incentivise long-term thinking by management and be aligned with and support the achievements of the business strategy and objectives.
3. Executives should have meaningful direct equity holdings while employed and thereafter; buying shares is one of the best ways of aligning the interests of management and investors.

4. Boards should retain the ultimate flexibility to apply discretion and 'sense check' final payments to ensure that they are aligned with the underlying long-term performance of the business.

5. Companies should be transparent on why rewards have been transferred to the executive, setting out targets, their relevance to meeting long-term goals, which targets were met and justifying all adjustments made to accounting measures for remuneration purposes.

Fixed remuneration

We expect a base salary for executives to be commensurate with the size and complexity of the company. Although salary levels at peer companies may be considered, these should not set a definite benchmark. Salary increases should not be automatic each year. Any increase to salary levels should not exceed what is offered to the general workforce, and its impact on total remuneration should be assessed before approval.

Addressing the cost-of-living crisis – the remuneration committee of those companies that have decided to give employees on lower salaries a significant pay increase to help them navigate the current crisis should exercise caution if they plan to use the average workforce salary increase rate when setting executive salaries. Consideration should be given to the impact of a similar increase on the total pay for an executive, given the inclusion of incentives that are based on a percentage of base pay.

Incentive arrangements

Annual bonus

Companies may choose to award annual incentives to executive directors. We believe that any annual incentive should be geared to delivering operational performance. A significant portion of the annual incentive should be linked to the delivery of financial performance.

The bonus should be set as an appropriate proportion of base salary and be capped.

In line with our focus on long-term growth and performance, we would encourage the reduction of short-term annual bonus levels. A bonus of 200% of salary should be reserved for the largest global companies. We will generally not support any increases to the annual bonus.

Personal performance: LGIM's current view is that for board directors, personal performance amounts to delivering the strategy. We therefore expect strategic targets to be meaningful and quantifiable. We are conscious that the weighting for personal/strategic targets continues to grow. LGIM may vote against the remuneration policy if the weighting is high and the measures are not meaningful/quantifiable or sufficiently explained. LGIM expects a threshold level of corporate financial performance to be met before any element under this section is triggered. The exception being in a turnaround situation when changes to non-financial strategic targets may take priority for a few years. However, these circumstances should be clearly explained within the remuneration report.

To highlight the integrity of the target-setting process, companies should disclose the weightings of each bonus component and the target ranges, at the very least on a retrospective basis.

Targets that are commercially sensitive to the business should be disclosed within a year of payment; if this is not possible, an explanation of why the target continues to be commercially sensitive is expected.

Strategic/qualitative and personal targets should be separated with each having its own weighting. These targets and the eventual outcome should be fully explained.

Companies exposed to high levels of environmental, social or governance (ESG) risks should include relevant and clearly measurable targets that focus management on mitigating these risks. ESG metrics should be meaningful, measurable, aligned to the company's strategy and subject to third-party verification.

For companies in high-risk sectors, where the health and safety of employees is key, we would expect a health and safety modifier to be introduced to the annual bonus to ensure that board members are held accountable for any loss of life within the workplace. Where a company is held responsible for any fatality within the workplace, we expect the remuneration committee to apply downward discretion on any performance-based pay earned. Although we expect any reduction to be material, if it is less than 20%, LGIM will vote against the remuneration report.

We ask companies to pay a portion (at least one-third) of the bonus in the form of shares that are deferred for at least two years on an ongoing basis. We also expect companies to put in place contractual and statutory provisions that may allow for a reduction or forfeiture of the annual bonus component in exceptional circumstances. To provide clarity, what constitutes exceptional circumstances should be set out, but should not be too narrowly defined.

Long-term incentive plan (LTIP)

We believe companies should motivate and reward executives by granting equity incentives that will align their interests with those of long-term investors. Incentives should be structured to motivate management to build a sustainable business that will generate positive returns for investors over the longer term. We therefore strongly encourage all companies to put in place a long-term incentive plan.

In the interest of simplicity, we advocate the adoption of one long-term plan. We strongly discourage the adoption of any additional incentive plans that would complicate the remuneration structure.

LTIP awards:

- Should be capped either as a percentage of salary or a fixed number of shares. Where a fixed number of shares is used, we would expect the level of award being offered to be reviewed every three years to ensure it is at a level commensurate to when the plan was first adopted. Any increase to levels of reward should be subject to shareholder approval.
- Where a company has experienced a significant fall in the value of its shares, resulting in a greater number of shares being awarded under incentive plans for the year, companies are expected to reduce the size of the award to ensure there is no prospect of reward for failure. Where this has not happened, the committee should provide an undertaking to reduce awards when they vest. At the point of vesting, LGIM will expect a detailed explanation of how the remuneration committee has applied discretion to ensure appropriate adjustments were made to avoid windfall gains. LGIM will vote against the remuneration report where we believe that the remuneration committee has not been thorough in its decision-making and/or not provided sufficient information to explain its final decision.

LTIP performance conditions:

As a general rule, long-term incentive performance targets should be disclosed in advance and should not be adjusted retrospectively.

We do not generally support the setting of targets at a level that is below the previous year's performance goals. However, if due to exceptional circumstances the remuneration committee believes it is appropriate to set lower targets, we would expect to understand why the new targets are considered to be equally stretching. Without such an explanation we would expect a reduction to the award size to reflect the reduction in performance targets.

The board should determine the right metrics to deliver the strategy and ensure that the level of stretch in the target is appropriate to deliver the right outcomes for all stakeholders. Metrics should be linked to long-term strategy and should be challenging, but achievable, without encouraging undue risk-taking.

