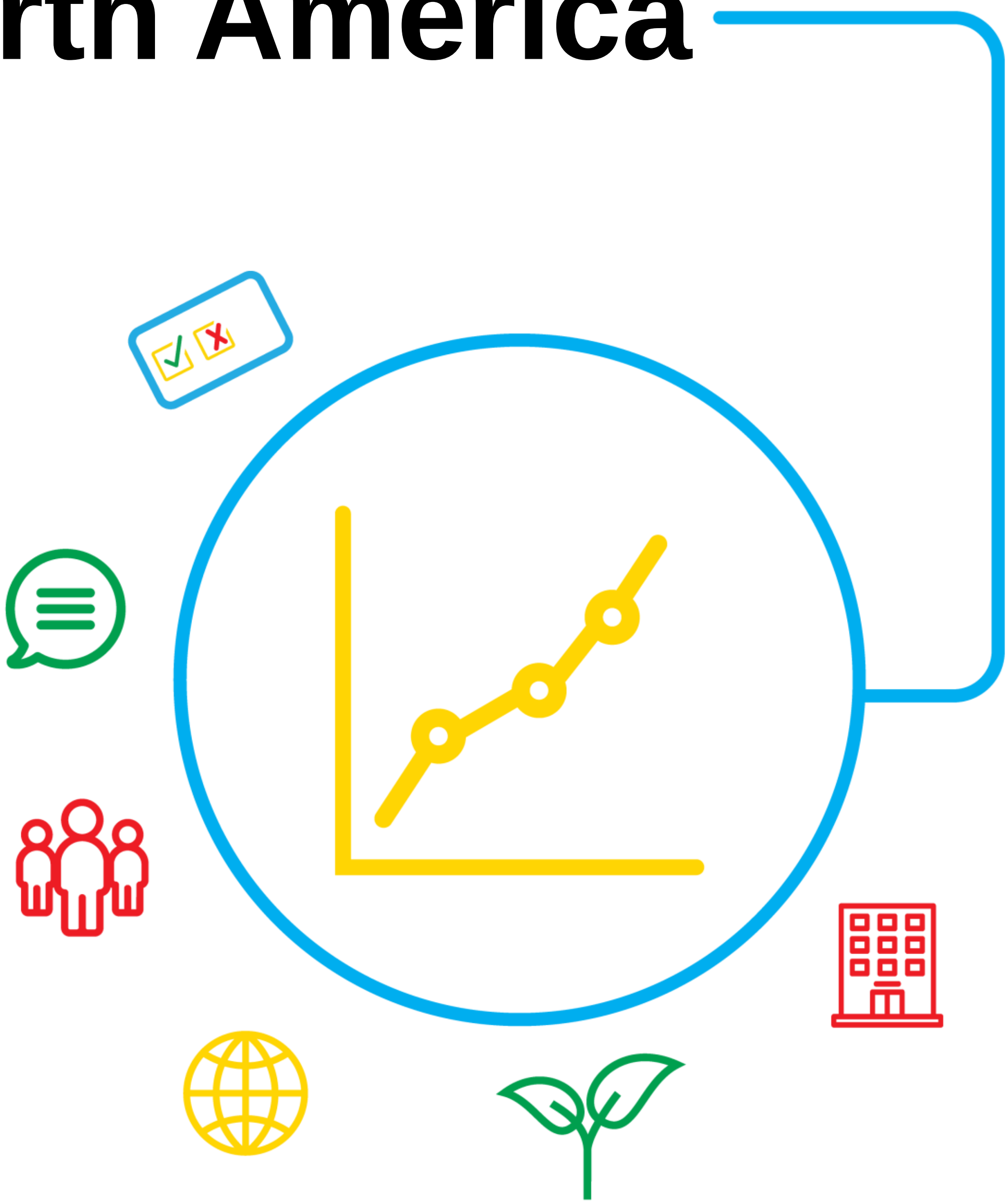
Corporate Governance & Responsible Investment Policy – North America



Legal & General
INVESTMENT MANAGEMENT

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Introduction

This policy sets out Legal & General Investment Management (LGIM)'s expectations of investee companies in the North American market in terms of corporate governance and outlines how LGIM exercises its votes. This policy is supplemented by, and should be read in conjunction with, LGIM's main Corporate Governance and Responsible Investment Policy - General. This provides a full explanation of LGIM's approach to voting and engaging with companies on environmental, social and governance (ESG) issues that are not differentiated by market, and is available on the website.

LGIM endorses the newly launched framework for US Stewardship and Governance by the Investor Stewardship Group, supporting the need for investor-led best practice guidelines for both companies and investors in this market. The Principles for US Listed companies identify 6 principles that are fundamental to good governance at listed companies and reflect many of the beliefs that are set out in this policy. However, LGIM's principles may be more specific and, on certain issues, more robust.

LGIM values engagement with its investee companies as a way to share knowledge and establish a relationship where views can be exchanged. Experience has taught us that companies find these engagements as useful as we do. We are also encouraged by the steady increase of direct engagement with board members as regular meetings with those who are directly involved in decision making is invaluable for us to gain a deeper understanding of specific issues.

As investors become more engaged with North American companies and as companies become more comfortable with requesting feedback on environmental, social and governance issues, progress continues to be made in this market.

Company board

INTRODUCTION

Every company should be headed by an effective board whose members are responsible for the management and long- term success of the company. LGIM continues to consider the separation of the roles of chief executive officer (CEO) and chair to be best practice as the roles are very different and require different skillsets. Further information can be found in our General policy on our website.

ROLE

The chair and the chief executive officer

The combining of these roles is far more common in the North American market but where companies are looking to depart from best practice with a combined chief executive officer (CEO) and chair, or a CEO becoming chair, LGIM expects meaningful explanation and justification in company disclosures. LGIM would also expect companies to consider a separation of the roles at transition points of the CEO role. LGIM will consider the merits of both situations and will evaluate on a case by case basis but in both instances the company should have:

- a majority or fully independent board;
- fully independent board committees;
- a strong lead independent director to ensure board balance;
- established governance guidelines;
- not exhibited sustained poor performance;
- no problematic governance or management issues.

