Japan corporate governance and responsible investment policy

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Introduction

This document sets out Legal & General Investment Management Limited's (LGIM) expectations of investee companies in the Japanese market in terms of responsible investment best practice. This is region specific and therefore separate to our Global Principles document, which provides a full explanation of LGIM's approach and expectations in respect of key topics that we believe are essential for an efficient governance framework.

LGIM recognises that the move towards strong corporate governance in Japan begins with compliance with Japanese legislative and regulatory frameworks. This responsible investment policy goes beyond minimum compliance and reflects LGIM's approach with respect to key 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 at broader global guidelines and principles, such as those provided by the United Nations Global Compact, OECD guidelines and ILO conventions and recommendations.

While 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 daily operations. Companies should aim to minimise the negative impact 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, and it is available here.

Company board

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

The board has the crucial task of setting the strategy of the business, while ensuring the necessary resources are available to enable its implementation and making sure that appropriate risk management and internal controls are in place. It establishes the philosophy for the company, ensuring that stakeholders' views are considered and embedded in its culture. The board is expected to take into account environmental, social and governance considerations and to report on company performance in these areas. It is also responsible for ensuring the integrity of the company's accounting and reporting, and the effectiveness of its internal control systems. 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 will help make the company successful. We expect each director on the board to fully exercise their duties and promote the long-term success of the company.

We expect the board's decisions and actions to demonstrate leadership in managing the company's responsibilities to stakeholders, and for them to limit any negative impact that operations have on the environment.

Board chair and chief executive officer (CEO)

The responsibilities of the board 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 inside directors and encourage the outside directors to actively participate in board discussions. It is the chair's role to regularly assess whether board members have the adequate expertise for their roles, if they are making a sufficient time commitment and whether there is an appropriate level of diversity. We expect the board chair to be clearly named and identified in all relevant company disclosures, including in the English version of the annual report, in meeting documentation and on the website.

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

Given the importance of the chair's role, we expect the appointment of an independent director as board chair, who will set the agenda for meetings and lead sessions, and who is separate from the inside-company chairperson.

We would not expect a retiring CEO to take on the role of board chair. These two roles involve separate responsibilities and a different approach to board relationships and the company's strategy. Additionally, we recognise the challenge for those who have had executive responsibilities to adequately distance themselves as a non-executive chair. Where a company would find the presence of the former CEO on the board beneficial in times of transition, our preference is that the CEO is used as a consultant rather than as a formal board member, and we would stipulate that this should be for a maximum period of one year.

A key point for Japanese companies to note is that the board chair (Gicho) is different from the company chairperson (Kaicho). In Japan, it is common for a Kaicho[1], who is typically a former CEO, to be at the helm of the company. Nonetheless, from the perspective of an independent chair, we focus on the Gicho rather than the Kaicho for companies in Japan.

The case of the combined chair and CEO

Although many Japan-listed companies do not separate the roles of the board chair and CEO, it is important to provide guidance on our views.

We believe that the roles of the chair and CEO are substantially different and require distinctly different skills and experience. This division of responsibilities also 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

[1] A Kaicho is not a legal term in the Companies Act and transparency around the responsibilities of the role is usually insufficient.

authority and responsibility on the board. Therefore, we will vote in favour of resolutions that separate the chair and CEO roles.

While LGIM typically does not support the election or re-election of any individual who holds both a board chair and CEO role, this policy does not currently apply to Japanese companies. Nonetheless, we expect Japanese companies to appoint an independent director as board chair, and to provide disclosures in English regarding the individual chairing the board. We also expect Japanese companies to provide a clear explanation if they choose not to separate the roles of board chair and CEO.

For more details, please refer to our board guide on the topic, available here.

Senior or lead independent director

The position of senior or lead independent director may not yet be well established in Japan. We believe, however, that this is an essential role on the board. This person should lead the succession process for the chair and appraise the chair's 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 the senior or lead independent director to be an unquestionably independent outside director.

While the presence of a senior independent director should not be limited to cases where there is a combined board chair and CEO, this is of extra importance when the company combines the two roles. 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.

Please see our website for a thought piece on the role of the senior independent director, available here.

Structure and operation

Board structure

Japan's Companies Act offers listed companies three options for board structures. Our voting policy may vary depending on the structure of the board.

Statutory auditor (Kansayaku) model (two-tier model)

This structure consists of a board of directors and a board of "statutory auditors" (Kansayaku, also referred to as the "Kansayaku board" or "audit and supervisory board"). The law stipulates that at least half of the Kansayaku board must be composed of outside Kansayaku. The role of Kansayaku is to monitor the company's financial reporting and auditing practices as well as the directors' conduct. The legal position of Kansayaku is that of a fiduciary, and their duties include: attendance at all board meetings, determination of audit policy, deciding methods for monitoring and investigating the company, auditing accounts, and reporting breaches of directors' duties. Although Kansayaku have an important role and the obligation to attend board meetings and express their opinions as necessary,, they do not have voting rights.

Three-committee model (one-tier model)

This US-type structure consists of three committees, responsible for audit, nomination and remuneration. The majority on each committee must consist of outside directors. Under this model, the main role of the board is to monitor the performance of executive officers appointed by the board.

For auditing purposes, this structure is considered preferable, because the audit committee is an integral part of the board. As board directors, committee members have the right to vote and the ability to exert direct influence on board decisions. As a result, they are considered to have greater capacity to positively influence the robustness of a company's internal controls.

Audit and supervisory committee structure (hybrid model)

Hybrid board structures with an audit and supervisory committee (Kansatouiinkai, also referred to as the "supervisory committee") emerged as an amendment to the Companies Act in 2015. A majority of the audit and supervisory committee members are required to be outside directors.

While the role of the audit and supervisory committee is similar to that of the Kansayaku board under the two-tier model, this committee has the right to give its opinion on the nomination, removal and remuneration of directors who are not committee members.