Financial performance targets should use the reported numbers without further adjustments, save for share buy-backs and other capital changes. Any adjustments should be consistent, explained and reconciled with reported numbers.

Long-term incentive performance metrics should be measured over a period of not less than three years. We do not support retrospective changes to pre-set performance conditions.

The LTIP should not have too many performance conditions, as each additional measure will dilute the importance of the performance that it intends to reward and increase complexity. We expect at least one measure to be linked to shareholder returns. Other measures should be linked to the strategy of the business, such as KPIs that are selected by the board and reflect the company's ESG risks as well as target opportunities.

Use of ESG metrics:

ESG metrics should be meaningful, measurable, aligned to the company's strategy and subject to third-party verification.

Companies within sectors that can have a significant effect on climate change should link part of their pay to delivering on their climate mitigation goals. The performance targets should be linked to SBTi approved/or equivalent transition plans aimed to achieve net zero by 2050 or sooner. Targets should also be set to create new opportunities that not only improve revenue, but also have a positive impact on climate.

By 2025, companies will be five years away from reaching their 2030 climate change transition goals. By this time, we expect a majority of companies to have a clear idea of what must be done to hit these crucial targets. Therefore, from 2025, LGIM will be escalating its policy on climate change. To gain LGIM's support for a new remuneration policy being put to shareholders from January 2025, we will expect to see climate targets within the long-term plan. These targets should be in line with stated transition goals to reaching net zero and across the full value chain (scope 1-3). Ideally, they should be SBTi approved.

This will apply to companies in the following sectors: Autos, Apparel, Aviation, Aluminium, Banks, Cement, Chemicals, Food, Forestry, Glass, Insurance, Logistics, Mining, Oil & Gas, REITs, Shipping, Steel, Technology and Telecoms, Multi-Utilities and Utilities.

The weighting for climate targets should represent at least 20% of the overall LTIP award at these companies. For those companies that have adopted a restricted share plan, one of the underpins should be specific to achieving set transitional carbon reduction targets.

The use of diversity targets would be relevant for sectors that struggle to recruit women.

LGIM discourages the use of employee engagement targets, as we believe this is something a well-governed company with an inclusive culture should be doing. Financial incentives should not be necessary to drive such a programme. A better metric for companies, especially those that have a high level of staff turnover, would be to set targets around employee retention to gauge whether their policies are working.

Oil and gas companies – remuneration should prioritise financial value over fossil fuel production volumes. The use of measures that directly encourage volume growth (such as reserve replacement ratios or production targets) risks incentivising overinvestment at a time when growth in demand seems increasingly uncertain and should therefore be avoided. LGIM prefers financial measures (relating to total shareholder return, balance sheet strength) or other strategic metrics. The use of volume growth targets may result in a negative vote.

Accrued dividends on share awards should only be paid on those shares that ultimately vest.

Restricted schemes

We do not believe that this structure is right for all companies. Therefore, companies will have to justify why this type of arrangement is appropriate and why the existing incentive structure is no longer suitable. We expect a restricted scheme to have the following attributes:

- Award levels should be reduced to 50% or less of the normal long-term incentive grant, to take account of certainty of reward
- Restricted schemes should be long term and applied through different business cycles
- Shares should be held for a minimum of five years prior to release
- The vesting of shares should be subject to a) meeting a threshold level of financial performance that is pre-disclosed, b) the remuneration committee being satisfied that over the period since grant, the company's overall performance and the individual's leadership is such that the release of shares is warranted; and c) from 2025, for those companies in the sectors that have the greatest impact on climate change - meeting pre-disclosed transition climate targets should act as an additional gateway
- Discretion may be applied to reduce awards if at the end of the holding period, the company's performance and the shareholder experience are not aligned (see: p23, para. 2 of the Executive Remuneration Working Group report)
- For leavers, unvested restricted shares should be pro-rated for time and subject to the same vesting timeframe and holding requirements as set out above
- A shareholding guideline must be in place that is material while in employment and following the participant's departure from the board

- In keeping with our policy for other long-term incentive plans, LGIM expects substantial share price falls over the year to be captured in the grant size of restricted share awards

Holding periods

We encourage the use of post-vesting holding periods because we find this helps align the remuneration structure with long-term performance.

Malus and clawback

Employment contracts should be designed to enable the application of malus and clawback, which should apply to all elements of variable remuneration.

To provide clarity for all stakeholders, remuneration committees should set out the circumstances under which malus and clawback will be applied. These circumstances should not be too narrowly defined.

Equity dilution

We believe that strict guidelines should be adhered to in relation to the issuance of shares for incentive schemes to limit potential dilution for shareholders. We expect no more than 10% of a company's equity to be used for all share schemes over a 10-year period and no more than 5% in 10 years for discretionary schemes. The annual run rate, or burn rate, should also be reasonable, or about 1%.

Treasury shares should be included within these limits. Such restrictions should apply to all shares, whether they are market purchased or newly issued.

Shareholding guidelines

We expect companies to encourage their directors and senior executives to build up and retain a meaningful interest in the shares of the company they manage. This is an essential part of aligning directors' interests with those of investors.

As a minimum, a shareholding guideline should be equivalent to the value of the annual share award made under an LTIP, or equivalent to three years of restricted share awards.

LGIM expects 100% of vested LTIP and deferred bonus shares to be retained (except those sold for tax purposes) until the shareholding requirement is achieved.

Vested shares, deferred bonus shares and shares subject to a holding period can count towards meeting shareholding guidelines.

Directors should be encouraged to buy shares and pledge them to meet the shareholding guideline, until such time as sufficient shares have been earned through incentive arrangements.