LGIM would also expect the company to consider the separation of these roles at a CEO transition period as a matter of course. LGIM would also expect the company to clearly explain why, for instance, a dual role is considered to remain the best structure for the company. This explanation should go beyond stating that it is simply in the best interest of shareholders, as a boilerplate statement, given that this is very subjective. LGIM would expect a more clear and valuable explanation.

Where a company currently separates the roles of CEO and chair, LGIM would expect the company to retain this structure and where it is believed the structure should change, this should be put to a shareholder vote for approval. The board should not unilaterally take the decision to re-combine the roles without prior shareholder approval as it pertains to a key risk function oversight.

Lead independent director

The lead independent director (LID) role has been adopted by more and more companies in this market in recent years as the recognition of the need for a counteracting balance to a combined chair and CEO has increased. If a company does have an independent chair then LGIM would still expect there to be a LID, who acts as an important touch point for shareholders. LGIM would expect the LID to be available to shareholders on an annual or ad hoc basis to discuss any relevant issues.

LGIM expects the role of the LID to be clearly set out with clearly defined and comprehensive duties. The duties should include, but are not limited to, the following:

- presides at all meetings of the board as well as at those at which the chair is not present, including executive sessions of the independent directors;
- serves as liaison between the chair, management and the independent directors;
- approves information sent to the board;
- approves meeting agendas for the board with the ability to add agenda items;

- approves meeting schedules to assure that there is sufficient time for discussion of all agenda items;
- if requested by major shareholders, ensures that he/she is available for consultation and direct communication.
- authority to call a board meeting (as well as a meeting of the independent directors of the board) at any time;
- guides the annual assessment of the board and chair;
- meet regularly one-on-one with the CEO.

In order to illustrate the effectiveness of the LID role, LGIM encourages companies to provide a letter authored by the LID in the annual proxy statement. This letter should disclose the focus areas of the board over the last year and provide some guidance as to the expected focus for the coming year. This will enable shareholders to gain some more detailed insight into board discussions, helping to facilitate shareholder engagement with the LID and other board members.

Voting on role of boards

LGIM will usually support company management on board elections. However, if the company does not provide a satisfactory explanation in its proxy statement or has not engaged with LGIM directly, then factors which may lead to withholding support from directors include:

- Concerns about an individual director's performance;
- Concerns about overall business performance and strategy;
- Concerns on board composition, succession planning, and effectiveness.

LGIM will generally support:

- A shareholder proposal requesting the separation of the roles of chair and CEO as we continue to see this structure as best practice.
- The appointment of a lead independent director.

STRUCTURE AND OPERATION

Diversity

The diversity of the board is an issue that is familiar to the boards of North American companies and many already take this into account when recruiting directors. However, LGIM raises this issue when engaging with companies and considers the diversity of a board in terms of gender, experience, skills, geographic knowledge and nationality. LGIM believes these factors should reflect the wider company and customer base in order to be stronger, more resilient and successful. See our thought piece on diversity on our website: www.lgim.com/corporategovernance.

LGIM considers diversity to be a key structural issue for the board as well as for executive levels below the board. LGIM expects companies to look to the widest pool for its talent and supports companies that may put up for election a director without previous board experience or a director without CEO experience that have relevant knowledge and expertise to assist the board. Where there are no women on the board, LGIM will generally vote against the Chair of the Nomination Committee at S&P 500 companies.

Independence

The independence of non-executive directors is important and valued to ensure a balanced and well-functioning board.

LGIM supports the New York Stock Exchange (NYSE)'s criteria on non-executive director independence but also applies its own criteria. A non-executive director would not be considered independent if he or she:

- Has been an employee of the company or group within the last five years;
- Has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director, or senior employee of a body that has such a relationship with the company;
- Has received or receives additional remuneration from the company, apart from a director's fee, such as the company's share option, performance related pay, or pension scheme;

- Has close family ties with any of the company's advisers, directors, or senior employees;
- Holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- Represents a significant shareholder.

Re-election of directors

The board should ensure planned and progressive board refreshment and LGIM encourages the annual re-election of all directors. This strengthens board accountability and allows shareholders to more easily express dissatisfaction with board decisions.

Where an individual director fails to receive a majority of the votes cast in an uncontested election LGIM would expect they tender their resignation. The board should accept the resignation or provide a robust and timely explanation for not accepting. Where a company does not provide such disclosure, the director should not be allowed to remain on the board.

Declassified board

The existence of a classified board in North America, whereby directors are elected on a staggered basis every three years, remains at some companies. LGIM believes this is not in shareholders' interests as it not only reduces board accountability and turnover but can act as a takeover defense. Therefore, LGIM will encourage a company to move away from a classified structure and will support shareholder proposals put to the company to declassify the board.

Majority vote

Many North American companies still elect directors by a plurality vote standard. Under this standard if one shareholder holding only one share votes in favor of a nominee, then that nominee "wins" the election and takes a seat on the Board. This standard was assumed by companies as they were concerned that one or more directors would not receive a majority of votes resulting in failed elections. In recent years, more North American companies have adopted a majority vote standard for board elections whereby a nominee would have to receive the support of a majority of the shares voted in order to be elected. LGIM believes that this structure should be assumed by all companies as it increases accountability of board members to shareholders. The election of directors is a fundamental shareholder right and so should be undertaken in a democratic way. LGIM will support shareholder proposals put to the company to implement a majority vote standard.

In general, companies with a plurality vote standard use "withhold" as the contrary vote option in director elections, and companies with a majority vote standard use "against". Essentially these are both negative votes with "abstain" not a valid option in this market.

