



Corporate Governance and Responsible Investment Policy

UK 2020

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Company board

Legal & General Investment Management's (LGIM) board of directors is responsible for the management and long-term success of the company, taking into account the best interests of the company and its stakeholders. It should always act as a steward of stakeholders' interests.

The board sets out our strategy and direction, ensuring that the necessary resources are available to enable its implementation and that appropriate risk management and internal controls are in place. It's our philosophy, ensuring that stakeholder views are considered and embedded in its culture. The board is expected to take into account environmental, social and governance (ESG) considerations and to report on company performance in these areas. It is also responsible for ensuring the integrity of our accounting and reporting, and the effectiveness of internal control systems. Lastly, the board is ultimately accountable to investors and other stakeholders and should make sure board decisions are effectively communicated to them.

Board leadership

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

The Board chair and the chief executive officer (CEO)

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

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

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

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

We would therefore not expect a retiring CEO to take on the role of chair. These two roles involve different responsibilities and a different approach to board relations and the company. Additionally, we have concerns that a hands-on CEO may find it difficult to become a hands-off chair. Where a company would find the presence of the former CEO on the board beneficial in times of transition, we encourage the CEO to be consulted by the board but not be a formal board member and would stipulate for this to be for a maximum period of one year.

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

The case of the combined chair and CEO

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

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

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

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

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

Senior independent director

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

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

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

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

https://www.lgim.com/files/_document-library/capabilities/the-role-of-the-senior-independent-director.pdf

Non-executive directors

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

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

Structure and operation Independence

An independent board is essential to ensure the board exercises efficient oversight and consistently acts in the best interests of the company and its stakeholders. Its importance on the performance of a company has been shown in several academic studies.

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

We recognise that non-independent, non-executive directors can offer significant skills and sector knowledge. This can help a company to perform at its best and to maximise value. In this instance, subject to board balance being maintained, we will

support a company if it wants to retain a non-executive director beyond the recommended nine years. However, the company must provide a full explanation of the benefits to the company of extending their services for another term.

In relation to the chair's independence, we recognize that companies need time to comply with the changes to the UK Corporate Governance Code introduced in 2018. Therefore, we will continue to treat a chair as independent until they have served on the board for 12 years. We will start to apply the nine-year rule from Jan 2021. In exceptional circumstances where a chair is required to remain beyond the 12 years, we would encourage early engagement with us to provide an explanation.

Diversity

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

Therefore, when recruiting members, a board should be cognisant of all elements of diversity that appropriately represent a company's operations, including gender, age, nationality, ethnic origin, background and experience. Consideration should also be given to the geographies in which the business operates, its future strategic international expansion plans and its consumer base.

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

Companies should ensure that candidates with appropriate skills and qualities are sought through the widest possible means such as the use of recruitment consultants, public advertisements, and the leverage of other relationships in the industry. Companies should also be prepared to look outside of the usual pool of candidates to include those from a less traditional 'corporate board' background. They should also be willing to recruit those without previous board experience as many, if not all, of the board members will have this experience and this will help to expand the candidate pool and the board's cognitive diversity.

For the UK market, we have publicly supported the initiative for companies to achieve a minimum of 30% women on FTSE 350 boards; and for 30% women at senior management level of FTSE 100 companies by 2020. In addition, we support the similar target developed by the UK Government's Women on Boards Report, and the Hampton-Alexander Review.

We expect all companies in the FTSE 350 to have a minimum of 30% women at board level. For smaller companies we expect at least one woman at board level.

As the diversity conversation has broadened beyond gender, we would expect companies to start to collect their data on ethnicity throughout all levels of the company. In 2019 the Government consulted on reporting on the ethnicity pay gap. We would expect companies to understand their data on this area of diversity and start to report on it.

Our article on diversity can be found here:

<http://www.lgim.com/uk/en/capabilities/corporategovernance/influencing-the-debate/>

Succession planning

Succession planning is a vital component of an efficient board. It ensures board continuity, and that individuals with the right sets of skills sit on the board.

We expect companies to put in place a formal and transparent procedure for the appointment of new directors. The external board evaluation exercise should assist in this task. We encourage companies to disclose this information in their annual disclosures. A skills matrix linked to the strategy of the company would be a useful diagram. In addition, we would welcome an explanation of how any newly-appointed directors fit into the matrix and the minimum time commitment needed to fulfil the role.

Re-election of directors

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

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

In addition to the biographical details of each director we also encourage the disclosure of attributes and skills which the director brings to the board and how these fit with the long-term strategic direction of the business. A skills matrix linked to the strategy would be useful.