Board committees:

Audit, nomination and remuneration committees

Board committees ensure that specific directors are responsible for key board functions.

Globally, we ask for the nomination committee to comprise a majority of independent non-executive directors, while emphasising that the remuneration and audit committees should consist exclusively of independent non-executive directors. It is essential that these committees are able to freely discuss and act on sensitive areas without an inside director in attendance. Non-independent directors may attend some or part of the meetings on occasion by invitation, but should not be a member of the audit and remuneration committees.

Japan-listed companies with the three-committee model are required to put in place three separate board committees responsible for the core board functions of audit, nomination and remuneration. For those companies, we will vote against the president or company chairperson if the candidate sits on the remuneration or audit committee.[2]

By contrast, companies with the Kansayaku model or audit and supervisory committee model have the discretion to establish voluntary advisory committees on nomination and remuneration. For such companies with board structures not legally obligated to form such committees, we maintain our expectations regarding independence and expect the board to uphold the committees' recommendations.

[2] This currently applies only to companies with a three-committee structure due to availability of public information.

Additional board committees

Companies may consider it appropriate to set up additional board committees to assist the board in its 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 risks are a significant factor, LGIM would recommend that a sustainability committee is established that includes board members.

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

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 impact the size and composition of the board.

Independence

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

We expect unaffiliated outsiders to bring an independent perspective to boardroom discussions and make observations and suggestions that are pertinent to the company, but which inside directors may not have thought of, or may be reluctant to address. A relevant and suitably diverse mix of skills and perspectives is critical to the quality of the board and the strategic direction of the company.

It is important that directors are independent of one another, and that any interlocking board relationships are disclosed and explained.

To remain competitive and attractive to foreign investors, Japanese companies should focus on establishing a board that meets the international best practice trends. Notwithstanding, we recognise that reaching the optimum level of independence will be a continuous, iterative process, and companies need time to test the dynamics of new board composition.

To balance these considerations, we call for a minimum of one-third of directors to be independent and ask companies to outline the steps to be taken to increase independence in the future. Regardless of the board structure, we will vote against the chair or most senior member of the board if, after the shareholder meeting, the board is not at least one-third independent. We additionally expect companies to comply with the 2021 Corporate Governance Code in instances where the code requires a higher level of board independence. For instance, we will vote against the chair or most senior member of the board at companies with a controlling shareholder unless at least half of the board comprises independent outside directors. We will be looking to raise the thresholds for board independence, to bring Japan closer into line with other developed markets.

An outside director under Japanese law is generally someone who:

- Is not an employee of the company or group;
- Has not been an employee of the company or group within the last five years;
- Is an outsider who represents less than 10% of the company’s voting common stock;
- Does not have close family ties with any of the company’s advisers, directors, or employees.

In addition to the conditions above, we will consider candidates who fall under any of the following categories as non-independent:

- Individuals who work or worked at major shareholders of the company;
- Individuals who work or worked at the main providers of financial services to the company;
- Individuals who work or worked at the lead underwriter(s) of the company;
- Individuals who work or worked at business partners of the company and the transaction value is material from the recipient’s perspective or is not disclosed;
- Individuals who worked at the company's audit firm;
- Individuals who offer or offered professional services such as legal advice, financial advice, tax advice or consulting services to the company;
- Individuals who have a relative(s) working at the company as executives or employees in important positions;
- Individuals who worked at the company; or
- Individuals who work or worked at companies whose shares are held by the company as "cross-shareholdings" (this includes not only mutual shareholdings, but also unilateral holdings held for reasons other than pure investment purposes); or
- Individuals who have served on the board for more than 12 years.

Advisory positions (Komon/Sodanyaku)

Advisory positions unique to Japanese companies, known as “Komon” or “Sodanyaku,” are usually held by the former company president or another senior executive.
They are not held accountable to shareholders as they do not serve on the board. Still, they can apply pressure on the board and are often referred to as “ghosts in the boardroom” or “corporate backseat drivers”. In cases where the former CEO remains as a senior adviser, they may exercise unreasonable influential power over incumbent management members, which could be detrimental to the board’s functioning and dynamic.

With no basis in law, these roles vary from company to company. Furthermore, companies are not required to disclose details of these positions, but are given the option to do so in the Corporate Governance Report required by the TSE. Based on this report, we will vote against the chairman or most senior member of the board when there is a lack of disclosure on the presence of an advisory position, their role and the duration of the appointment. To avoid a vote against, we recommend that any company that does not have a "Komon" or "Sodanyaku" should make that known to investors in its corporate governance report.

Additionally, we expect all companies to provide disclosure on the roles and responsibilities of the advisory position and what the individual is paid. Such disclosures should be provided in English before the annual general meeting (AGM).

Board diversity

We expect all companies in which we invest globally to have at least one woman on their board.[3] In Japan, we started voting against the appointment of the most senior member of the board (usually the company chair or president) or the nomination committee chair of TOPIX 100 companies with all-male boards in 2020. We currently vote against the most senior member of the board or the chair of the nomination committee unless at least 15% of the board at TOPIX 100 companies are women, and where the board does not have at least one female director at all other Prime-listed companies.

Starting in 2025, we will expand this policy further to the TOPIX 500 where there is less than 15% board gender diversity. We will also require all other companies, including but not limited to Prime-listed companies, to have at least one woman on the board. We will continue to expand our policy to a greater number of Japanese companies and also look to require a higher threshold of board diversity over time.

We also expect companies to promote diversity below board level, namely at the executive and management levels, as well as throughout their entire workforce. We expect Japanese companies to observe the provisions of the 2021 Corporate Governance Code and comply with sustainability disclosure requirements within the annual securities report (yukashoken hokokusho), including gender pay gap information.

For more information, please refer to our diversity policy.

