



# LGIM's corporate governance and responsible investment policy - Japan

2020

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This Policy document sets out Legal & General Investment Management's (LGIM) expectations of investee companies in the Japan market in terms of environmental, social and governance (ESG) issues. This is a region-specific document and is therefore separate to our Global Principles document which provides a full explanation of LGIM's approach and expectations in respect of key topics we believe are essential for an efficient governance framework.

LGIM adapts its policies to address the economic, political and cultural differences in corporate governance practices globally. LGIM recognises that the move towards strong corporate governance in Japan begins with compliance with Japanese legislative and regulatory frameworks. This voting policy goes beyond minimum compliance and reflects LGIM's approach and with respect to key topics we believe are essential for an efficient governance framework, and for building a sustainable business model.

LGIM publicly discloses its voting decisions monthly, including the rationale for votes against management. These reports are accessible on the **investment stewardship section** of the LGIM website.

# Company board

**The 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 has the most important task of setting the strategy and direction of the business, ensuring that the necessary resources are available to enable its implementation and that appropriate risk management and internal controls are in place. It establishes the philosophy for the company, ensuring that stakeholder views are considered and embedded in its culture. The board is expected to take into account environmental, social and governance considerations and to report on company performance in these areas. It is also responsible for ensuring the integrity of the company's

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

The chair should be able to challenge the inside directors and encourage the outside directors to actively participate in board discussions. It is the chair's role to regularly assess whether the board members have the adequate skills and are diverse enough to make a positive contribution. We expect the board chair to be clearly named and identified in all relevant company disclosures, including in the English version of the annual report, in meeting documentation and on the website.

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

**Given the importance of the chair's role, we expect the appointment of an independent director as board chair** to set the agenda for the meetings and lead sessions, independently of the insider company chairperson.

We would 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.

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

### The case of the combined chair and CEO

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

We believe that the roles of the chair and CEO are substantially different, requiring distinctly different skills and experience. This division of responsibilities also 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. Therefore, we will vote in favour of resolutions that separate the chair and CEO roles.

**From this year, we are taking a stronger stance on combined roles and will vote against the election or re-election of any individual holding such a combined role on a global level.** We have decided not to apply this policy to Japan due to unique features of the market. **However, we do expect Japanese companies to appoint an independent director as board chair and disclose in English who chairs the board and to provide a clear explanation and justification for the reason why.**

For more details, please refer to our board guide on the topic, available at: <https://www.lgim.com/files/document-library/capabilities/separating-the-roles-of-ceo-and-board-chair.pdf>

### Senior or lead independent director

The position of Senior or Lead Independent Director is not yet well established in Japan. We believe, however, that the position serves an essential role on the board and should lead the succession process of the chair and appraise the chair's performance. Additionally, they should meet investors regularly in order 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 the senior or lead independent director to be a fully independent outside director.

While the presence of a senior independent director should not be limited to cases where there is a combined board chair and CEO, this is of extra importance when the company combines the two roles. Where companies have historically combined the positions of CEO and chair and have chosen to keep this structure, we expect a strong, senior independent director or deputy chair to be appointed and for a meaningful explanation and justification to be provided in annual disclosures.

Please see our website for a thought piece on the role of the senior independent director at at: <https://www.lgim.com/files/document-library/capabilities/the-role-of-the-senior-independentdirector.pdf>

1. A Kaicho is not a legal term in the Company Law and transparency around the responsibilities of the role is usually insufficient.

## Structure and operation

### Board structure

Japan's Company Law offers listed companies three options for board structures. A vast majority of Japanese companies adopt the traditional structure with a statutory auditor (**Kansayaku**) board (adopted by more than 70% of listed companies), followed by the structure with an audit & supervisory committee (adopted by about 25% of listed companies). Companies with the three-committee model are the smallest minority. Our voting policy may vary depending on the structure of the board.