Board effectiveness

Board tenure

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

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

Board mandates

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

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

We expect non-executive directors not to hold more than five roles in total. We consider a board chair role to count as two directorships due to the extra complexity, oversight and time commitment of this role. A practising executive director should not hold more than one non-executive director role within an unrelated listed company.

Board meetings and attendance

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

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

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 disclosing attendance records in their annual disclosures.

We expect directors to have attended no less 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.

Board size

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

Board evaluations – 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.

We expect an internal board evaluation to take place annually. This evaluation should be led by the chairman, with assistance from the company secretary. We expect an external evaluation of the board to take place at least every three years. These should be performed by an independent third party to avoid conflict. 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 disclosed in the company's annual disclosures, as well as progress on the outcomes of previous board evaluations. Any potential conflict of interest with external reviewers should also be disclosed.

Non-executive director induction

The chair of the nominations committee is responsible for ensuring that incoming non-executive directors receive a comprehensive induction to the company on joining the board and that training is available on an on-going basis. This will allow new directors to contribute to board meetings as soon as possible. This is especially important if the chair is considering a board member who does not have previous corporate board experience.

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

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

We would also encourage new board members to use their investors as a resource to help them in performing their duties. We hold an annual event, usually in September, that is aimed at non-executive directors and covers ESG topics of interest. We also regularly publish worldwide thought leadership pieces on relevant topics related to corporate governance, stewardship and responsible investment which can be accessed through our website.

Stakeholder engagement

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

Employee voice

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

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

- To appoint a worker director who will sit at board meetings and be allowed to speak and provide feedback. e.g. Sports Direct, Capita plc.
- To establish a formal workforce advisory panel, e.g. Marks & Spencer plc.
- The third is to appoint a non-executive director as a designated point of contact for workers, e.g. L&G plc.

We do not consider any single model superior to another. All companies should embrace their employees as valued assets and select the method that is most effective for their business model and current circumstances.

There are factors which 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
- 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

- Clear action plans for issues that impact employees are distributed to all staff via newsletter or all-staff email. A dedicated page on the intranet with its existence made aware to all staff. Open and transparent communication is important to get employee buy-in to the process. ‘Town halls’ should supplement written communication
- A feedback process for employees to help improve the process
- Employee engagement and staff turnover should be a score that is tracked over time, disclosed in the annual report and potentially linked to executive pay
- 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 positive correlation between employee engagement and performance.

In the future, 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 staff turnover. Greater public disclosure will increase awareness, improve practices, and can lead to greater productivity and long-term performance for all companies in the market.

- Investor dialogue

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

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

Culture

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

Company boards should disclose information that helps investors to understand company culture. Investors need reassurance that the CEO and management really drive the cultural message and set the tone from the top, and that this is regularly discussed and challenged by the board, as well as monitoring how the cultural message filters down to the rest of the organisation.

We expect companies to disclose information including:

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

For more details on our position, please refer to our publications on the topic available at: <http://www.lgim.com/uk/en/capabilities/corporate-governance/influencing-the-debate/>

Board committees

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

We expect all listed companies to put in place three separate board committees responsible for the core board functions of audit, nomination and remuneration.

Companies may also choose to put in place additional board committees where necessary and appropriate, such as a risk committee, governance committee or sustainability committee.

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

Audit committee

The audit committee is responsible for monitoring the integrity of the financial statements of the company; appointing external auditors; monitoring their qualifications, independence as well their effectiveness and resource levels. This committee is also responsible for the overall risk management of the company to ensure that sound and robust internal controls are in place to appropriately manage the company’s financial, operational and reputational risks.

As the audit committee plays a vital role in safeguarding investors' interests, we expect all companies to have an audit committee comprised entirely of independent non-executive directors. The committee should comprise at least three members, with sufficient financial experience to provide oversight and accountability; as such, we expect the audit chair to have financial expertise.

Non-independent directors may attend audit committee meetings by invitation but should not be members of the committee. The company chair may be a member of the committee if they are considered independent on appointment and continues to be independent but should not chair the committee. We assess the chair's independence on an annual basis.

Members should have sufficient time to examine the company's financial statements and to liaise with both internal and external auditors. The chair of the audit committee should be available to answer investors' concerns on specific audit issues.

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

Nomination committee

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

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

Given the key role of this committee in board composition matters, we expect it to be entirely composed of independent non-executive directors.