Succession planning

Succession planning is a vital function of an effective board. It ensures continuity, provides individuals with the right skills to sit on the board and can help to avoid the dangers of groupthink.
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

[3] We do not count Kansayaku as board members

explanation of how the skills of newly appointed directors are complementary. The minimum time commitment expected of each director should also be made clear.

Re-election of directors

In Japan, directors serve in their positions until the conclusion of the AGM for the last business year that falls within two years from the time of their election. Nevertheless, we support proposals that reduce the director's term to one year, as permitted by the Companies Act, and encourage others to follow.

The provision of biographical information on directors is essential to enable shareholders to make an informed decision about the appropriateness of nominee directors. In addition to the biographical details of each director, we also encourage the disclosure of the attributes and skills the director brings to the board and how these fit with the long-term strategic direction of the business.

Re-election of Kansayaku

The Companies Act stipulates that at least half of the Kansayaku should be outsiders, but with no obligation for them to be independent. It is vital that true independence from the company is maintained in the Kansayaku board. Therefore, we vote against outside Kansayaku nominee members who are not independent (regardless of the overall independence of the Kansayaku board). We also vote against inside Kansayaku nominee members unless the Kansayaku board after the meeting is at least 50% independent.

Board effectiveness

Culture

Culture has become an increasingly discussed topic in recent years among businesses, investors and even regulators, and its measurement and assessment are exercises 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.

For investors to understand the company's culture, disclosure from the board is necessary, given its role in setting values. Investors need reassurance that the CEO and management are 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 the organisation.

We expect companies' annual disclosure to include:

- How culture is measured and how it relates to the business strategy;
- How the mission statement of the company and its values are communicated and reinforced;
- Any key performance indicators (KPIs) that are linked to culture;

- Any relevant data linked to the workforce such as: turnover percentage, attrition analysis and how exit interviews are used.

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

For more details on our position, please refer to our publications on the topic available here.

Board tenure

The regular refreshment of the board helps to ensure that its members remain independent from management and third parties, that different perspectives feed into board discussions, and that skillsets remain relevant. A regularly refreshed board is more likely to question established practices, avoid groupthink, and exercise more efficient oversight over management to stay ahead of market changes.

We expect all companies globally to put in place an individual director term limit of a maximum of 12 years.

Board mandates

We believe it is important for inside 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 external appointments, they should be mindful of the time commitment required to exercise their duties on multiple boards. We would encourage inside directors not to undertake more than one external directorship of an unrelated listed public company.

Although it is not yet a voting issue, in Japan we encourage outside directors to limit their number of board positions to a total of five public company board roles. We consider an independent board chair role to count as two board roles due to the extra complexity, oversight and time commitment that it involves.

To help investors assess how directors with other board mandates are performing their duties, we would like the company to disclose the level of time commitment expected from outside directors.

Board meetings and attendance

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

Director attendance at board meetings is a vital part of the 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 fewer than 75% of the board and committee meetings held. Where a director does not attend a board or committee meeting, the company should report to investors the reasons for non-attendance. Where a director's attendance is below 75%, and the board has not provided an explanation for the absence, LGIM may vote against the director's re-election.

Board size

We consider that board effectiveness is optimised when it comprises no more than 15 members and its composition should depend on the size and complexity of the company. By their nature, small boards that are suitably diverse are better equipped to facilitate active, constructive debate and agile decision-making processes. We will vote against the most senior non-independent member of the board standing for re-election when the board exceeds 15 directors[4].

Although Japanese boards have historically been larger than in other markets, a downward trend has continued. We will generally support resolutions to reduce board size.

Board effectiveness review – internal and external

The evaluation of directors is a key way of improving board effectiveness and ultimately its performance. It is also a way for investors to determine from the outside the quality of debate and interaction between board members.

Japan's Corporate Governance Code states that boards should conduct an annual board-effectiveness evaluation and disclose a summary of the results.

We expect an internal board evaluation to take place annually. This should be led by the most senior independent director on the board, or if managed externally, by an independent third party. We expect an external evaluation of the board to take place at least every three years. It should be performed by an independent third party to avoid conflicts of interest. External reviewers can also bring different perspectives on the functioning of the board, as well as experience of how other boards operate.

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. We would expect the external board reviewer to be refreshed after they have conducted two consecutive reviews.

For more details on our position on the topic, please refer to our short thought-piece on the topic, available on our website here.

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 votes have been cast against a board-recommended resolution, we expect the board to engage with shareholders to determine their reason for voting against. The next annual report should provide information on the steps taken to address shareholder concerns.

[4] This applies to companies with a two-tier board with statutory auditors (Kansayaku) or the hybrid audit and supervisory committee structure.

Stakeholder engagement

We believe companies should be managed taking account of the interests of their stakeholders on material issues. Therefore, regular dialogue with key stakeholders is encouraged to ensure a good understanding of material concerns. We expect companies to report in their annual disclosures how engagement with key stakeholders has fed into board discussions.

Employee dialogue

We acknowledge that different countries, as a result of regulation or best-practice codes, may have different approaches to how boards should consider the views of their employees. We believe investors should be able to hold directors accountable for their consideration of employee views.

Where hard or soft law does not provide any guidance, we encourage companies to set up an appropriate structure. Companies may prefer the appointment of employee representatives on the board, the use of forums or advisory panels, or to nominate a current independent outside director to seek out employees' views at different levels of the business and to regularly report these back to the board.

Whichever method is adopted, there are factors that we have observed that can be conducive to a good process:

- Select a method that builds trust within the company, is valued by all employees and encourages participation;

- Ensure there is a clear mechanism for all staff to feed into the process, regardless of whether that is through a regular meeting with their designated workforce member/non-executive director/employee director or via email;

- Create clear action plans for issues that impact employees and distribute these to all staff via a newsletter or all-staff email. A dedicated page on the intranet with its existence made known to all staff is also a good idea. Open and transparent communication is important to get employee buy-in to the process. “Town halls” should supplement written communications;

- Ensure there is a feedback mechanism for employees;

- Employee engagement and staff turnover should be tracked over time, and published in the annual report;

- 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 productivity, as studies show that there is a positive correlation between employee engagement and performance.