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

Japan's traditional board structure consists of a board of directors and a board of 'statutory auditors (Kansayaku)' (also referred to as the 'Kansayaku board' or 'audit and supervisory board'). The law stipulates that at least half of the Kansayaku board must be composed of outside Kansayaku. The role of Kansayaku is to monitor the company's financial reporting and auditing practices as well as the directors' conduct. The legal position of Kansayaku is that of a fiduciary and their legal duties include: attendance of all board meetings, determination of audit policy, and methods for monitoring and investigating the company, auditing accounts, and reporting breaches of directors' duties.

Yet Kansayaku are not integrated into the board's formal decision-making process and do not have the authority of directors.

Although they have the right to express their opinions on any matter at board meetings, they do not have voting rights: 'The de facto role of Kansayaku is to serve as an adviser to senior management on what is happening deep within the organisation and how to improve management' (ACGA, 2013, p. 12).

### Three-committee model (one-tier model)

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

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

### Audit & supervisory committee structure (hybrid model)

Hybrid board structures with an 'audit & supervisory committee (Kansatouinkai)' (also referred to as the 'supervisory committee') have also emerged as an amendment to the Company Law in 2015. A majority of audit & supervisory committee are required to be outside directors. An increasing number of companies have moved from the traditional Kansayaku model to this hybrid model.

While the role of the audit & supervisory committee is similar to that of the Kansayaku board, this committee has rights to give its opinion on the nomination, removal and remuneration of directors that are not committee members. This is considered a positive development, providing the outside directors are independent. In many cases, however, such committees are chaired by the CEO or other senior executives, which may undermine the purpose of independent oversight.

### Board committees

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

Japan-listed companies with the three-committee model are required to put in place three separate board committees responsible for the core board functions of audit, nomination and remuneration. By contrast, this is not a requirement for companies with the Kansayaku model or audit & supervisory committee model where it is up to the discretion of companies to establish voluntary advisory committees on nomination and remuneration. We welcome the trend where we see an increasing number of Japan-listed companies introduce such voluntary advisory committees thereby strengthening the independence and accountability of the nomination and remuneration functions of the board.

Given the important role of the nomination committees and remuneration committees, we expect them to comprise of independent directors. We believe that **no inside director should sit on the nomination committee**; this includes the President/ CEO/ executive chairperson. Whilst we understand that it is important that feedback is received by the nomination committee from the President, it is essential the committee is able to freely discuss and act on sensitive areas without the President in attendance. The President may still be invited to some or part of the meetings on occasion, if deemed necessary by the nomination 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.

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.

### Board 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 could 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 the 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.

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. They should also be willing to recruit those without previous board experience and this will help to expand the candidate pool and the board's cognitive diversity.

In Japan, positive trends in board composition and diversity are emerging. Yet significant challenges must still be overcome in order to ensure Japan stays competitive within the globalised economy. We believe that Japan can benefit further from unrealised opportunities if company strategies are subject to a healthy debate, mediated by diverse and well-balanced boards.

**As a minimum we expect all companies globally to have at least one woman on their board. Starting this year, we will vote against the appointment of the most senior member of the board or the nomination committee chair of TOPIX100 companies that have no woman on the board. Given the importance of diversity for a well governed board, we will expand our policy to a greater number of Japanese companies over time. We also expect companies to seek to promote diversity below board level, at executive committee, senior management and workforce level.**

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 ask companies to disclose diversity data at board, executive committee and senior management levels, as well as the rest of the workforce. We also ask for disclosure on the company's policy on diversity.** A diversity policy should include meaningful

information demonstrating how the company is working on its challenges. This will allow investors to be able to assess the extent to which diversity is embedded in the company's strategy and its efforts and progress towards improving diversity levels.

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/>

### 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.

Unaffiliated outsiders should bring an independent mind and an external perspective to boardroom discussions. They should raise issues and suggestions that are pertinent to the company, but which inside directors may not have thought of or may be reluctant to address. A relevant and suitably diverse mix of skills and perspectives is critical to the quality of the board and the strategic direction of the company.