Board mandates

The over-boarding of directors is an issue LGIM considers carefully. LGIM will suggest that a director with a full-time CEO role at a large public company should not undertake more than one other outside non-executive directorship. Additionally, as non-executive director, board positions become more involved and challenging. Therefore, LGIM would not expect individuals to hold more than a total of 4 public company board roles, in order to ensure sufficient time to exercise the role effectively (subsidiary companies are not considered as a separate company).

Board evaluation

LGIM expects the board to perform an annual internal board evaluation, guided and/or facilitated by the LID and/or the chair of the Nomination Committee. The process of evaluation and how this is of benefit should be clearly set out. The exercise should be regularly reviewed to ensure that the way it is undertaken remains beneficial and that necessary changes can be made.

There is no requirement for North American companies to perform external board evaluations. LGIM would, however, always encourage a company to perform such evaluations on a periodic basis, as they are beneficial for identifying issues pre-emptively that the board may need to work on and may avoid potentially facing negative votes for director elections. LGIM encourages the company to perform these periodically (e.g. every three years) and to view them as a positive exercise to help identify areas where the board could perform better, ensuring the company is led by the best group of people.

The LID should be able to discuss the high level outcomes of these evaluations which shareholders in order to foster an informative discussion and a deeper understanding of the workings of the board. Please see our thought piece on this topic on our website: www.lgim.com/corporategovernance

Board tenure

The discussion around board tenure has become a key focus in this market. Whilst the majority of board members in the North American market do not have tenure limits, many companies do apply retirement ages for their directors. However, LGIM does not consider retirement ages to be an adequate limitation on board tenure as these can be and often are easily extended. Instead,

Voting on structure & operation of boards

LGIM will usually support company management on board elections. However, if the company does not provide a satisfactory explanation in its proxy statement or has not engaged with LGIM directly, then factors which may lead to voting against directors include:

- A lack of a majority of independent directors;
- A classified board structure;
- A plurality vote standard;
- A lack of board diversity – LGIM will vote against the Chair of the Nomination Committee of S&P 500 companies, where there is an all-male board;
- Over-boarding – Where LGIM considers a director/executive director to be overboarded, we will vote against a CEO at their "home" companies as well as at the companies where they hold non-executive roles. LGIM will vote against an over-boarded non-executive on the boards of all the companies at which they sit;
- Poor attendance – where a director has attended less than 75% of board and/or committee meetings without an adequate and meaningful justification;
- Board responsiveness – where the board has failed to act on a majority supported shareholder proposal for the last 2 years; or has failed to address issues with a director who received more than 50% against vote in the previous year;
- As part of our engagement activities to escalate an issue of concern.

LGIM will generally support:

- A proposal requesting the declassification of the board;
- A proposal requesting a majority vote standard for the election of directors.

To encourage board refreshment LGIM will generally vote against:

- The chair of the Nomination Committee if the average tenure of the board is 15 years or more;
- The chair of the Nomination Committee if there has not been any new board appointments for 5 years or more;
- The chairs of the key board committees and/or the Lead Independent Director if they have been serving on the board for 15 years or more.

LGIM supports the limitation of board tenure, whether this comes through a formal policy or through a more informal approach. See our separately published thought piece on board refreshment on our website and our voting on this issue at the end of this section – http://www.lgim.com/corporategovernance.

Skill sets

LGIM expects the company to disclose separate information on the skill sets of board members within the proxy statement, enabling shareholders to easily understand the composition of the board in terms of skills. Also disclosed should be narrative around why the specific skill sets identified are important for the company and aligned with the long-term strategy.

BOARD COMMITTEES

LGIM expects listed companies to have a fully independent audit, nomination, and compensation committee. This ensures that specific independent directors are responsible for these key board functions. Companies may also have other committees such as a governance committee or a research and development committee.

Audit Committee

LGIM expects all companies to have an audit committee comprised entirely of independent directors. The function of the audit committee is very important as it safeguards shareholders' interests. In order that it operates effectively, it is vital that at least one of the members has financial experience. In addition, members should have sufficient time to examine the financial reports that they are provided with and to liaise with both internal and external auditors.

Compensation committee

LGIM expects the committee to comprise independent non-executive directors that have the time to devote to matters of executive remuneration. The chair of the Committee should have served on the board for at least a year prior to their appointment and be able to devote sufficient time to both engage with shareholders where necessary and to take a leading role in establishing a policy that meets the expectations of management which will deliver the desired strategy.

Compensation committees should seek independent advice. Therefore, external advisors and consultants advising the committee should be fully accountable to the committee. A large voting opposition (>20%) to the say on pay proposal should not be ignored and the committee should:

- Publish an explanation for the dissent in disclosures including what the board is doing to address concerns.
- Consider re-tendering the compensation consultant contact.

The committee should consider carefully, and be able to demonstrate, how it has reviewed the pay policy of the entire workforce when setting pay for the executive team. The committee should also make itself aware of the views of the company's largest shareholders, whose pay policies are generally published on their websites. LGIM will consider voting against the election of individual board directors where we do not support compensation plans for the second consecutive year.

Nomination committee

LGIM believes that the nomination committee performs a vital role of ensuring that adequate succession plans are in place to enable orderly and successful board succession. The nomination committee should consider diversity when appointing new board members and should consider directors who do not have previous board experience and should ensure that any search firms used look to the widest pool for candidates. The nomination committee should also ensure that there are rigorous onboarding processes which are disclosed to shareholders as this is an important part of ensuring new board members are prepared to contribute effectively.

Voting on board committees

LGIM will usually support company management on board elections. However, if the company does not provide a satisfactory explanation in its proxy statement or has not engaged with LGIM directly, then factors which may lead to voting against directors include:

- Concerns with specific committee decisions (e.g. a lack of pay for performance correlation by the compensation committee);
- A non-independent director who sits on any of the three board committees;
- The company lacking a formal audit, compensation or nomination committee.