We would like to see companies disclose in their annual report 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 last few years.

Public disclosure will increase awareness, improve practices, and can lead to greater productivity and long-term performance for all companies in the market.
For more details on our position on the topic, please refer to the short thought-piece available on our website here.

Investor dialogue

We believe that engagement is 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.

LGIM's stewardship priorities are such that we are focusing on material issues that are not only important to our clients, but also pose a risk to the long-term value of their assets, e.g., climate change, human rights, health, etc. As such, we are not always available to have general engagements.

LGIM encourages companies to proactively request engagement with their investors at the earliest opportunity where they are concerned that a specific governance issue might be subject to a negative vote and the board wishes to provide additional context/information, or seek investors' opinions.

For more information, please refer to our guide on the topic, available here.

Audit, risk and internal control

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

It is also responsible for presenting a true and fair view of the financial position of the company, and it should set out the future capital management plans and 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 the board to reveal to investors in the annual disclosures the details of the assessment and any conclusions and areas of concern raised, as well as actions taken to address such concerns.

Compliance with regulations

The audit committee should ensure that all laws and applicable regulations are complied with to avoid exposing the company to the undue risk of fines, censorship and reputational damage.[5] We will hold the audit committee or its equivalent responsible for failing to detect breaches in accounting practices.

[5] In terms of regulations, LGIM is in favour of streamlined disclosure requirements for the pre-AGM business report and financial statements (subject to the "first" audit based on the Companies Act) and the yukashoken hokokusho (subject to the "second" audit based on the Financial Services Agency's Financial Instruments and Exchange Act).

External audit

Auditors are an essential feature of an effective and transparent system of external supervision. To minimise potential conflicts of interest, the auditor's primary line of reporting should be to the audit committee, where one exists, and not to senior management. The auditors are ultimately employed to serve the shareholders, not the managers. Shareholders should be given an opportunity to vote on their appointment or re-appointment at each AGM.

High-quality audits are valued by investors and should be considered an asset rather than a cost to the business. It is important that the audit fee is reflective of the work involved, and that the auditor is selected based on quality rather than because it offers lower fees.

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 appropriate accounting standards. Any significant audit matters raised by the auditors should be fully explained by the board, including how these have been addressed.

The external auditors are also responsible for producing the auditors' report, which is a formal opinion and evaluation of the financial statements.

The board is responsible for appointing the company's external auditor. The company is expected to clearly disclose the audit firm used, the partner who led the audit, the tenure of that firm, and why the board considers the auditor to be independent and how any potential conflicts are being avoided.

In Japan, audit firm rotations are not mandated by regulations. Furthermore, the appointment of an external audit firm is typically only put to a shareholder vote when companies intend to appoint a new audit firm. This is because an audit firm is deemed to have been re-elected at the AGM, unless otherwise resolved by the meeting.

We believe the role of the external auditor should be put to tender on a regular basis to enhance the independence and quality of the external audit. Rotations should take place at least every 10 years, with the total tenure of the audit firm not exceeding 20 years. Within this timeframe we expect the lead audit partner to be subject to refreshment every five years. We expect the process of the tender to be disclosed, and the rationale for the appointment to be explained.

The fees for the external audit should be published in the annual disclosures. Where the external auditor provides non-audit services, these should be fully explained in the appropriate 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 proportionate approach to supporting a high-quality audit. We are not supportive of fixed auditor liability or restrictions on that liability.

The audit committee, Kansayaku/Kansayaku board, or audit and supervisory committee (depending on the board structure) is responsible for explaining how it has assessed the quality of the external audit and recommendations arising from the external audit, and this should be reported to investors when considered material by the board and/or the audit partner.

Internal audit

Companies should have an effective and sufficiently resourced internal audit system in place, which is designed to take account of new and emerging risks that will affect their business objectives and identify the level of risk taken. The process and procedures in place to manage such risks should be embedded in the risk-based control system for the company and should be summarised in the annual disclosures to investors.

The audit committee, Kansayaku/Kansayaku board, or audit and supervisory committee should have responsibility and oversight of the internal audit function.

Whistleblowing

We expect companies to establish a whistleblowing policy that is integrated into their code of conduct. The policy should be publicly disclosed and open to all employees across the supply chain. The whistleblowing reporting channels should be easily identified and independent from management, with a direct line to the board or audit committee, Kansayaku/Kansayaku board, or audit and supervisory committee to allow for appropriate oversight and independent escalation where necessary. Companies should ensure their policy safeguards the identity of any whistleblower 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.

Cyber security

The vulnerability of a company's IT systems can lead to material financial and reputational impacts. 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 customers' confidential data. Therefore, accountability should not be delegated. Cyber security should be a regular board agenda item. Any data breach incident should be disclosed to customers and the market in a timely manner.

For more information, please refer to our guide on the topic, available here.

Climate risks

We expect companies with climate change as 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 LGIM applying voting sanctions to companies that fall short of minimum expectations.

Remuneration

We regard appropriate remuneration levels as fundamental to recruiting, incentivising and retaining directors of the quality required to manage a company successfully. We seek disclosure and justification of the chosen remuneration structures and levels.

In general, Japanese companies are less prone to excessive remuneration structures than companies in other markets.

Cash retirement bonuses constitute a significant portion of executive remuneration, and the majority of these are not reflective of performance. In addition, equity-based incentives, mainly stock options, have not yet gained traction among Japanese executives. We believe that Japanese companies should adjust their executive remuneration structures to align with company performance and shareholder value creation. Accordingly, remuneration disclosure should focus on the structure of incentive arrangements.