Post-exit shareholding requirement

To promote long-term strategic decisions and shareholder alignment, directors should continue to hold a meaningful number of shares even after departure from the company.

Post-exit shareholding guidelines should reflect a significant proportion of the prevailing minimum shareholding requirement (no less than 80% of the in-post requirement).

These guidelines should remain in place for two years following the cessation of employment.

Where a company has set an in-post shareholding guideline that is substantially greater than LGIM's minimum expectations, then we will support a proportionally lower post-exit shareholding requirement providing it remains at least 80% of LGIM's minimum shareholding expectation.

Any shares purchased by a director with personal funds are excluded from the post-exit shareholding requirement.

Pensions

Pensions are a significant cost and risk for a company, as well as an element of remuneration that is not linked to performance, therefore the cost of providing a pension should be taken account of when evaluating a remuneration package. We will not support pension enhancement payments at retirement or when a contract is terminated early. Additionally, we will not support an individual being compensated for changes in tax. Companies should aim to reduce their pension fund liabilities and costs when recruiting new executives.

Pension provisions should be disclosed in full in the annual report and any changes to pension benefits should be fully explained.

Pension arrangements should be reduced over time so that they are more closely aligned with the general workforce.

For any remuneration policies that are up for renewal, we expect companies to introduce a pension provision for new and incumbent directors that is aligned with what is being offered to the general workforce.

We will vote against any new remuneration policy that has not introduced changes to address a disparity in pension provisions, unless the company can demonstrate that similar arrangements are available to the workforce.

Service contracts and termination payments

Executive contracts should provide for a maximum notice period of 12 months. We do not support provisions within service contracts that enhance contractual terms for loss of office following a change in control.

We would expect the notice period to be the same for employer and employee.

The contracts of key people should provide the company with the authority to claw back unvested and vested awards.

New joiners

When setting the remuneration package of a new executive who lacks experience of the company and/or the role, we encourage the remuneration committee to consider placing the individual on a lower salary than their predecessor with a view to increasing their pay over an extended period, subject to performance. The intention to adopt this policy should be highlighted to shareholders in the annual disclosures until the executive has reached market rates for the role.

Where possible, the existing remuneration arrangements should be used to incentivise new appointees.

New recruits should be encouraged to purchase shares in the company. Additional benefits in relation to the appointment, such as assistance to relocate, should mirror what is being offered to employees at all levels and have a time limit of two years.

The use of 'golden hello' payments is not supported. The use of buy-out awards is discouraged; however, where it is considered necessary it should only cover the expected loss of value and be awarded predominately in shares and subject to performance.

Departing directors

We expect companies to ensure that there have been no rewards for failure. Therefore, remuneration committees should take account of poor performance or any exceptional events, i.e. loss of life, when determining whether a director should be paid a bonus for the period worked.

Except for dismissal for cause and/or poor performance where awards are expected to lapse, any outstanding awards for leavers should be time pro-rated and allowed to run their course, subject to the same vesting conditions that applied at grant.

'Golden handshakes' are not supported, and any gift with a material value should be disclosed.

Benchmarking

When using benchmark data, remuneration committees should take into consideration factors such as: company size, geographic spread and performance relative to the benchmark peers. The peer group used should not be too large or too small as both extremes could produce misleading results. Companies should ensure they disclose meaningful information on the benchmarking data used and why it has selected the benchmark group. Directors at underperforming companies should not expect to be remunerated as highly as directors of companies where the performance has been outstanding.

Discretion

Companies can build trust with investors if they can demonstrate restraint, consistency and alignment with investor interests. Discretion applied to any earned award by executives is one way to demonstrate this alignment. We define discretion as anything that alters the monetary outcome of total remuneration.

We expect companies to set out:

- The main reasons that might give rise to the application of discretion

- Whether their discretion policy would apply to revising pay upwards as well as downwards
- The elements of pay to which discretion may be applied
- The effect that the application of discretion has had on the director's final pay outcome

Non-executive directors' fees

Non-executive directors' fees should reflect their level of responsibility and the time commitment of the role. The use of share options or other performance-related pay is not supported, but a proportion of the fixed fees being paid in shares is encouraged.

Other disclosures

Consultants' fees

A breakdown of fees paid to remuneration consultants should be disclosed, i.e. between those for advice to the remuneration committee and fees for other pay-related services to the company, to ensure impartiality.

The pay ratios

The Companies (Miscellaneous Reporting) Regulations 2018 were published in August 2018, requiring companies with an average number of UK employees of 250 or more to provide a set of pay ratios based on the CEO total single-figure remuneration versus the 25th percentile, 50th percentile and 75th percentile employee. Companies were offered three methods to select from in calculating these ratios.

We expect all companies to provide a pay ratio regardless of whether they have 250 full-time equivalent UK employees or not. Where they do not have 250 UK employees, a statement to this effect can explain the basis on which the ratio was calculated.

We would expect companies to use methodology option A – which requires the company to calculate the pay and benefits of all its UK employees for the relevant financial year, to identify their 25th, 50th and 75th percentile employee, and to use these numbers when calculating the ratios. Where a company opts for another method, we would expect a full explanation of why option A was not possible.

Remuneration policy table

The policy table provides an opportunity to explain in straightforward terms the company's remuneration structure.