ACCOUNTABILITY

LGIM expects to engage with its investee companies on a regular basis and concerns raised by investors should be managed effectively and reported to the company board. The directors of North American companies are not so accessible to shareholders; engagement is usually undertaken with investor relations and/or legal counsel. LGIM believes that the directors of North American companies should make themselves more accessible to shareholders in order to engage on any issues whether or not related to a vote at the company's AGM. These conversations will foster an understanding between directors and shareholders that will help both to navigate the key issues that are being considered and to more quickly resolve any issues that may arise.

Audit and risk

INTRODUCTION

LGIM believes that the board is responsible for determining the company's approach to risk, setting its culture and monitoring the controls in place to manage it effectively. The Audit Committee of the board is also responsible for recommending the appointment of auditors whose responsibility is to provide reassurance that the financial statements presented by executive directors are a true and fair reflection of the underlying health of the business.

INTERNAL AUDIT

Companies should also establish a whistleblowing policy that is integrated into its Code of Conduct for employees. Reporting channels for whistleblowing should be clear and procedures should promote individual responsibility. How bribery and any other illegal behavior are tackled should also be reported.

LGIM would support a company's decision to have a separate risk committee, particularly in financial institutions and other businesses that are more complex and operate in high-risk sectors. These companies would benefit from having independent oversight over the financial, operational and reputational risks faced by the business.

EXTERNAL AUDIT

LGIM expects companies to review the external auditor at regular intervals and consideration should be given to rotation to ensure independence is maintained. If, after an evaluation, the board decides to continue with the existing auditor, the audit committee report should provide an explanation of this decision and why this is in the best interests of the company and its shareholders.

However, our view is that a company should change its auditors every 15 years. The proxy statement should clearly disclose the audit firm used, the tenure of that firm, the tendering process and why the company considers the auditor to be independent. Where a company has a long-tenured auditor LGIM may instigate a further discussion during our engagement, in order to understand the company's approach further. Also disclosed should be a breakdown of non-audit work carried out as well as information on the fees paid for both audit and non-audit work. In addition, when a contract is being awarded for non-audit work, companies should try to use a different audit firm where possible. We also believe that a 50% upper threshold limit for non-audit fees to audit fees should be implemented.

CYBER SECURITY

Cyber attacks are a reality for many large organizations today – these have been considered as threats of a level equal to natural hazards or terrorist incidents. Insufficient security can mean many things – from the loss of confidential client records to corporate espionage – and can have significant financial implications. As such, this represents a significant financial and operational risk to the companies in which we invest. We don't see this as an issue that can simply be delegated to the IT function of an organization: the function should be owned and overseen by the board.

We believe that a company should take a risk-based approach to the issue and therefore the board should be assessing this matter strategically. It is the board's role to understand the infrastructure needed in the business to protect valuable information assets and key intellectual property. Therefore, during our engagement with companies, we have been discussing the board's approach to assessing cyber related issues and the impact on their business.

Voting on audit and risk

LGIM will usually support the re-election of the company's auditor; unless:

- Non-audit fees paid exceed the fees received for audit work by 50%, and there is insufficient information;
- The auditor has failed to recognize financial irregularities while carrying out their audit.

Compensation

INTRODUCTION

LGIM carefully reviews the compensation awarded to senior executives and believes that it should be an appropriate mix of base salary and performance-based short and long-term incentives. A company should provide comprehensive, timely and transparent disclosure of its compensation policies in the Compensation Discussion and Analysis document as part of its SEC filings.

The four main areas of focus when considering a compensation policy are the overall design and structure of the program including performance metrics, the quantum of awards paid to executives, the link between pay and performance, and the content and quality of the company's disclosure. This information should all be available in the Compensation Discussion and Analysis disclosure.

LGIM is increasingly concerned about the misalignment of both the structure and quantum of executive pay compared with company performance, but is supportive of payments for successful long-term performance. LGIM promotes structures that are simple, transparent and aligned to the long-term strategy and performance of the business.

In the North American market, companies are more frequently canvassing shareholder opinion on compensation plans to seek feedback on their structure. Although a formal consultation process remains to be established in this market, LGIM encourages companies to engage with shareholders on major compensation changes, so as to foster further understanding of expectations and ensure that mutually beneficial plans are put in place. LGIM also supports companies allowing investors a vote on compensation annually.

BASE SALARY

New appointees

LGIM believes that the compensation committee should be mindful of the impact on the general workforce and other members of the executive team when deciding on the pay for a new executive board member. The committee should consider placing new executives on a lower salary than the incumbent person they are replacing with a view to increasing their pay over a period subject to performance.

Salary increases

LGIM believes that pay increases should be aligned with that of the general workforce or inflation, unless there is a compelling reason why a higher pay award is necessary, i.e. promotional increase. Any significant increase in salary should be communicated clearly to shareholders.

LONG-TERM INCENTIVES

It is important that a company motivates and rewards executives by granting long-term equity incentives which will align directors' interests with those of long-term shareholders. These incentives should be structured to motivate management to build a sustainable business which will generate positive returns to shareholders over the longer term.

LGIM advocates the adoption of one long-term plan. The plan should not have too many performance conditions but should include at least one measure that is linked to shareholder returns ideally relative to a meaningful peer group or index. Other measures should be linked to the strategy of the business, such as Key Performance Indicators (KPIs) which are selected by management.

LGIM expects executive remuneration to be linked to sustained long-term shareholder returns and therefore prefers companies to consider schemes that have at least 3-year performance targets. We would support a scheme that even goes beyond the conventional 3-year targets, whether in the performance period or as a holding period after the equity has been awarded. Where a company has suffered a significant fall in share price, LGIM would expect the remuneration committee to reduce the size of long-term awards so that management is not unjustly rewarded with windfall gains if and when the share price recovers. Equity compensation plans should be comprised of a majority of performance awards linked to achieving stretching targets.