Key pay principles

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

- 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.

- Awards should incentivise long-term thinking by management and be aligned with and support the achievements of the business strategy and objectives.

- 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.

- 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.

- 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 function as an immovable benchmark.

Salary increases should not be automatic each year. Any increase in 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 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 bonuses for directors and Kansayaku

Companies may choose to award annual incentives to inside directors. We believe that any annual incentive should be geared to delivering the strategy of the business. A majority of the annual incentive should be linked to the delivery of financial performance. In addition, achieving a threshold level of financial performance should be a pre-requisite for the payment of any bonus that is based on personal or strategic objectives.

A way to highlight the integrity of the target-setting process is by disclosing the weightings of each bonus component and the target ranges, at the very least on a retrospective basis.

The disclosure of targets that are commercially sensitive can be delayed and disclosed within a year of payment; if this is not possible, an explanation of why the target continues to be commercially sensitive is advisable.

Ideally, strategic, qualitative and personal targets should be separated, with each having its own weighting. It is helpful if companies explain why targets were selected and any outcome.

Companies exposed to high levels of environmental, social, or reputational risk should consider including relevant and measurable targets that focus management on mitigating these risks. Any relevant environmental or social metrics selected should be meaningful, measurable, aligned to the company’s strategy and subject to third-party verification.

Measures such as health and safety should be used as a reducing rather than a compensating feature because ensuring the health and safety of employees should be embedded in the philosophy and values of the company and a normal expectation of running a successful business.

Companies that want to demonstrate best practice would put in place contractual and statutory provisions that allow for a reduction or forfeiture of the annual bonus component in exceptional circumstances (malus and clawback).

We do not expect outside directors, audit committee directors and statutory auditors to receive annual bonuses. Receiving a bonus can erode independence, and negatively influence the veracity with which management is scrutinised.

We will oppose the approval of annual bonuses for directors/Kansayaku if:

- Recipients are outside directors, audit committee directors and statutory auditors
- There is clear evidence of mismanagement on the part of the recipient; and/or
- The company’s performance has been poor.

Retirement bonuses for directors and Kansayaku

We expect the company to ensure that there are no rewards for failure. This requirement may be satisfied by introducing a remuneration committee to determine executive pay and to take into account poor performance or any exceptional events, e.g., loss of life, when deciding whether a director should be paid a bonus for the period worked.

With the exception of dismissal for cause and/or poor performance where awards should be lapsed, any outstanding awards of leavers should be time pro-rated and allowed to run their course subject to the same vesting conditions as those applied at grant.

Retirement bonuses are standard practice in Japan and make up a sizable portion of lifetime remuneration for directors and Kansayaku and this is not necessarily judged on performance. The details of bonus proposals, such as the amounts paid and the status of recipients, are seldom disclosed. This prevents shareholders from assessing the merits of bonus proposals, and potentially undermines investor confidence in the company's capital management practices.

We will oppose the approval of retirement bonuses or special payments if:

- Recipients are outside directors.

- Neither the individual payments nor the aggregate amount of the payments is disclosed, or it is disclosed, but it is not considered appropriate; and/or

- There is evidence of mismanagement on the part of the recipient.

Furthermore, we consider that outside directors should not receive special payments in connection with the abolition of a retirement bonus system. The receipt of special payments can erode independence, and act as a disincentive for outside directors or Kansayaku to speak out against management.

Long-term incentive plans (LTIP)

In general, stock option or long-term equity incentive plans should be promoted as a tool to better align the interests of directors with those of shareholders. Ideally, LTIPs should be introduced within the value of the total compensation that is currently on offer. We do not expect outside directors, or statutory auditors, to receive share-based incentives that require some level of performance to deliver value.

We believe that a company should motivate and reward inside directors by granting long-term 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.

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

The LTIP should not have too many performance conditions, but should include at least one measure that is linked to shareholder returns. Other measures should be linked to the strategy of the business such as KPIs that are selected by the board. Performance conditions should be measured over three years.

If share options are used, these should not be capable of exercise for a period of three years from the time of the award. Outstanding share options should not be re-priced.

Investors expect companies to disclose the performance metrics and as many of the performance targets under those metrics' as possible.

We will oppose deeply discounted option plans if:

- The total dilution from the proposed plan(s) and previous option plans exceeds 5% for mature companies, or
10% for growth companies;

- Recipients include individuals who are not in a position to influence the company's stock price, including employees of business partners or unspecified "collaborators;"

- The maximum number of options that can be issued per year is not disclosed; and/or

- No specific performance hurdles are specified.

Use of ESG metrics

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

Companies in sectors that can have a significant effect on climate change should link part of their pay to delivering their climate mitigation goals. The performance targets should be linked to SBTi (Science Based Targets initiative) 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 the climate.

By 2025, companies will have only five years to reach their 2030 climate change transition goals. By this time, we expect a majority of companies will have a clear idea of what must be done to hit these crucial targets. Therefore, from 2025, LGIM will escalate its policy on climate change. From January 2025, we will only support new remuneration policies being put to shareholders if there are climate targets within performance-based pay and ideally within the long-term plan. These targets should be in line with stated transition goals to reach 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 and gas, REITs, shipping, steel, technology, telecoms and multi-utilities.

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

We believe linking climate mitigation targets to executive pay can act as a motivational driver to deliver on climate reduction goals.

LGIM will vote against any relevant resolution relating to executive compensation from 2025 if no climate-related targets are used.

Companies outside of these sectors are also encouraged to link long-term executive compensation to climate 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 well-governed companies should have an inclusive culture in place. Financial incentives should not be necessary to drive such a programme. In our view, a better metric for companies, especially for those that have a high level of staff turnover, would be to set targets around employee retention to gauge whether their internal strategies to improve retention are working.