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

Remuneration committee

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

We expect remuneration committees to consist exclusively of independent non-executive directors. The company chair can be a member of the committee if considered independent on appointment and continues to be independent but should not chair the committee. We will assess the chair's independence on an annual basis. Non-independent directors may attend remuneration committee meetings by invitation but should not be members of the committee.

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

Remuneration committees should:

- Seek independent advice. External advisors, consultants and internal employees advising the committee should be fully accountable to the committee. The committee should exercise its own independent judgment when considering any advice provided by third parties
- Consider carefully and be able to demonstrate how it has reviewed the pay and related policies of the workforce when setting pay for the executive team and be able to demonstrate how this is aligned with the culture of the company
- Give consideration to the views of the company's shareholders. Most institutional investors' pay policies are available on their corporate website

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

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

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

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.

For example, we commonly see the implementation of risk, governance, sustainability, health and safety, research and development, or technology committees.

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.

Audit risk and internal control

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

The board is also responsible to its investors for presenting the true and fair view of the financial position of the company as well as its future prospects. Therefore, the established processes and procedures to ensure the independence and robustness of the internal and external audit functions, and the level of oversight from the board is expected to be demonstrated and explained to investors. Assessing the effectiveness of the resources available for the internal and audit functions forms part of the board's responsibilities. We expect boards to report to investors their conclusions of this review along with bespoke narrative as to the assessment and noted areas. These should be reported in companies' annual disclosures.

External audit

An external independent audit provides verification and assurance of the financial statements of a company to its investors. The opinion of the auditors is to provide assurance that the financial statements give a true and fair view of the financial health of the company. Any concerns raised by the auditors ought to be fully explained by the board, including how the concerns 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. We support and encourage the use of the extended audit report to provide greater insight to investors of the auditor's assessment of the accounts.

We support the role of the external auditor to be put to tender on a regular basis, at least every 10 years, with the total tenure of the auditor not exceeding 20 years. We expect the process of the tender to be explained, whether it included a firm outside the global top four firms and why the ultimate decision was taken.

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

The fees for the external audit ought to be disclosed in the annual reporting. Non-audit related services should not regularly be undertaken by the auditor. Where the external auditor does provide non-audit related services, these should be fully explained and disclosed in the appropriate annual disclosures. We do not expect excessive non-audit work to be conducted by the company's external auditors, as this will bring into question the independence of their judgment. 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 as an important and proportional approach to supporting a high-quality audit. We are not supportive of a fixed auditor liability or restrictions on that liability.

Recommendations arising from the external audit, are to be overseen by the board and the audit committee and should be reported to investors where 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 into the risk-based control system for the company and summarised in the annual report. The audit committee should have responsibility and oversight of the internal audit function.

Whistleblowing

We expect companies to establish a whistleblowing policy that is integrated into its Code of Conduct. The policy should be publicly disclosed and open to third-party use. The whistleblowing reporting channels should be easily identified and sufficiently independent from management, with a direct line to the audit committee to allow for appropriate oversight and independent escalation where necessary. Companies should ensure their policy safeguards the identify of any whistle-blower and that they are protected from internal harassment. Companies should also report how the risks associated with bribery and other illegal behaviour are being monitored and addressed.

Cyber security

The vulnerability of a company's IT systems can lead to a material financial impact. 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 and key intellectual property and therefore accountability should not be delegated. The issue should be a regular board agenda item and where there is an incident, we expect this to be disclosed to the market and customers in a timely manner.

Remuneration

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

As a long-term and engaged investor, we trust company boards to ensure executive directors' pay is fair, balanced and aligned with the strategy and long-term growth and performance of the business.

The remuneration committee chair's statement should explain:

- Why the outcome of the single figure is appropriate taking account of delivery of key performance indicators (KPIs), employee pay and shareholder experience in terms of value created
- Why the chosen remuneration award level is appropriate for the company. Any explanation should avoid as its main argument comparisons with peer median pay
- Details of engagement undertaken with all stakeholders. Referencing any engagement that has taken place with the workforce to explain how executive remuneration aligns with the wider company's pay policy. Engagement with shareholders and the impact this has had on remuneration policy and outcomes should also be set out
- Evidence of the exercise of discretion (up or down) during the year. We would define discretion as any change that alters the monetary outcome. Where discretion is applied upwards, and remuneration increases, we would expect to be reminded of when downward discretion was previously applied. When discretion is applied, we would also expect to understand what the monetary outcome would have been had the discretion not been applied. This will help us in applying our own judgment on the level of fairness.