We will particularly look for:

- How the company will address salaries over the next three years
- The company's policy on executive pension provisions and other in-service benefits
- Details of the maximum awards under the bonus/long-term plans
- The size of normal awards if they differ from the maximum
- Performance measures that will apply under the annual bonus and long-term plan, including the weights between the measures
- An explanation for the total potential award

Shareholder and bondholder rights

The provision of shareholder and bondholder rights is a basic entitlement for investors. We expect companies to acknowledge and respect the rights of investors by adhering to the highest market standards. This includes providing high-quality disclosures and equal treatment of shareholders. Below, we have outlined guidance on the topical issues that concern us as an investor:

Voting rights and share-class structures

LGIM supports the ‘one share one vote’ philosophy and favours share structures where all shares have equal voting rights and those rights are equal to the economic value held.

We do not support the issue of shares with enhanced or impaired voting rights.

Amendments to the company's constitution

It is common to see requests from companies seeking approval to update/amend their constitution.

We expect these changes to be clearly outlined and disclosed in the notice of meeting. We do not support changes to a company’s constitution that curtail or reduce shareholder rights.

We would expect substantially different changes to a company’s constitution to be proposed under separate resolutions and not to be bundled into a single amendment to the constitution. Where such a bundled resolution includes one or more changes that are not deemed supportable, this will lead to a vote against the entire proposal under the resolution.

Virtual/electronic general meetings

We believe that a company’s general meetings for shareholders are fundamentally important to the exercise of shareholder rights and integral to a good corporate governance system. Furthermore, we view physical shareholder meetings as providing an important mechanism by which a board is held publicly accountable to all its shareholders, both institutional and retail.

Shareholder meetings provide an invaluable opportunity to raise concerns with a board in a public forum and investors are able to use this mechanism as part of their stewardship activities. For example, they could be utilised as an escalation tool that enables shareholders to make statements and pose questions to the whole board.

We are cognisant that companies are keen to make sure that their shareholder communications keep pace with developing technology and conducting shareholder meetings electronically is an area of focus. We also agree that using technology, such as webcasts, to complement the physical shareholder meeting could be beneficial and could increase investor participation.

However, we believe that such technology should be used in parallel with the in-person meeting and should not lead to companies adopting a virtual-only approach. The shareholder meeting is the only

time that the whole board is present and publicly accountable to all shareholders. The attendance of the board at such meetings is a demonstration of its commitment to hear and understand the views of shareholders.

Virtual-only shareholder meetings remove this accountability due to the remoteness of participants.

Therefore, we are not supportive of the move towards virtual-only shareholder meetings. Any amendments to a company's constitution in relation to electronic meetings should confirm that a physical meeting will continue to be held unless it is prohibited by law.

Capital management

The board has a key responsibility to ensure a company has sufficient capital, overseeing the capital management of the company, efficient capital allocation and, when additional capital is required, facilitating its raising in an appropriate way.

Balancing the long-term investment needs of the company with shorter-term returns to investors is a critical role of the board.

Therefore, we support the right of shareholders to have a separate vote on the tools and authorities provided to the board to manage its capital structures. Such rights protect shareholder interests while balancing the need for board flexibility. For example, making sure that share issuances are not dilutive and capital is being raised in the long-term interests of investors.

Share issuance

We support a company's entitlement to issue shares to raise capital. However, such issuances should be limited to what is necessary to maintain business operations and should not expose minority shareholders to excessive dilution of their holdings in the company's shares. We would support a general authority to allot up to two-thirds of the issued share capital on a pre-emptive basis.

The existence of pre-emption rights is fundamental to protect shareholders from excessive dilution. It gives existing shareholders the right to be offered any new shares, pro-rata to their existing holdings, ahead of these being offered to non-shareholders.

In 2022, the pre-emption group updated its guidance on the level of share issuance that can be issued on a non-pre-emptive basis. The new limits permit the issuance of up to 10% of the issued share capital non-pre-emptively with a further 10% for financing an acquisition or other specified capital investment that has been disclosed. Although we generally support the template resolutions published by The Pre-Emption Group and expect such requests to be proposed as separate resolutions for shareholder approval, we would be concerned if companies were to adopt this level of dilution as the new norm, particularly large-cap companies. We would only expect companies to dilute shareholders to this extent where an injection of capital was time critical. We will be monitoring how companies apply this increased authority over the next few years before we provide further guidance.

We will not support the re-issue of shares at a discount to their net asset value.

Share repurchases or buybacks

Share repurchases or buybacks can be a flexible way to return cash to shareholders. We expect the board to be transparent in how the share buyback authority will be used in relation to other uses of capital (such as dividends, internal investment or externally for mergers and acquisitions).

However, the benefits of using this approach are dependent on factors such as the price at which shares are bought back, the company's individual financial circumstances and wider market conditions at the time. When utilising this authority, we expect companies to consider its impact on other areas.

For example, on remuneration, performance conditions governing incentive schemes may be affected by the exercise of a buyback authority. Furthermore, given the reduction in the number of shares in the market, the holdings of large shareholders will also increase, giving them more control. We would expect greater detail on the rationale for any buyback authority that is greater than 10% of the issued share capital.

Rule 9 waiver

Share buybacks can trigger Rule 9 of the Takeover Code where there is a significant shareholder or a concert party whose shares account for 30% or more of the issued share capital. In such circumstances, a share buyback can result in an automatic increase to their shareholding and eventual control without paying minority shareholders a premium. We will oppose Rule 9 waivers unless a mechanism is applied whereby any significant shareholder or concert party will participate in the sale to ensure their voting powers remain unchanged.

Debt issuance

Good transparency and disclosure by the company on the issuance of bonds is important for debt investors. In their reporting, we expect companies to include:

- A timely release of publicly available prospectuses both before the new issue and while the bonds remain outstanding
- A commitment to provide public access to on-going financials and disclosures
- A five-year financial history of the company.