For 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 and balance sheet strength) or other strategic metrics. The use of volume growth targets may result in a negative vote.

Directors and Kansayakus' compensation ceiling

Japanese companies are less prone to excessive or misaligned remuneration structures than companies in other markets.

This notwithstanding, the management of Japanese remuneration still requires structural realignment. Performance-based remuneration occupies a relatively small portion of total pay. We will generally support proposals calling for an increase in the director compensation ceiling if this increase is intended to introduce or increase the performance-based pay component for inside directors. If proposals seek an increase in non-performance-based director pay, or it is unclear whether pay is performance based, we will examine these on a case-by-case basis. We will vote against proposals seeking to increase director compensation in cases where there are concerns of mismanagement.

We recognise that companies that disclose their remuneration structures may be penalised in this policy. In order for the policy not to act as a disincentive to disclosure, we will consider voting against company directors for inadequate disclosure.

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 the 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.

Transparency

We encourage companies to allow investors to be able to appropriately identify and assess their performance on material ESG issues.

We expect companies to adopt an open approach to the public disclosure of information, within the limits of what they can disclose. We would also encourage disclosures, in particular the main elements of the annual securities report (yukashoken hokokusho), to be made in English and disclosed well before the

AGM to allow access to important information by a greater number of investors. This is particularly important so that voting decisions can be made, based on the latest information on governance issues such as cross shareholdings.

Improved transparency encourages informed voting, engagement and the integration of environmental, social and governance issues into investment decisions.

Furthermore, we would like to see companies disclose their attempts to engage with investors (including minority shareholders) and who at the company undertook that discussion. Our expectations are listed in the sustainability section below.

AGM timing

The Japanese market continues to have a highly condensed AGM season, in which the majority of AGMs occur in a single week near the end of June.

We would encourage Japanese companies to change the record date and hold their AGMs later in the year. By separating the record date from the end of the business year, companies will no longer need to hold the AGM within three months of the close of the business year. We believe this will alleviate unnecessary time pressure on companies and audit firms, and in turn make it possible for the AGM season to be less concentrated. This will also give companies time to translate key documents into English. Companies that move the record date closer to the AGM will also find themselves more in line with global practice.

Virtual/electronic general meetings

We believe that a company's general shareholder meeting is 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 institutional and retail investors.

Shareholder meetings provide an invaluable opportunity to raise concerns with a board in a public forum, and investors can 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 ask 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 increase investor participation.

However, we believe 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 its shareholders. The attendance of the board at that meeting 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. The public nature of AGMs and full attendance of the board is also important to allow us to bring matters to the board's attention. Removing this tool impairs our ability to hold boards to account on behalf of our clients. Companies that adopt a "virtual-only" approach may also risk giving the impression that they are attempting to filter questions or limit the participation of shareholders and that they do not want to be subject to the varied questions of their investors.

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.

Article amendments

It is common to see requests for amendments relating to various issues, including capital increases, changes to capital structures, board size and composition, as well as takeover and defence-related plans bundled together as a single voting resolution.

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 are introduced to 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.

Capital management

The board is responsible for ensuring a company has sufficient capital, as well as overseeing its capital management and 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.

We therefore 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, e.g. making sure that share issuances are not overly dilutive and capital is being raised in the long-term interests of investors.

We support the TSE's request, made in March 2023, for all listed companies on the Prime and Standard Markets to take "action to implement management that is conscious of cost of capital and stock price."

The TSE explains that "this starts with gaining a proper understanding of their cost of capital and profitability based on the balance sheet and continues with analysing and assessing the current situation around these and the market valuation at board meetings, preparing and disclosing plans for improvement, and then using dialogue with investors to update them on the progress of these efforts." We expect actions to be directed towards these areas, rather than solely focused on share buybacks and dividend increases.

Issuance of shares

The current practice allows Japanese boards to have the discretion to issue shares within the authorised capital (a maximum of four times the current issued capital) on the condition that the issuance price does not constitute an advantage. If a price is considered advantageous, shareholder approval will be required. With this in mind, we believe that issuances should be limited to what is necessary to maintain business operations and should not expose minority shareholders to excessive dilution of their holdings.

We regard pre-emption rights as fundamental to protecting shareholders' investments in a company, and to fostering investor confidence. However, it is common for Japanese companies to undertake significant private placements without offering pre-emption rights to existing shareholders. Companies should consider alternative means of raising capital that do not expose minority shareholders to excessive dilution of their shares.

We may consider voting against the re-election of directors if there are serious concerns with capital management.

Share repurchases

Share repurchases can be a flexible way to return cash to shareholders. We expect the board to be transparent about how this share-buyback authority will be used in relation to other potential options (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 the wider market conditions at the time. When utilising this authority, we expect companies to consider its impact on other issues. For example, on remuneration, performance conditions governing incentive schemes may be affected by the exercise of a share 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.

Japanese companies, when stipulated in their articles of incorporation, have the option of waiving the requirement for prior shareholder approval for share repurchases. We would expect a detailed rationale for any buyback authority that is greater than 10% of the issued share capital.

Debt issuance

Good transparency and disclosure by the company on bond issuances is important for debt investors. In its reporting, we expect a company to include a:

- Timely release to the public of prospectuses both before the new issue and while the bonds remain outstanding;
- Commitment to provide public access to ongoing financials and disclosures; and
- Five-year financial history of the company.

Cross shareholdings

While cross shareholdings - where listed companies hold the shares of other listed companies - are in gradual decline; in Japan, the practice is still prevalent. Cross holdings may serve a strategic objective, but they can also cause problems including poor corporate governance or the inefficient use of capital.

We expect companies to fully comply with the Corporate Governance Code's provisions on cross shareholdings, which call for companies to disclose their policies with respect to cross shareholdings, including their policy regarding the reduction of such holdings. The Code further requests companies to annually assess whether or not to hold each individual cross shareholding and to disclose the results of this assessment.