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

Key principles

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

1. The structure of remuneration and the payments awarded should be fair, balanced and understandable. This means: fair in terms of what the company has achieved; balanced in terms of quantum to the executive, employees and investors; and understandable for the recipient, the board and investors
2. Awards should incentivise long-term thinking by management and be aligned to and support the achievement of the business strategy and objectives
3. Executives should have meaningful direct equity holdings while employed and thereafter; buying shares is one of the best ways of aligning the interests of management and investors
4. Boards should retain ultimate flexibility to apply discretion and 'sense-check' the final payments to ensure that it is aligned with the underlying long-term performance of the business
5. Companies should be transparent on why rewards have transferred to the executive, setting out targets that were set, their relevance to meeting long-term goals, which targets were met and fully justify all adjustments made to accounting measures for remuneration purposes.

Fixed remuneration

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

Incentive arrangements

Annual incentive

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

Additionally, the bonus should be set as an appropriate proportion of base salary and should be capped.

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

To highlight the integrity of the target-setting process, companies should disclose as many components of the bonus targets as possible, retrospectively.

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

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

We would expect companies that are exposed to high levels of environmental, social or reputational risk to include relevant targets that focus management in mitigating these risks.

To better align with investors and company performance, we ask companies to pay a portion of the bonus in the form of shares that is deferred for at least two years on an on-going basis. We also expect companies to put in place contractual and statutory provisions that may allow for a reduction or forfeiture of the annual bonus component in exceptional circumstances. To provide clarity, what constitutes exceptional circumstances should be set out.

Long-term incentive plan (LTIP)

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

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

LTIPs should be capped either as a percentage of salary or a fixed number of shares. Where a fixed number of shares are used, we would expect the level of award being offered to be reviewed every three years to ensure it is at a commensurate level as when the plan was first adopted. Any increase to levels of reward should be subject to shareholder approval.

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

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

The LTIP should not have too many performance conditions, as more than four conditions would increase complexity. At least one measure should be linked to shareholder returns. Other measures should be linked to the strategy of the business, such as KPIs which are selected by the board.

Long-term incentive performance should be measured over a period of not less than three years.

To enable investors to assess the appropriateness of long-term incentive arrangements, we expect companies to disclose the metrics and targets used under the plan.

We do not support retrospective changes to performance conditions that have been pre-set. We also expect companies to put in place contractual and statutory provisions that may allow for a reduction or forfeiture of the long-term incentive component in exceptional circumstances.

Holding periods

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

In addition, to encourage the right values and behaviour of directors to drive the business for the long-term benefit of investors, we would encourage all companies to consider requiring directors to continue to hold a significant proportion of the minimum shareholding requirement for two years post retirement.

Restricted schemes

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

- Award levels should be reduced to 50% or less of the normal long-term incentive grant, to take account of certainty of reward
- Restricted schemes should be long-term and applied through different business cycles
- Shares should be held for a minimum of five years prior to release
- The release of shares should be subject to a condition that requires the remuneration committee to be satisfied that over the five years since the grant, the company's overall performance and individual's leadership is such that the release of shares is warranted
- Discretion may be applied to reduce awards, if at the end of the holding period, the company's performance and the shareholder experience is not aligned. (See: p23, para. 2 of the Executive Remuneration Working Group report)
- For leavers; unvested restricted shares should be pro-rated for time, and subject to the same vesting timeframe and holding requirements as set out above
- A shareholding guideline must be in place that is material while in employment and following their departure from the board (see below)

Malus and clawback

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

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

Equity dilution

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

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

Service contracts and termination payments

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

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

Contracts of key people should provide the company with the authority to apply claw-back of both unvested and vested awards.

New joiners

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

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

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

Departing directors

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

Except for dismissal for cause and/or poor performance where awards 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 that applied at grant.

Benchmarking

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

Discretion

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

We expect companies to set out:

- The main reasons that might give rise to the application of discretion
- Whether their discretion policy would apply to revising pay upwards as well as downwards
- The elements of pay to which discretion may be applied

Shareholding guidelines

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

As a minimum, the shareholding requirement should be linked to the total value of share-based variable pay. For example: A company offering a bonus of 200% of salary, with 50% being deferred into shares and a long-term incentive award over 250% of salary, should aim to have a shareholding requirement of 350% of salary to be met over a 5-year period.