Companies should explain clearly how performance metrics are to be calculated, i.e. adjusted earnings per share, especially if it differs from the reported numbers. Another area where further explanation is required is in relation to the accounting treatment of significant acquisitions, disposals, share-buy backs and foreign currency.

Performance shares

LGIM supports the granting of share awards based on performance metrics, but awards should be capped either as a percentage of salary or as a fixed number of shares and all grants should be subject to rigorous pre-established performance conditions. We would expect PSUs to make up at a minimum 50% of a long term equity award.

Share options

LGIM supports the award of share options as part of an equity award if the company feels that they remain incentivizing, but ideally they should not exceed 20% of the mix of equity awards. However, LGIM considers stock options to be time-based rather than performance-based awards as the stock price can increase due to external factors rather than solely due to management performance.

Restricted shares

LGIM will support restricted share units that make up a long-term equity award. However, we would expect RSUs to only make up 50% or less of a long-term equity award.

Transaction bonus schemes

LGIM does not support introducing a separate scheme to reward the completion of an acquisition or for extracting synergy benefits. We believe existing schemes would provide adequate reward if the acquisition strategy, as part of the long-term strategy for the company, is successful.

Retention bonus

LGIM does not support these plans as retention should be addressed through existing schemes and the discretionary nature around such retention awards make it hard for them to be assessed against company performance.

Share buybacks

LGIM will encourage a company to return cash to shareholders via a special dividend if it holds a significant amount of cash on its balance sheet that is not required to fund its working capital or for future acquisitions. LGIM believes that not keeping excessive amounts of cash is prudent capital management. A share buyback could be used if appropriate but this will depend on the price of the shares as LGIM would not encourage companies to undertake a buyback if the company is highly valued.

There is a concern that some companies spend significantly more on share buybacks than on research and development and capital expenditures. While stock buybacks may boost stock prices in the short term, they deprive companies of the capital necessary for creating long-term growth. LGIM pays close attention to earnings per share measures used in long-term equity plans and would expect companies to adjust earnings numbers as stock buybacks can inflate these numbers, against which executives are rewarded.

Equity dilution

LGIM believes that strict guidelines should be adhered to in relation to the issuance of shares for incentive schemes, limiting potential dilution to shareholders. LGIM expects no more than 10% of a company's equity to be used for all share schemes over a 10-year period and no more than 5% in 10 years for discretionary schemes. Treasury shares should be included within these limits. Such restrictions should apply to all shares whether market purchased or newly issued. The issuance of shares should be accompanied by clear disclosure and an explanation to shareholders.

Hedging of stock

LGIM believes that the hedging of shares by executives in the shares of the companies where they are employed severs the alignment of interests of the executive with shareholders. We believe companies should adopt strict policies to prohibit executives from hedging the economic risk associated with their share ownership in the company.

Pledging of stock

LGIM believes that shareholders benefit when employees, particularly senior executives, have "skin in the game".

LGIM therefore recognizes the benefits of measures designed to encourage employees to both buy shares out of their own pocket and to retain shares that they have been granted.

LGIM also recognizes however, that the pledging of shares can present the risk that an executive with significant pledged shares and limited other assets may have an incentive to avoid a forced sale of shares in the face of rapid stock price decline. Therefore, to avoid substantial losses from a forced sale to meet the terms of the loan, the executive may have an incentive to boost the stock price in the short term in a way that is unsustainable and so hurting shareholders in the long term. Concerns regarding pledging may not apply to less senior employees, given the latter group's significantly more limited influence over a company's stock price. Therefore, the issue of pledging shares should be reviewed in that context, as should policies that distinguish between the two groups.

Pay ratio

In 2015 the SEC adopted a final rule requiring public companies to disclose the ratio of the compensation of its CEO to the total compensation of the median company employee. The disclosure will be required after the first full fiscal year following 1 January 2017, so the first disclosures will be in the 2018 proxy season. The company will be permitted to select its methodology for identifying its median employee's compensation which the company is allowed to determine every three years. Non-US employees from countries in which data privacy laws or regulations make companies unable to comply with the rule can be excluded.

To identify the median employee, the SEC rule would allow companies to select a methodology based on their own facts and circumstances. A company could use its total employee population or a statistical sampling of that population and/or other reasonable methods. A company could, for example, identify the median of its population or sample using:

- Annual total compensation as determined under existing executive compensation rules; or
- Any consistently-applied compensation measure from compensation amounts reported in its payroll or tax records.

LGIM encourages companies to use its total employee population and to identify the median by using annual total compensation as determined under existing executive compensation rules. We encourage companies to use this one method so that the information provided will be consistent and therefore comparable.

The disclosure of this information will further heighten scrutiny on executive compensation practices, with specific focus on how CEO compensation compares to the median employee. Depending on the magnitude of pay ratios the new disclosures may exacerbate existing concerns among investors around executive compensation.

The pay ratio disclosure will provide shareholders with additional company specific information that can be used when considering a company's executive compensation practices, an important area of corporate governance on which shareholders now have advisory votes. This disclosure illustrates the recognition of the dangers of disparity in pay levels and if used effectively the compensation committees should use the data to better moderate pay packages and reduce the trend of pay disparity. The changes in CEO-to-worker pay ratios will be a useful measure of growing CEO pay levels and will hopefully reduce CEO pay levels and encourage boards to also consider the relationship of CEO pay to other company employees. Companies with high pay ratios will have to explain and justify the ratio to their shareholders, putting more focus on the reasons behind potentially large CEO pay quantum.

LGIM will use the pay ratio information on a relative basis across sectors rather than an absolute basis, allowing us to compare the employee compensation structures of companies over time and against their competitors. Such disclosure will provide valuable information about which companies are investing in their human capital, an increasingly important contributor to shareholder value and strong business culture. However, LGIM will use this information as only one part of the assessment of overall compensation.