Therefore, management should be prepared to engage in an open dialogue with shareholders to demonstrate the value created through cross holdings, and to share plans for such holdings to be reduced.

We also consider cross shareholdings when we determine if an outside director is independent. In 2022, we started voting against the board chair if the company allocates 20% or more of their net assets to cross holdings with no clear rationale for this decision. We will continue to review this threshold and look to tighten our policy over time.

Mergers and acquisitions (M&A)

We will normally support a proposal that will create shareholder value, provided the financial terms, quality of management and synergies represent an improvement on the status quo. In a majority of cases, we will support management if the deal is value-creative for shareholders, it makes strategic sense and is considered beneficial to both parties.

To make an informed assessment, we expect management to be transparent on the terms of the transaction and its financial and cultural integration implications on the long-term business strategy. We also expect all companies to explain how the transaction is expected to yield significant long-term benefits for the company and its stakeholders, including investors.

We encourage the independent outside directors, together with the board chair (if they are independent), to hold separate meetings with their investors without executive management present, to explain 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 outside 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 consider putting in place a separate ad hoc committee of independent outside directors to consider the merits of the transaction, and to engage with their investors.

Takeover defence plans – poison pills

“Poison pill” is the term given to an artificial device implemented by a company to deter takeover bids. Well-designed poison pills may strengthen the board’s negotiating position and allow it to obtain more favourable terms from an acquirer.

It is vital that this process is controlled by the independent members of the board, who are more concerned with shareholder value than with protecting the company’s position. We do not expect a poison pill to entrench management or protect the company from market pressures, which is not in investors’ best interests.

We will also examine if there is sufficient independent board oversight in the use of such a mechanism. Starting in 2024, we will strengthen our expectation and threshold for board independence by voting against poison pill proposals unless the board consists of a majority independent directors.

A poison pill should not be capable of activation until a threshold of 20% of the outstanding issued share capital is triggered. The duration of any poison pill (defined as the sum of the number of years the company has had a pill in place and the number of years the proposed pill will be effective) should not exceed three years; thereafter, shareholder approval should be sought. The bid evaluation committee should be composed of a majority of independent outside directors, or independent statutory auditors and who meet our guidelines on attendance.

We also expect the company to post its proxy circular on the stock exchange website at least four weeks prior to the meeting, to give shareholders sufficient time to study the details of the proposal and where necessary, engage with management about them.

For more details, please refer to our board guide on the topic available here.

Related-party transactions

Related-party transactions (e.g. between a controlling shareholder and an issuer) are significant for minority shareholders as there is a risk that a related party may take advantage of its position.

All transactions must therefore be authorised by the board of directors. We also expect the company to set up a committee comprising independent outside directors to ensure that such transactions are conducted on the basis of an independent assessment and valuation.

In addition, we expect companies to publish sufficient information about such transactions in their annual disclosures to enable informed voting decisions to be made. Disclosure should extend to the level of support offered by the independent outside directors.

Shareholder proposals

We consider all shareholder proposals tabled at a company's AGM in the wider context of the corporate governance practices at the company, and also in relation to 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.

LGIM may support certain shareholder proposals on key topics where we want to draw attention to the importance of the issue for investors. The level of investor support for a topic is a helpful way for companies to learn about matters that are material to shareholders.

Where 20% or more of votes have been cast against the board recommendation for a resolution, we expect the company to consider the benefits of the proposal and to discuss this with its shareholders. We additionally expect the outcome of such discussions and actions taken to be included in its annual disclosures.

Political donations and lobbying activity

We will not support direct donations by companies to political parties or individual political candidates. We believe that companies should fully disclose all political contributions, direct lobbying activity, political involvement and indirect lobbying via trade associations. There should be full transparency regarding memberships 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 would benefit the causes the company supports and how they are linked to its strategy;
- A public statement from the company outlining where it disagrees with the associations of which it is a member on a particular issue, and the reasons why it believes it is beneficial to remain a member; and
- Disclosure of where responsibility sits within the company for the oversight of such relationships.

Allocations of dividends and profits

We will evaluate each resolution on a case-by-case basis and oppose proposals that would remove the right for shareholders to approve dividend payments. Particular attention will be paid to cases where a company proposes to pay a dividend exceeding its net profit, which could damage the company's long-term financial health.

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 on 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 the issues that 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 to be 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 E&S impact and 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. Companies should 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 company boards to have sufficient expertise and experience to ensure effective strategic and operational oversight. More information can be found here.

Sustainability strategies

Building a sustainable business model that enhances performance and creates 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 maximising broader positive stakeholder impacts. While it is important for the targets to be achievable, companies may benefit from setting challenging goals in order 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 in key company reporting; this includes the annual report and accounts, with supplementary information in sustainability reports and on their corporate websites.

We are very supportive of the International Sustainability Standards Board's (ISSB's) first two standards, published in June 2023. The standards present a global baseline for sustainability disclosures acting to amalgamate previously disparate disclosure requirements. LGIM expects companies to align their sustainability disclosures with the ISSB's published standards and any new ones, building on much of the work already in place from previous disclosures through standards such as GRI, SASB, etc. 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 sustainability data externally by a reputable independent assurance provider, based on recognised standards. This can be evidenced by making the assurance statement public. The verification exercise should provide comfort and credibility to stakeholders, including investors, around the sustainability data disclosed.

We encourage companies to make disclosures to key third-party sustainability agencies that are in line with best-practice international guidelines.

Financial impact quantification

The 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 to better understand their risk exposure and achieve a net benefit by managing sustainability impacts effectively.

We encourage companies to demonstrate a commitment to best sustainability practices and, where appropriate, quantify the financial impacts to internalise the associated costs and benefits. For example, to the extent that they are material6, 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 sustainability agenda and broach cross-sectoral and inter-sectoral sustainability 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 comprehensively disclose their public policy engagement activities, including trade association memberships (see section above on political donations).