That said, we would encourage FTSE 100 companies to set aspirational shareholding guidelines:

FTSE 1 – 30 – 5 x salary

FTSE 31 – 50 – 4.5 x salary

FTSE 51 – 100 – 4 x salary

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

Post-exit shareholding requirement

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

A post-exit shareholding requirement of vested shares should be set that is significant in relation to the in-post shareholding requirement and held for two years. As a guide, vested shares, deferred bonus shares and shares subject to a holding period can count towards meeting shareholding guidelines.

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

Pensions

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

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

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

For any remuneration policies that are up for renewal from January 2020, we expect companies to introduce a pension provision for new board directors that is aligned with what is being offered to the general workforce.

In addition, where contracts are being re-negotiated for existing directors we expect pension provisions to be lowered to that of the average workforce.

We will vote against any new remuneration policy that has not introduced changes to address the disparity in pension provisions unless the company can demonstrate that similar arrangements are available to the workforce. Although we would not force existing directors to reduce their pension provisions, we would encourage them to do so voluntarily.

Non-executive directors' fees

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

Other disclosures

Consultants fees

A breakdown of fees paid to remuneration consultants, i.e. between fees for executive remuneration advice to the remuneration committee and fees for other pay related services to the company.

The pay ratios

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

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

We would expect companies to use methodology option A – which requires the company to calculate the pay and benefits of all its UK employees for the relevant financial year, to identify their P25, P50 and P75, and use these numbers when calculating these ratios. Where they opt for another method, we would expect a full explanation of why A was not possible.

Remuneration policy table

The policy table provides an opportunity to simply explain the company's remuneration structure. We will particularly look for:

- How the company will address salaries over the next three years;
- Details of the maximum awards under the bonus / long-term plans;
- The size of normal awards if they differ from the maximum;
- Performance measures that will apply under the annual bonus and long-term plan including the weights between the measures;
- An explanation for the total potential award.

Shareholder and bondholder rights

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

Voting rights and share class structures

We support the 'one share one vote' philosophy and favour share structures where all shares have equal voting rights and those rights are equal to economic value held.

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

Amendments to the company's constitution

It is common to see requests from companies seeking approval to update/amend their constitution as they impact members' rights.

We expect these changes to be clearly outlined and disclosed in the notice of meeting.

Virtual/electronic general meetings

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

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

On virtual shareholder meetings, investors are cognisant that companies are keen to make sure that their shareholder

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

However, we believe that such technology should be used in parallel with the in-person meeting and should not lead to companies adopting a virtual-only approach. The shareholder meeting is the only time that the whole board is present and publicly accountable to all shareholders. The attendance of the board at such meetings is a demonstration of its commitment to hear and understand the views of shareholders.

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

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

Capital management

The board has a key responsibility in ensuring a company has sufficient capital, overseeing the capital management of the company, ensuring an efficient capital allocation and, when additional capital is required, it is raised in an appropriate way.

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

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

Share issuance

We support a company's entitlement to issue shares to raise capital. However, such issuances should be limited to what is necessary to maintain business operations and should not expose minority shareholders to excessive dilution of their shares.

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

A request to increase the authorised share capital without pre-emption rights should be limited to 5%. The revised Pre-Emption Group guidelines permits the issue of an additional 5% of share capital where the additional 5% is for financing an acquisition or other specified capital investment that has been disclosed. We support the template resolutions published by The Pre-Emption Group and expect such requests to be proposed as separate resolutions for shareholder approval.

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

Share repurchases or buybacks

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

However, the benefits of using this approach is dependent on factors such as the price of the shares at which they were bought back, the company's individual financial circumstances and wider market conditions at the time. When utilising this authority, we expect companies to consider its impact on other issues. For example, on remuneration, as performance conditions governing incentive schemes may be impacted by the exercise of a buyback authority. Furthermore, given the reduction in the number of shares in the market, the holdings of large shareholders will also increase giving them more control. We expect any buy-back authority to be limited to 10% of the issued share capital.

Rule 9 waiver

Share buy backs can trigger Rule 9 of the Takeover Code where there is a significant shareholder or a concert party whose shares account for 30% of the issue share capital. In such circumstances, a share buyback can result in an automatic increase to their shareholding and eventual control without paying minority shareholders a premium. We will oppose rule 9 waivers.

Debt issuance

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

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

Mergers and Acquisitions (M&A)

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

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

In addition, we believe that a strong governance framework is essential during any M&A activity. Companies should therefore make sure the independent non-executive directors are informed at an early stage and can obtain independent advice at the cost of the company, with advisors remunerated on a fixed fee basis. A strong 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 its impacts on the company. The board may also consider putting in place a separate ad hoc committee of independent non-executive directors.