Pay versus performance disclosure

In 2015 the SEC proposed a rule that will require companies to disclose the relationship between compensation actually paid to named executives and the financial performance of the company. The company would be required to disclose executive compensation actually paid to the CEO and the average for all other NEOs along with the total shareholder returns of the company and a peer group for the same period. The proposed rules would require the inclusion in the proxy of a new table as well as a graphic or narrative description of the relationship between pay and company TSR and company TSR and peer group TSR.

PERFORMANCE METRICS & TARGETS

The board should determine what the right metrics are to deliver the strategy, and what level of stretch in the target is appropriate to deliver the right outcomes for all stakeholders.

- Metrics should be linked to long-term strategy, stretching but achievable;
- Performance targets should use the reported numbers without further adjustments, save for share repurchases and other capital changes. Any adjustments should be consistent, explained and reconciled with reported numbers;
- Long term incentive performance targets should be disclosed prospectively and short-term annual bonus targets retrospectively;
- Targets that are commercially sensitive to the business should be disclosed retrospectively, within two years;
- Companies should disclose as many of the bonus targets as possible to highlight the integrity of the target-setting process;
- Strategic/qualitative and individual targets should be fully explained;
- Where an EPS measure is used, this should be adjusted for share buybacks;
- Dividends can be accrued but should only pay out on shares that vest;
- In addition to compensation committee discretion, clawback should apply to all elements of performance-related pay and be fully explained.

QUANTUM

As the executive compensation landscape continues to evolve to meet the needs of modern corporations, companies must take into account the current social sensitivities around inequality of pay.

We entrust the current board to ensure that executive pay is set at an appropriate level to drive positive corporate behaviour and performance. In doing so, the board should consider the wider impact of executive pay e.g. the general workforce, public perception and the economic climate.

Boards should not consider increases to individual elements of compensation in isolation and should consider the ratcheting effect. The board should question whether the total package is appropriate for a role of this nature, preferably without referring to benchmark data, i.e. perform a sense check, even if performance targets are met.

- Boards are expected to consider the pay ratios between the CEO’s single figure to median employee. Is it sensible in light of the industry in which it operates? Are the ‘year-on-year’ changes in the ratio appropriate in light of performance?
- Salary increases should be in line with the general workforce unless there has been a genuine change to the role with increased responsibilities in which case a phased increased is expected. When reviewing base salary, consideration should be given to the impact of any change on the total package.
- We would encourage the reduction of short term annual bonus levels. 200% of salary should be reserved for the largest global companies.

The focus on median pay has contributed to the general increase in executive compensation for all companies with less focus being given to the actual performance of the individual company and absolute pay. For this reason, LGIM discourages the over reliance on benchmark data as pay schemes vary considerably between companies. When considering the constituents of a benchmark, attention should be given to the relative performance as well as size of the companies. For instance, use the same benchmark to review pay and performance.

BENCHMARKING

The focus on median pay has contributed to the general increase in executive remuneration for all companies with less focus being given to the actual performance of the individual company. Benchmarks should be used only as a starting point, and should be limited to only include companies of a similar size and complexity. For example, a small cap company should not consider companies that are in the S&P 100 within their benchmark group, and a retailer should not consider a bank to be an appropriate benchmark. The comparator group should not be too large or too small that it creates a distortion in outcomes and a company should fully explain the rationale for the benchmark selected. LGIM expects the company to disclose the benchmark index used or the constituents if a small group of companies is used.

Companies should consider their own performance relative to their chosen benchmark when deciding the level at which pay is set. Companies whose performance is within the lower quartile relative to their peers should not be aiming to set base pay at the median. Benchmarks used for assessing compensation should be consistent with benchmarks used to assess company performance.

EMPLOYMENT CONTRACTS & SEVERANCE PAYMENTS

Employment contracts

Re-location benefits

LGIM will support reasonable re-location benefits paid to executives which the company should fully explain with information on how the figure was determined.

Severance arrangements and change in control provisions

Directors should not expect compensation for the early termination of their contract and the compensation committee should ensure that employment contracts do not leave any room for payment in the event of poor performance. When setting employment contracts the board should consider the level of potential severance pay and also disclose the performance conditions under which such severance benefits are paid. Severance payments should be limited to a maximum of one times base salary and bonus, and under a change in control situation limited to 2.99 times base salary and bonus.

Under the Dodd-Frank Act companies are required to provide additional disclosure regarding compensation arrangements with executive officers in connection with merger transactions, known as “golden parachutes”. Disclosure should be made of all agreements and understandings that the acquiring and target companies have with the executive officers of both companies. Companies should provide a separate shareholder advisory vote to approve “golden parachute” arrangements in connection with a merger, acquisition, consolidation, proposed sale or other disposition of all or substantially all assets. LGIM will consider each arrangement on a case by case basis taking into account various factors including the value of the payments, the tenure and position of the executive, and whether there is a single or double-trigger provision.

The accelerated vesting of equity due to a change in control does not reward performance and would not be an element LGIM would support. Instead, equity should move to the newly merged company and should vest over a period of time if performance conditions are met. If the board considers accelerated vesting appropriate then this should only be triggered if a change of control has occurred and the executive loses his job in the new company - known as a “double-trigger”. Accelerated vesting should not occur simply on a change of control with the executive remaining employed in the new company – known as a “single-trigger”. Such accelerated vesting of awards made under a change in control situation should be done on a pro-rata basis so that only awards that have met performance conditions are given.

Tax gross-ups

A provision of the Tax Reform Act was implemented to limit the severance packages of executives by imposing an excise tax penalty if severance payments exceeded the regulated 2.99 times base salary and bonus. The intention was that this tax policy would cap such severance payments as there would be tax disadvantages for both the company and individual. However, the unintended outcome was that companies would insulate the executive from these potentially adverse tax consequences by agreeing to gross-up the severance payments.