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

The Japan Corporate Governance Code states that "boards should establish and disclose independence standards aimed at securing effective independence of outside directors, taking into consideration the independence criteria set by securities exchanges." The code also imposes a 'comply or explain' rule to listed companies to appoint at least two independent outside directors based on the independence criteria developed by the Tokyo Stock Exchange. In addition, the Company Law revision of 2019 will require companies to appoint at least one 'outside' director. The impact of this revision will however be minimal as most Japan-listed companies had at least one independent director and more than 70% of companies had at least two independent directors in 2019 according to data compiled by the Tokyo Stock Exchange.

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

To balance these considerations, we call for a minimum of one third independent directors and request companies to outline the steps to be taken to increase independence in the future. The selection of this target was based on our past experience, which demonstrates that a minimum of three independent directors is necessary to engage the board in meaningful debate.

It should be noted that this target for both independence and the outside director requirement will be raised going forward, to bring it into line with other developed markets. This rule applies to all companies, regardless of the board structure, or when companies are controlled by majority shareholders.

Under Japanese law, 'outsider directors' are defined as having no previous employment history with the company or its subsidiaries. This definition is extended under the TSE Listing Rules to include candidates with close family ties, clients, service providers or significant business partners.

**An outside director is someone who:**

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

**An independent director is someone who:**

- Has not been an employee of the company or employee or director of the group within the last five years;
- Is not an employee at the main lenders or banks to the company;
- Is not an employee at the lead underwriter(s) of the company;
- Has not worked at the company's audit firm;
- Is not offering, or has not previously offered, professional services such as legal advice, financial advice, tax advice or consulting services to the company;
- Does not have close family ties with any of the company's advisers, directors, or employees.

**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 its annual disclosures. This includes

what skills the company is looking for and why the selected individual is the right fit for the board.

**Re-election of directors**

In Japan, directors are to be elected every two years according to the Company Law. However, an increasing number of companies have put forward proposals to reduce the term to one year. We would support such proposals from companies and encourage others to do so.

We have engaged in constructive dialogue with Japanese companies in order to express our views on board composition. The outcome of these engagements is expected to generate an **increase in independence and disclosure of directors' associations**. In the event that this does not occur, we will signal disapproval by voting against the company chairperson. If the chairperson is not present, we will vote against the most senior member in the ballot. This strategy will apply to all board structures. In Japan, it is common to vote against the CEO in order to cast dissatisfactory votes. However, we believe that, as the CEO is responsible for running the company, voting the CEO out due to an inadequate board structure is not the most prudent course of action. Instead, it is preferable that the chairperson be mandated to take responsibility for ensuring that the board structure is robust and competitive.

The provision of biographical information on directors is essential to enable shareholders to make an informed decision about the appropriateness of nominee directors. In addition to the biographical details of each director we also encourage the disclosure of 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.

**Re-election of Kansayaku**

The Company Law stipulates that half of Kansayaku should be outsiders, but with no obligation for them to be independent. It is vital that true independence from the company is maintained in the Kansayaku board, especially as half of the members are company executives and therefore are less likely to flag issues to outside shareholders. As such, we vote against insider and affiliated outside directors, where Kansayaku board are composed of less than 50% independent directors.

## Board effectiveness

### Board tenure

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

Whilst different regions have different best practice guidance on this issue, **we expect all companies to put in place an individual director term limit of a maximum of 12 years for outside and independent directors.**

### Board mandates

We believe it is important for inside directors to seek external board appointments as this will help broaden their skills and knowledge, enabling them to provide more input on board discussions. **However, when taking up external appointments, they should be mindful of the time commitment required to exercise their duties on multiple boards.** We would encourage inside directors not to undertake more than one external directorships of an unrelated listed public company.

**We also encourage outside directors to limit their number of board positions to a total of five public company board roles.**

We consider an independent board chair role to count as two board roles due to the extra complexity, oversight and time commitment that it involves.

In order to help investors assess how directors with other board mandates are performing their duties, we would like to see disclosure of how much directors are expected to contribute to the role and how their other mandates do not prevent them from effectively exercising their duties.

### Board meetings and attendance

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

Director attendance at board meetings is a vital part of the role to ensure contributions to board decisions and fiduciary duties to investors are fulfilled. We therefore expect companies to allow investors to assess directors' attendance at board and committee meetings by 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. We would not expect to see a trend in a director's non-attendance at meetings.