Mergers and acquisitions (M&A)

We support proposals that are expected to create value for investors over the long term.

To enable an informed assessment, we expect management to be transparent on the terms of the merger and its financial and cultural integration implications for the long-term business strategy. We also expect companies to explain how the transaction is expected to yield significant long-term benefits for the company and its stakeholders, including its investors. We encourage company the chair and non-executive directors to hold separate meetings with investors without management present, and to have an honest conversation about the risks and opportunities of the transaction. In a contested takeover, we will aim to meet with both parties before making a final decision.

In addition, we believe that a strong governance framework is essential during any M&A activity. Companies should therefore make sure the independent non-executive directors are informed at an early stage and can obtain independent advice at the cost of the company, with advisers remunerated on a fixed-fee basis. A process should be in place to ensure there are no conflicts of interest. The skillset of the board must also be reviewed, including past M&A experience, to ensure the board is appropriately equipped to successfully lead the transaction and manage its impact on the company.

The board may also consider putting in place a separate ad hoc committee of independent non-executive directors.

Related party transactions

Related party transactions (e.g. between a controlling shareholder and an issuer) are an important issue for minority shareholders as there is a risk that a related party may take advantage of its position. Adequate safeguards must be put in place to provide protection for the interests of the company and the shareholders who are not a related party, including minority shareholders.

All transactions must be authorised by the board of directors. We also expect companies to set up a fully independent audit committee, which ensures that such transactions are conducted based on an independent assessment and valuation.

In addition, we expect companies to disclose sufficient information about such transactions in their annual disclosures to enable informed voting decisions to be made.

In line with the continuing obligation for listed companies, those companies with controlling shareholders should ensure that they have in place a controlling shareholder agreement. This is to demonstrate that, despite having a controlling shareholder, the listed company is at all times able to carry on its activities as an independent business.

Shareholder proposals

We consider all shareholder proposals tabled at a company’s shareholder meeting in the wider context of the corporate governance practices at the company and the long-term benefits for investors. We expect companies to provide a meaningful discussion of the proposals to enable shareholders to make an informed judgement. We expect majority-supported shareholder proposals to be adopted. Where there has been significant support (20% or more), we expect companies to consider the benefits of the

proposal and to discuss this with their shareholders and to include any outcomes in their annual disclosures.

Political donations and lobbying activity

We will not support direct donations to political parties or individual political candidates by companies. We believe that companies should fully disclose all political contributions, direct lobbying activity, political involvement and indirect lobbying via trade associations. There should be increased transparency regarding membership of and monies paid to trade associations and lobbying groups, including:

- A breakdown of payments to political parties, candidates and associations, trade associations and think tanks, and of direct and indirect lobbying activity on policy and legislative proposals, etc
- A clear explanation of how each of the above associations, contributions and actions etc benefit the causes the company supports and their link to the company's strategy
- A public statement from the company outlining those issues where it disagrees with the associations of which it is a member and setting out why continued membership is beneficial
- Disclosure of where responsibility sits within the company for the oversight of such relationships

Sustainability

As a major global investor, we have a fundamental interest in ensuring that shareholder and bondholder value is not eroded by a company's failure to manage the risks associated with its natural and social environment. We believe that, if companies take advantage of the need to move towards a more sustainable economy, investors can benefit through protection from future risks and the potential of better long-term financial outcomes.

Sustainability governance, process and operations

With this in mind, we expect our investee companies to meet minimum standards in how they identify, assess, manage and disclose sustainability-related risks and opportunities across their business operations. Our key expectations are laid out below:

Risk identification and management

Material environmental and social (E&S) risks will vary between sectors and from company to company, depending on a range of factors. Stakeholders will also have different views on what issues are material for them. Despite this complexity, it is important that all companies across different sectors undertake an analysis of E&S issues that could be material to their business over varying timeframes.

A dynamic risk-mapping exercise should identify the degree to which a company is exposed to each risk element. It should also be used to identify business opportunities such as new products and services, and potential efficiency gains as a result of changing policy, technology and business environments.

Robust E&S risk-management processes should be integrated into company Enterprise Risk Management (ERM) systems. The approach should be holistic and implemented across all business operations that either can be considered exposed to environmental and social-related risks, and/or that may produce negative externalities. Where possible, such systems and processes should be externally verified.

Where risks have been identified for the business, comprehensive policy statements should be disclosed to all stakeholders to demonstrate the company's commitment to managing these risks.

Governance and accountability

Responsibility for managing a company's societal and environmental impact and the related risks to the business is shared across all business functions. Ultimately, accountability sits at board level. We expect the fulfilment of sustainability targets and commitments to be the responsibility of the CEO and the board. We expect companies to disclose the governance processes they have in place to oversee and manage these risks. Where material to the business, we encourage companies to link executive remuneration to the delivery of these commitments.

Where specific material issues, such as climate change, are identified, whether over the short, medium or long term, we expect companies to have sufficient expertise and experience on the board to ensure effective strategic and operational oversight. More information can be found here.

Sustainability strategies

Building a sustainable business model that enhances performance and builds resilience should be at the core of business strategies. E&S issues should not be viewed as peripheral components of business operations or simply ethical and compliance obligations. Where material risks and opportunities have been identified, there should be a clear link to a company's overall strategic priorities. Plans to mitigate risks and realise opportunities should be disclosed clearly.

Reporting and disclosure

Target-setting

Companies should set targets to focus their efforts on realising their strategic E&S objectives, mitigating and managing material E&S risks and impacts, as well as to maximise broader positive stakeholder impacts. While it is important for the targets to be achievable, companies may benefit from setting challenging goals to maximise their overall impact. We expect companies to report suitable metrics that allow progress against these targets to be tracked effectively.