In agreeing to tax gross-ups on employment agreements, the compensation committee may be committing the company to paying excessive amounts in the event of a change in control. LGIM does not support such payments and many companies have begun to phase out such tax gross-ups which LGIM encourages.

Clawback provisions

LGIM expects listed companies to adopt a policy for recouping incentive-based compensation paid to current and former executives in the event of an accounting restatement due to material non-compliance with any financial reporting requirement. LGIM encourages companies to adopt a robust clawback policy that goes beyond financial metrics to include issues such as bribery and corruption especially where a material risk for the company.

SHARE OWNERSHIP GUIDELINES

LGIM expects companies to encourage share ownership among its directors and senior executives. Shareholding requirements should be meaningful, taking into account the size of the company and potential size of share awards received. We would expect any shareholding guideline to be achieved using shares that are not subject to any deferral period. We also expect there to be a policy for post-exit holding, where an executive would be expected to hold 50% of his or her equity for 2 years after leaving the company. This ensures that executives are still impacted by the decisions made whilst at the company that may take time to play out.

PENSIONS

Pensions are a significant cost and risk for the company as well as an element of remuneration that is not linked to performance. The long term cost of providing a pension should be taken into account when determining a remuneration package. Companies should aim to align pension costs across the company.

LGIM will not support pension enhancement payments at retirement or when a contract is terminated early. Pension provisions should be disclosed in full in the report and accounts and any changes to pension benefits should be fully identified and explained. Individuals should not be compensated for changes in tax laws and regulations.

COMPENSATION CONSULTANT

As mandated in the Dodd-Frank Act the SEC approved new listing requirements for both the NYSE and NASDAQ requiring compensation committees to consider six factors in assessing compensation consultant independence. The factors are:

Provision of other services to the company;

2. Fees paid by the company as a percentage of the advisors total annual revenue;

3. Policies and procedures of the advisor to mitigate conflicts of interest;

4. Any business or personal relationships of the consultant with any member of the compensation committee;

5. Any company stock held by the consultant;

6. Any business or personal relationships of the consultant with any executive officer of the company.

The SEC has stated that not one factor should be viewed as a determinative factor. LGIM believes that this assessment is an important process for every compensation committee to undertake. Compensation consultants are engaged to provide objective expert advice to the compensation committee, so when the consultant or its affiliates receive substantial income from providing other services to the company, we believe the potential for a conflict of interest arises and the independence of the consultant may be lessened.

Voting on compensation

When voting on a company's compensation report or various equity plans LGIM will evaluate the structure of the compensation policy as a whole, as well as company performance and the quality of disclosure of all elements of compensation.

Although not an exhaustive list, LGIM may vote against the advisory vote on executive compensation due to the following:

- Executive compensation that is not aligned with company performance;
- Performance targets which are not sufficiently challenging;
- Executive compensation that is predominantly focused on short-term stock performance rather than long-term value creation;
- A majority of the long term compensation equity awards not linked to performance metrics;
- The comparator group companies are inappropriate leading to excessive compensation levels;
- Executive and/or director compensation is significantly higher than at realistic peer companies not justified by outstanding company performance;
- Egregious or excessive bonuses, equity awards or severance payments, including golden handshakes and golden parachutes;
- Guaranteed bonuses;
- Retention bonuses or one-off equity awards that are excessive or are not adequately justified;
- Discretionary bonuses paid when short or long-term incentive plan targets have not been met;
- Where discretion is exercised to allow a bonus or long-term incentive to vest without sufficient justification;
- Where there is insufficient disclosure regarding the use of discretion by the compensation committee;
- Directors who receive excessive perquisites;
- Directors who receive tax gross-ups under employment agreements or perquisites;
- Dilution rates that are excessive without sufficient justification;
- Disclosure on performance targets and how awards are calculated is poor;
- Overall disclosure is inadequate.

LGIM will support:

- A shareholder proposal requesting the company pro-rata the accelerated equity awards vested upon a change in control.

Shareholder rights

INTRODUCTION

The rights of shareholders are a fundamental element of corporation governance as they ensure the protection of shareholders as well as allowing shareholders fair access to a company.

ACTING BY WRITTEN CONSENT & CALLING SPECIAL MEETINGS

Shareholders should have the right to call special meetings. This benefit allows a shareholder to put resolutions to all shareholders at a specially convened company meeting. Generally, LGIM believes that companies should allow shareholders with a minimum holding of 10% to call special meetings as this allows sufficient access but prevents abuse of this benefit. However, LGIM will take into account the company shareholding structure when assessing whether this threshold is appropriate. There should not be any material restrictions to the ability of shareholders to call this meeting.

If a threshold of 10-25% holding (depending on the company shareholding structure) to call a special meeting is in place and if other governance practices are strong, as well as the company's open engagement with shareholders, then LGIM will not support the right to act by written consent as this can disenfranchise some shareholders to the benefit of only a few.

COMPANY BYLAWS

LGIM believes that exclusive forum bylaw provisions limiting a shareholder's choice of legal venue are not in the best interests of shareholders. Such clauses may effectively discourage the use of shareholder derivative claims by increasing their associated costs and making them more difficult to pursue. As such, shareholders should be wary about approving any limitation on their legal recourse including limiting themselves to a single jurisdiction (e.g. Delaware) without compelling evidence that it will benefit shareholders.

LGIM will vote against exclusive forum bylaws unless the company:

- provides a compelling argument on why the provision would directly benefit shareholders;
- provides evidence of abuse of legal process in other, non-favored jurisdictions;
- maintains a strong record of good corporate governance practices.

LGIM also expects companies to put bylaw amendments that have the potential to reduce or negatively impact shareholder rights to a shareholder vote.