Sustainability themes:

LGIM focuses on 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 and nutrition) and human rights issues, such as income inequality and modern slavery. Meanwhile, other issues, such as food waste, the 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 are very supportive of the International Sustainability Standards Board's (ISSB's) first two standards, published in June 2023. The standards present a global baseline for sustainability disclosures acting to amalgamate previously disparate disclosure requirements. LGIM expects companies to align their sustainability disclosures with the ISSB's published standards and any new ones.

Specifically in relation to climate disclosure, with the Financial Stability Board's (FSB's) announcement that the TCFD will now be integrated into the ISSB, we expect companies to develop their climate

[6] In accordance with IAS 1. Presentation of Financial Statements, 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

disclosures in line with IFRS S2 requirements, with a focus on improving approaches to scenario analysis and the quantification of financial impacts that result from climate risks.

In addition to IFRS S2 disclosure, we expect companies to report using the CDP climate questionnaire, which is aligned with the TCFD and IFRS S2 frameworks 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 also report via the CDP Water and Forest questionnaires.

Science Based Targets (SBTs) 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 SBTs aligned with the Science Based Target initiative's recent net-zero standard. Additionally, 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 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 in relation to 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 regards to climate disclosure will be removed from select LGIM funds, including our Future World funds, subject to tracking error constraints. In all other funds where we cannot divest, we will vote against the board 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

We believe that biodiversity loss presents a major global systemic risk.

We expect companies to assess their impact and dependency 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.

As a signatory to the Finance for Biodiversity Pledge, we have committed to collaborating and knowledge sharing, engaging with companies, assessing their impacts, setting targets and reporting publicly. Our nature framework and related policies can be found on our website.

Deforestation

LGIM recognises the importance of ending commodity-driven deforestation to tackle climate change, reduce biodiversity loss, and support food security. We are a signatory to the COP26 Commitment on Eliminating Agricultural Commodity Driven Deforestation from Investment Portfolios.

In 2022, LGIM published 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 companies in high-risk sectors with little or no deforestation policies of their own. Since 2023, LGIM has voted 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 on our deforestation policy here.

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. In certain sectors, the lack of a comprehensive deforestation policy constitutes one of our ‘red lines’ under the Climate Impact Pledge.

Circular economy

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

We believe 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.’ This 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 efforts on supporting a transition from a ‘linear’ economic model to a ‘circular economy’ model. LGIM’s expectation of companies will be expanded; it currently includes:

- Strengthened disclosures on the approach to a circular economy and the reduction of waste and pollution;
- A circular economy commitment, strategy, business model and policy across the value chain;
- Disclosure of the proportion of raw, re-used, recycled and compostable materials;
- Explanation of how the strategy is embedded, including any targets and progress made;
- Board-level oversight;
- Activities undertaken to protect and regenerate nature and ecosystems; and
- Any lobbying activities.

Water

Globally, we need a ‘Just Transition’ to economies that are 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 action being taken to protect our most precious resource.

LGIM will focus engagement activities 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 include: strengthening disclosures on their approach to the 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. The World Bank has estimated that AMR could result in a 3.8% loss in global GDP, an impact comparable to that of the 2008 global financial crisis.

We ask pharmaceutical companies involved in antimicrobial manufacturing to manage their effluent waste to reduce the risks of AMR, and we ask animal pharmaceutical companies to transparently disclose their AMR stewardship efforts. We also ask companies in sectors such as the food industry to apply the World Health Organization's guidelines on antibiotic use in food-producing animals, including in their supply chain. Further, we expect all water utility companies to be aware of the possible risks of AMR from contaminated water.

For more information on our concerns please read our health policy and blogs on the scale of the AMR problem, why the issue matters to investors, and how we're engaging with 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.

For more information on our concerns please read our health policy.

People

Human capital management

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 affects 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 provide 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.

The value a company places on employees can be measured by its efforts to receive and act upon employee feedback. Therefore, companies should also support workers' rights by allowing participation in freedom of association and collective bargaining.

Employee welfare

Companies should ensure that their workforce receives adequate training to gain the appropriate skills to carry out their jobs safely and 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 leave and paternity leave. We expect companies to provide access to services to help workers with any medical issues such as mental health, private health cover etc.

Diversity and inclusion

Just as we believe a diverse mix of skills, experience and perspectives is essential for boards to function and perform optimally, we similarly expect the companies they oversee to embrace different forms of diversity, including gender, ethnicity and neurodiversity. Our expectations on diversity and inclusion extend beyond the executive level and apply throughout the company. For more information on this topic, please refer to our diversity policy.

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 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.

Modern slavery

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 their supply chains. As such, we expect companies to adhere to all applicable laws pertaining to modern slavery that could result in financial and reputational risks, as well as potentially cause distress to those workers involved.

We believe merely putting in place a code of conduct is not sufficient for ensuring modern slavery does not exist within the supply chain. We expect companies to have a more rigorous process that includes, and is not limited to, due diligence audits, local workforce interviews and using technology to provide full traceability of all components of goods or merchandise sourced.

For more information please read our human rights policy.

Income inequality

Living wage: We expect all companies to pay employees at least the national minimum wage as mandated by law. We believe it is important that employers pay a living wage to ensure employees avoid the poverty trap, which can create hardship, stress and health problems that combined may have an impact on the operational performance of a company.

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 living wage also extends to all contractors who operate within a company's operational 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, we are calling for greater transparency on employee practices. We expect companies to say in their annual disclosures whether they are paying a minimum wage or a living wage.

We also ask companies to disclose the steps 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 free meals, interest-free loans etc.

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

Pensions: Companies should consider the long-term health and wealth of their employees and where possible, 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 can be a 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. The offer of shares should be linked to continued service.

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

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.

Important information

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