Public disclosure and transparency expectations

Transparency and disclosure are key tools that enable investors to undertake a robust analysis of investment risks and opportunities, and allocate capital accordingly. We expect companies to demonstrate their commitment to the disclosure of sustainability information and data, through publication in key company reporting; this includes the annual report and accounts, with supplementary information in sustainability reports and on their corporate website. We encourage companies to align their sustainability reporting to best-practice frameworks (such as GRI and SASB) and where relevant, to relate the Sustainable Development Goals (SDGs) to their strategic priorities and operations. Disclosing in a clear and consistent manner is important in facilitating the analysis of trends in this area.

We encourage our investee companies to be proactive and undertake where possible the verification of their ESG data externally by a reputable independent assurance provider, based on recognised standards. This can be evidenced by making the assurance statement public. This verification exercise should provide comfort to stakeholders, including investors, around the ESG data disclosed, and should strengthen the credibility of companies' ESG data.

We encourage companies to disclose to key third-party sustainability agencies, and in line with best-practice international guidelines.

We expect the following public disclosures at a minimum:

- ESG reporting standards
- Verification of ESG reporting
- Scope of Greenhouse gas (GHG) emissions
- Tax disclosure
- Director disclosure
- Remuneration disclosure

We will vote against the board chair at companies that score poorly on transparency within our LGIM ESG score and show no improvement after engagement. The list of companies voted against is published on our website. For further information on each of these key criteria, please see our public ESG score methodology document available on our website here.

Please refer to the ESG Transparency section of this document for additional details about our expectations on company disclosures.

Financial impact quantification

Quantification of sustainability risks and potential impacts can help investors make more informed capital allocation decisions, according to their risk, return and impact objectives. Quantification practices can also support companies in better understanding their risk exposure and achieving a net benefit by managing sustainability impacts effectively.

We encourage companies to demonstrate a commitment to best sustainability practices and, where possible, seek to quantify the impact in financial terms to internalise the associated costs and benefits. For example, to the extent that they are material[1], companies should explain how climate-related matters are considered in preparing their financial statements.

Industry collaboration

Companies may benefit greatly from sharing knowledge and experience with their peers by joining and contributing to industry-wide associations. We encourage collaboration between companies where appropriate, to progress the broader ESG agenda and broach cross-sectoral and inter-sectoral ESG challenges. Where relevant, we expect companies to engage with regulatory bodies to promote best practices and policies to achieve sustainability targets.

Lobbying transparency

Whether companies perform individual engagement with regulators or policy makers, or collaborative engagement as part of an industry association, we expect them to be transparent and to

[1] In accordance with IAS 1.7, information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements

comprehensively disclose their public policy engagement activities, including trade association memberships. (See section above on political donations).

Sustainability themes

LGIM focuses on the material issues that can impact a company's long-term sustainability, both financially and reputationally. Some of these issues apply across multiple sectors, such as climate change, biodiversity, health (e.g. antimicrobial resistance (AMR) and nutrition) and human capital management issues such as income inequality and modern slavery. Meanwhile, other issues such as food waste, reduction of waste and plastic use are more sector specific.

Below we highlight our expectations in relation to some of our key themes. More information and articles on our position on broader themes can be found here.

Climate change

Climate change is a defining factor in companies' long-term prospects. We expect companies to disclose how they may be impacted by climate-related risks and opportunities, and how these factors are considered within their strategy. We expect to see companies developing their climate disclosures against the Taskforce on Climate Related Financial Disclosures (TCFD) framework. Specifically, companies should be looking to improve approaches to scenario analysis and the quantification of financial impacts that result from climate risks. In addition to TCFD, we expect companies to report using the CDP climate questionnaire, which is aligned with the TCFD framework and crucially provides investors with climate data on a large universe of companies in a comparable format. For sectors where it is material, we strongly encourage companies to report via the CDP Water and Forest questionnaires.

Science Based Targets (SBT's) are decarbonisation targets aligned with the objective of the Paris Agreement. We therefore encourage all companies we invest in to commit to and work towards approved SBT's aligned with the Science Based Target initiative's recent net-zero standard. Alongside this, we expect companies to articulate how their business models reflect a Paris-aligned transition.

As part of our Climate Impact Pledge, we expect companies to not only have greenhouse gas (GHG) reduction targets in place, but also to disclose board oversight of climate change and other sector-specific policies. More information on our expectations of different sectors, and the metrics we use to assess companies can be found here.

In relation to climate change, we would expect companies to publicly disclose any concerns they may have with current or evolving legislation and to publicly report on any lobbying activity that is undertaken as a result of such concerns. We recognise that achieving the Paris Agreement requires policy action in a wide range of areas. Therefore, we expect companies to engage with policymakers and regulators to encourage the introduction of policies to enable a net-zero transition for their respective sectors.

Companies that fail to meet our minimum standards with regard to climate disclosure will be removed from select funds, including our Future World funds, subject to tracking error constraints. In all other funds where we cannot divest, we will vote against the chair or other directors, to ensure we are using one voice across our holdings.

Please see more on LGIM's policy on climate change here, and our climate impact pledge here.

Nature:

Biodiversity

Biodiversity loss is currently happening at a rate greater than at any other time in human history. This matters to investors as biodiversity loss presents a major global systemic risk, with more than half of the world's gross domestic product (GDP) – around $44 trillion – dependent on nature.