Related party transactions

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

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

In addition, we expect companies to disclose sufficient information about such transactions in its annual disclosures to ensure shareholders remain informed and enable informed voting decisions to be made.

In line with the continuing obligation 9 for Listed Companies, companies with controlling shareholders should ensure that they have in place a controlling shareholder agreement. This is to demonstrate that, despite having a controlling shareholder, the listed company is at all times able to carry on its activities as an independent business.

Shareholder proposals

We consider all shareholder proposals tabled at a company's AGM in the wider context of the corporate governance practices at the company, and the long-term benefits for investors. We expect companies to provide a meaningful discussion of the proposals to enable shareholders to make an informed judgment. We expect majority supported shareholder proposals to be adopted. And where there has been significant support (25% or more) then we would expect companies to consider the benefits of the proposal and to discuss this with their shareholders and to include this in their annual disclosures.

Political donations

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

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

Sustainability

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

Material risks and opportunities:

Material environmental and social (E&S) risks will vary between sectors and from company to company, depending on a range of factors. However 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, services, and efficiency gain potentials that the company may face in changing policy, technology and business environments.

Sustainability as part of business strategy:

Building a sustainable model should be at the core of business strategy, rather than seen as a side element in the form of ethical obligations. Where material risks and opportunities have been identified, there should be a clear link to the overall business framework.

Policies to mitigate key risks:

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

Management systems to mitigate risks

Managerial systems and procedures should be put in place for all business operations that either can be considered exposed to environmental and social-related risks, and/or that may produce negative externalities. Where possible, such systems should be externally verified.

Target-setting

Companies should set targets for mitigating and managing material E&S risks and impacts, as well as for maximising potential positive stakeholder impacts. While it is important for the targets to be achievable, companies may benefit from setting challenging goals in order to maximise overall benefit.

Science Based Targets are decarbonisation targets aligned with the objective of the Paris Agreement. Where material to the business, we encourage the companies we invest in to set Science Based Targets.

Public disclosure

Transparency and disclosure are key tools which enable investors to undertake a robust analysis of investment risks and opportunities, and allocate capital accordingly. We expect companies to demonstrate their commitment to the disclosure of sustainability information and data, through publication in key company reporting; this includes the annual report and accounts, with supplementary information in sustainability reports and on websites.

We encourage companies to disclose to key third-party sustainability agencies, in-line with best-practice international guidelines. In relation to climate change, we expect to see companies moving to report in line with guidance of the Taskforce on Climate Related Financial Disclosures (TCFD). We also encourage companies to relate the Sustainable Development Goals (SDGs) to their business strategy and operations, and disclose on this in a clear and consistent manner.

Governance and accountability

Responsibility for managing a company's societal and environmental impact and the related risks to the business sits with all employees. However, accountability should sit at the board level. We expect sustainability commitments to form part of the responsibility of the CEO and the board. We expect companies to disclose the governance processes that are in place to oversee and manage these risks. Where material to the business, we encourage companies to link executive remuneration to delivery of these commitments.

Where climate change is identified as a material issue for the business – whether over the short, medium, or long term, we expect companies to have sufficient expertise and experience on the board to ensure effective strategic and operational oversight.

Financial impact quantification

Quantification of sustainability impacts can assist investors to more effectively allocate capital, according to their risk, return and impact objectives. Companies can also achieve a net benefit in managing sustainability impacts effectively. We encourage companies to demonstrate a commitment to best sustainability practices and where possible, seek to quantify the impact in financial terms in order to internalise the associated costs and benefits.

Engagement transparency

Companies may benefit greatly from sharing knowledge and experience with their peers by joining and contributing to industry-wide associations. They might also engage with regulatory bodies to promote best practices.

We expect companies to be transparent in disclosing their public policy engagement activities, whether this be individual engagement, or collaborative engagement as part of an industry association.

In relation to climate change, we would expect companies to publicly disclose any concerns they may have with current or evolving legislation and to publicly report on any lobbying activity that is undertaken as a result of such concerns.

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. This is why 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 therefore believe that investors have a responsibility to 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 regards to planning, 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.

Where we deem insufficient action is being taken, we have already publicly committed to vote against the chair of the board on the issue of climate change on a global basis. Our global standard on diversity means that where there are no women on the board we have pledged to vote against the chair and/or the chair of the nomination committee. Where companies fail to meet minimum standards of globally accepted business practices, as set out in our Future World Protection List, we will vote against the election of the chair of the board, across our entire equity holdings.

Contact us

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