ACCESS TO PROXY

Under the Dodd-Frank Act issuers can no longer exclude shareholder proposals related to a director nomination or election process unless the proposal would disqualify an existing nominee, remove a sitting director before the expiration of his or her term, or affect the outcome of an upcoming director election.

LGIM considers proxy access to be a standard shareholder right and will support proposals that allow access for 20% of the board, or at a minimum two seats, to be proposed to the proxy if a shareholder group of no more than 20 shareholders owns 3% of outstanding shares for 3 years.

LGIM considers:

- Restrictions on re-nominations when a nominee fails to receive a specific percentage of votes as inappropriate – resubmission requirements are not required for management's candidates therefore should not apply to candidates proposed by shareholders.
- Securities on loan should be counted towards the ownership threshold – provided the shareholder shows it has the legal right to recall shares for voting purposes and will vote them at the shareholder meeting along with representation that the

shareholder will hold those shares through the date of the meeting.

- A requirement that a nominator provide a statement of intent to continue to hold the required percentage of shares after the annual meeting as unnecessary – nominating shareholders may not know their intent to hold, sell or buy shares until after the election, so the pre-filing holding period of 3 years coupled with the requirement to hold the shares through the shareholder meeting is adequate.
- A prohibition on a nominator from using proxy access for the two annual meetings following an annual meeting at which its nominee is elected to the board (except for the nominee initially elected) to be inappropriate.
- A group of funds to count as a single shareholder for the purposes of meeting the 3% ownership threshold with aggregation limits.

SUPERMAJORITY VOTE STANDARD

Supermajority provisions go against the principle that a simple majority of voting shares should be sufficient to effect change at a company. The supermajority provision serves to entrench management by preventing amendments that would be in the best interests of shareholders.

CUMULATIVE VOTING

Cumulative voting allows shareholders to cumulate their votes for one or more directors on the ballot. Each shareholder is entitled to as many votes as are equal to the number of their shares multiplied by the number of directors to be elected. The shareholder may cast all of such votes for one nominee or may distribute them among two or more nominees at their discretion. LGIM does not support cumulative voting as it does not protect minority shareholder rights.

DUAL CLASS SHARE STRUCTURES

Companies should adopt a one-share, one-vote standard and avoid adopting share structures that create unequal voting rights. We expect boards of companies with dual or multiple class share structures to review these structures on a regular basis and establish, in advance of their IPO and/or as company circumstances change, mechanisms to end or phase out controlling structures at an appropriate time.

COMPANY RE-INCORPORATION

LGIM will support a company's discretion in respect of re-incorporation within the US provided shareholder benefits are not in effect lessened in the new US state.

REIMBURSEMENT OF PROXY EXPENSES

LGIM will support a dissident shareholder for reasonable costs incurred in putting forward a shareholder proposal which has been successful and gained majority support from shareholders.

Voting on shareholder rights

LGIM will oppose:

- Share issuances with impaired or enhanced voting rights;
- Cumulative voting provisions;
- The adoption of exclusive forum bylaws without shareholder consent where the appropriate board member will be voted against;
- A proposal for re-incorporation into a different US state if shareholder benefits are lessened.

LGIM will support:

- Shareholder proposals to abolish supermajority voting provisions;
- Shareholder proposals to approve recapitalization plan for all stock to have one vote per share;
- Shareholder proposals to allow shareholders to call a special meeting with 10% holding;
- Shareholder proposals to allow shareholders to act by written consent if the special meeting threshold is set above 25% taking into account the shareholding structure of the company;
- Shareholder proposals to allow shareholders holding 3% for 3 years of company stock to propose nom-inees up to a maximum of 20% of the Board, or at least 2 seats.

Shareholder proposals

INTRODUCTION

The prevalence of shareholder proposals is far higher in the North American market than in most other regions with the majority of proposals focusing on shareholder benefits and social and environmental issues. LGIM considers 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 shareholders and wider governance landscape. Companies should provide a meaningful discussion of the shareholder proposals to enable shareholders to make an informed judgment. LGIM will consider all proposals on a case by case basis but a proposal may often form a point of engagement with the company whether or not LGIM supports the proposal.

POLITICAL DONATIONS

LGIM will not support direct donations to political parties by companies but appreciate that political dialogue is an important part of a company promoting and protecting its interests as well as contributing the development of an effective regulatory environment. LGIM believes that companies should produce a comprehensive report in this area, fully disclosing any political contributions, lobbying activity, and political involvement via trade associations. There should be increased transparency around the memberships and monies paid to trade associations and lobbying groups along with a clear explanation of how these associations benefit the causes that the company supports and where the oversight of these relationships lies.

Voting on shareholder proposals

LGIM will consider shareholder proposals on a case by case basis and in the wider context of the corporate governance practices at the company as well as the long-term benefits for shareholders and shall vote accordingly.

Sustainability

INTRODUCTION

As a major global investor, LGIM has a fundamental interest in ensuring that shareholder value is not eroded by a company's failure to manage its impact on its natural and social environment. At the same time, LGIM believes that a company's value can be enhanced over time through taking advantage of opportunities which arise from identifying efficiency in its operations. For more information please refer to the Sustainability section of LGIM's General CG & RI Policy – www.lgim/corporategovernance

LGIM expects companies to disclose material sustainability issues that impact the company in its public documents. .Such disclosures should also explain how the company manages its own impact on the environment and society such as GHG emissions and labor standards, and what it is doing to manage and mitigate these. Specifically on climate change, our engagements with companies will be focused around the Future World Fund – please see our website for more information: www.lgim.com/futurefunds

Voting on sustainability

LGIM will vote against:

- Relevant board members where disclosure is not adequate;
- Relevant board members in line with our climate pledge.

Contact Us

For any further information on anything you have read in this report or to give us feedback, please contact us at corporategovernance@lgim.com. Please visit our website www.lgim.com/corporategovernance where you will also find more information including frequently asked questions.

Important Information