We expect companies to assess their impact and dependencies on biodiversity with a view to managing risk, as well as mitigating and, over time, reversing negative impacts. We encourage companies to commit to having an overall positive impact on biodiversity and to consider the direct as well as indirect activities of their supply chains. We will be seeking greater disclosure from investee companies in line with the Taskforce on Nature-related Financial Disclosures (TNFD) framework and SASB standards.

As a signatory to the Finance for Biodiversity Pledge, we have committed to collaborating and knowledge sharing, engaging with companies, assessing impacts, setting targets and reporting publicly. Our Biodiversity Policy is the first step in formalising LGIM's approach to delivering on these commitments. Please see more information on LGIM's policy on biodiversity here.

Deforestation

LGIM recognises the importance of ending commodity-driven deforestation to tackle climate change, reduce biodiversity loss, and support food security. We are proud to be a signatory to the COP26 Commitment on Eliminating Agricultural Commodity Driven Deforestation from Investment Portfolios. We fully support the call for financial institutions to take ambitious measures to eliminate commodity-driven deforestation within their investments.

In 2022, LGIM launched its deforestation policy. In line with our COP26 commitment, the policy commits LGIM to assessing commodity-driven deforestation risk in investment portfolios. This has been done, and where identified, we have contacted such companies in high-risk sectors with little or no deforestation policies of their own. LGIM is likely to vote against the board chair or other board directors of these companies. LGIM is also encouraging companies and data providers to improve the quality and availability of data on deforestation risk. You can read more about our deforestation policy here.

Although our policy was published in 2022, LGIM has been engaging with key companies in high impact sectors on the topic of deforestation since 2017 as part of its climate impact pledge commitment. For example, LGIM's expectations of investee companies within the Apparel sector, require these companies to demonstrate how they are improving the circularity of materials and eliminating deforestation from supply chains. In the Food sector, we expect a transition away from high-impact products and progress on decarbonising agricultural supply chains. The lack of a comprehensive deforestation policy constitutes one of our 'red lines' under our climate impact pledge.

Circular Economy

Our current globalised economic model can be described as 'linear.' Many of our production processes follow the same route, extraction of raw materials, manufacture, use and disposal ('take-make-waste'). The system does not put a value on the materials that are at the 'end-of-life' stage, or the environmental and social implications.

This traditional linear system can be reformed, accelerating our 'just' transition to net zero and nature-positive economies, with ecosystems restored. The economic model that can reform our system at scale is the introduction of the 'circular economy'. It is a key component of LGIM's approach to nature. It is based on three principles, driven by design: eliminate waste and pollution, circulate products and materials (at their highest value), and regenerate nature. LGIM will focus its engagement on supporting a transition from a 'linear' economic model to a 'circular economy' model. LGIM's expectation of companies will be increasingly expanded but will include: strengthening disclosures on approach to circular economy and reduction of waste and pollution; whether a circular economy commitment, strategy, business model and policy are in place across the value chain; proportion of raw, re-used, recycled and compostable materials; explanation of how the strategy is embedded, targets and progress; board-level oversight; protection and regeneration of nature and ecosystems; and lobbying activities.

Water

Globally, we need a 'Just Transition' to economies that are both net zero and nature-positive, and in which ecosystems are restored. Water is a key element of this, as it is the very essence of life on this planet. It permeates our lives and has an impact on all of us, reaching across all sectors, businesses and economies. Water can have a diversified impact along a company's value chain, directly impacting operating risks and financial performance.

In its current form, the water system presents a long-term systemic market risk that will impact LGIM, the markets that we invest in and our investment returns, and ultimately our clients. The challenges are significant and there is insufficient global scale action being taken to protect our most precious resource. LGIM will focus engagement on key areas of the water system, i.e. water scarcity and security, and water quality. LGIM's expectation of companies will be expanded, and will include: strengthening disclosures on approach to impact on water quantity and quality; whether a commitment, strategy and policy is in place across the value chain; explanation of how the strategy is embedded, targets and progress; board level oversight; protection and regeneration of nature and ecosystems; and lobbying activities.

Health

Antimicrobial Resistance (AMR)

The importance of tackling AMR should not be underestimated. It can have a material financial impact on investments. In 2017, the World Bank estimated that the world will lose 3.8% of its annual GDP by 2050, if action to stem the spread of anti-microbial resistance (AMR) is not taken. That is equivalent to the economic damage caused in the 2008 financial crisis. The Bank further estimated that global output losses could amount to more than USD 1 trillion by 2030 and up to USD 2 trillion by 2050. In a worst-case scenario the World Bank estimated that additional healthcare expenditures globally could amount to USD$1.2 trillion on an annual basis. Moreover, the World Health Organisation (WHO) describes AMR as one of the top 10 global public health threats facing humanity today. A study published in January 2022 confirmed that 1.27 million deaths globally in 2019 were directly attributable to bacterial AMR. We expect all water utility companies to be aware of the possible risks of AMR from contaminated water. In addition, we ask pharmaceutical companies involved in antimicrobial manufacturing to manage their effluent waste to reduce the risks of AMR. Further, we also ask companies in for example the Food sector to apply the WHO guidelines on antibiotic use in food-producing animals. For more information on our concerns, please read our blogs on the scale of the AMR problem, why the issue matters to investors, and how we're engaging water utility companies on AMR.

Nutrition

Poor nutrition can have a negative health impact on individuals, workforces and broader societies. This can create a financial burden on economies from increased healthcare costs, both private and public, and on companies from absenteeism. For consumers to make informed decisions about the food they consume and to promote healthier diets, we encourage companies to be transparent on their nutrition strategies; demonstrate progress on these strategies; commit to disclose the share of the company's portfolio and sales associated with healthy food and drink products (using government-endorsed nutrient-profiling models such as the Health Star Rating or NutriScore); and set targets to increase the proportion of these sales.

People:

Employees are one of the greatest assets a company can have. We believe that the value they bring to the long-term sustainability of the company should not be underestimated.

Human Capital

Human capital – As an investor, it is important for us to understand the culture of the companies in which we invest our clients' money and how that culture impacts the people working within its operations. We expect companies to disclose information that will provide a holistic view of their culture. We would ask companies to disclose metrics such as: workforce turnover and how that compares with the sector average, skills and development training, compensation, benefits, workforce demographics including diversity and health and safety.

Human Rights:

We expect companies to respect workers' human rights as set out in the Universal Declaration of Human Rights and the main instruments through which it is codified, such as the International Labour Organization's eight core conventions. In addition, we expect companies to be mindful of and comply with the principles of the United Nations Global Compact; OECD guidelines for multinational enterprises and all local and national laws and regulations relating to the protection of employees. LGIM votes against the chair or other directors of any company that is on the UNGC violator list for 3 consecutive years.

Employee fulfilment/wellbeing:

Employee Voice

The value placed on employees can be measured by the effort a company makes to receive and act upon employee feedback. Therefore, in addition to what is discussed in more detail above, companies should support workers' rights by allowing participation in freedom of association and collective bargaining.

Employee Welfare

Companies should ensure that their workforce has received adequate training to equip them with the appropriate skills to carry out their jobs effectively. Workers should be protected from harassment, discrimination and all forms of forced or compulsory labour. Their working environment should be safe, and annual training on health and safety within the workplace should be compulsory. All workers should receive benefits such as paid sick leave, maternity and paternity leave. Where possible, companies should provide access to services to help workers with any medical issues, such as mental health, private health etc.

Income Inequality

Real living wage: We expect all companies to pay employees as a minimum the national living wage as mandated by law. However, we believe that to ensure employees avoid the poverty trap, which can

create hardship, stress and health problems that together can have an impact on the operational performance of the company, it is important that employers pay the real living wage as set by the Living Wage Foundation.

A living wage should be sufficient to afford a decent standard of living for the worker and their family. Elements of a decent standard of living include food, water, housing, education, health care, transportation, clothing and other essential needs including provision for unexpected events.

Our expectation that workers receive a real living wage extends to all contractors that operate on their premises. Procurement practices should ensure that workers' pay is ring-fenced from negotiations on price to ensure they receive a living wage.

To better inform investors about the culture of the company that they are investing in and to further develop our policy on this topic, we are calling for greater transparency on employee practices. We expect companies to publish in their annual disclosures whether they are paying the real living wage to UK employees and whether they are an accredited living wage payer. We also want to understand what steps are being taken to ensure their suppliers are paying or working towards paying their workers a living wage. Additionally, we want to understand whether companies are offering all employees the opportunity to work for a minimum of 15 hours a week and what other benefits are in place to alleviate financial hardship, such as paid sick leave, free meals, interest free loans etc. LGIM may take voting action against companies that fail to provide greater transparency on these policies by 2025.

Financial wellbeing training – it is not only important to ensure that all workers are receiving a real living wage, but it is equally important that they receive guidance on issues such as money management, where to get financial help etc. We encourage all companies to provide their employees with training on this important topic.

Pensions: We would ask companies to consider the long-term health and wealth of their employees and where possible, to increase the non-contributory element of pension provisions.

Equity ownership: We encourage all companies to offer employees the opportunity to participate in equity ownership. We believe that this is a good performance motivator and retention tool. To ensure sufficient take-up, we encourage companies to offer free shares to all employees or to those earning below the national median pay level, which was £33,000 for 2022. The offer of shares should be linked to continued service.

Gender pensions gap/ethnicity pay gaps – we expect companies to make themselves aware of these inequalities that exist in their organisation and to take positive steps to reduce them.

Modern Slavery

Can take a number of forms, such as child labour, forced labour and human trafficking. Companies should ensure that they are not permitting modern slavery to take place either within their own operations or within their supply chains. As such, we expect companies to adhere to all applicable laws pertaining to modern slavery, which can result in financial and reputational risks to the company as well as potentially causing distress to those workers involved. Therefore, putting in place a code of conduct is not sufficient for ensuring modern slavery does not exist within the supply chain. We expect a more

rigorous process to be in place, which includes and is not limited to due diligence audits, local workforce interviews and technology to provide full traceability of all components of goods or merchandise sourced.

Diversity and Inclusion

We believe a diverse mix of skills, experience and perspectives is essential for a board to function and perform optimally. We expect boards to embrace different forms of diversity: gender, ethnicity and neurodiversity. Our expectations on diversity and inclusion not only extend to the executive level, but run throughout the company. This is discussed in greater detail above.

Why adherence to these principles is important for LGIM

We believe that integrating environmental, social and governance considerations into investment processes can help mitigate risks and improve long-term financial outcomes. For this reason, we embed both top-down and bottom-up ESG analysis into our investment processes. In addition, positive and negative externalities generated by companies can have consequences for the economy and society at large. We believe that investors have a responsibility to a broad set of stakeholders and the market as a whole. We need and expect companies to play their part. Our sustainability principles set out our minimum expectations of companies with regard to the prioritisation, management and disclosure of sustainability issues. These principles naturally feed into our voting and investment decisions, and for certain themes we have very structured processes in place.

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Legal & General Investment Management

One Coleman Street

London

EC2R 5AA

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