### Board size

We consider that board effectiveness is optimised when membership sits between 5 and 15 members, depending on the size of the company and complexity of the business. By their nature, small boards that are suitably diverse are better-equipped to facilitate active, constructive debate and agile decision-making processes. We will vote against the most senior of the board standing for election when the board size exceeds 15 directors

Although Japanese boards have historically been larger than in other markets, a downward trend continued from 2008 until recently. We will generally support resolutions that intend to reduce the board size. The proportional percentage requirements in independence directors aim simultaneously to reduce the number of directors on the board.

### 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.

Japan's 2018 Corporate Governance Code states that boards should conduct an annual board effectiveness evaluation and disclose a summary of the results. As a response, we have seen an increasing number of Japan-listed companies begin to conduct evaluations of board effectiveness, but most evaluations are done internally without an external evaluator.

We expect an internal board evaluation to take place annually. This evaluation should be led by the most senior independent director of the board, or if managed externally, by an independent third party. We expect an external evaluation of the board to take place at least every three years. 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. We would expect the external board reviewer to be refreshed at least every two terms.

For more details on our position on the topic, please refer to our short thought-piece on the topic, available on our website at: [https://www.lgim.com/files/\\_document-library/capabilities/a-guide-to-board-effectiveness-reviews.pdf](https://www.lgim.com/files/_document-library/capabilities/a-guide-to-board-effectiveness-reviews.pdf)

## Stakeholder engagement

**We believe companies should be managed to take into account the interests of their stakeholders on material issues.** Understanding and taking into account key stakeholders' views allows 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 acknowledge that different countries, through regulation or best practice codes, may have different approaches to how boards should consider the views of their employees. We believe investors should be able to hold directors accountable for their consideration of employee views.

Where hard or soft law does not provide any guidance, we encourage companies to set up a structure they find appropriate.

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

[https://www.lgim.com/files/\\_document-library/capabilities/a-guide-to-effective-employee-engagement.pdf](https://www.lgim.com/files/_document-library/capabilities/a-guide-to-effective-employee-engagement.pdf)

### 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.

As shareholders we particularly value the ability to speak directly to the board, as in our experience it is more likely to facilitate positive change.

For more details on our position, please refer to our publications on the topic available at: [http://www.lgim.com/files/\\_document-library/capabilities/lgim-guide-to-board-investor-dialogue.pdf](http://www.lgim.com/files/_document-library/capabilities/lgim-guide-to-board-investor-dialogue.pdf)

## Culture

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

For investors to understand company culture, requires disclosure from the board, given its role in setting values. 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 feeds down to the rest of the organisation.

We expect companies to disclose in their annual disclosure aspects such as:

- How culture is measured and how it relates to the business strategy
- How the mission statement of the company and its values are communicated and reinforced
- Any key performance indicators (KPIs) that are linked to culture.
- Any relevant data linked to the workforce such as: turnover percentage, attrition analysis, and how exit interviews are used.

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/>

# 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 for presenting the true and fair view of the financial position and future prospects of the company to its investors. 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 external audit functions forms part of the board's responsibilities. We expect the board 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 the company's annual disclosures.

## External audit

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

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

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 should 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.**

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, and why the board considers the auditor to be independent and how any potential conflicts are being mitigated.

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

In Japan, audit firm rotations are not mandated by regulations. Additionally, the appointment of external audit firms is typically only put to a shareholder vote when companies intend to appoint a new audit firm. Auditors sit for a one-year term and can be reappointed without shareholder approval. Accordingly, this is not a matter that is frequently put to vote. Nonetheless, in any future possibility that an audit firm would be up for re-election, we will vote against the appointment of any audit firm with tenure of 30 years or more.

**The fees for the external audit should be disclosed in the annual disclosures.** 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 an important and proportional approach to supporting a high-quality audit. We are not supportive of fixed auditor liability or restrictions on that liability.

The audit committee, Kansayaku / Kansayaku board, or audit & supervisory committee (depending on the board structure) should explain how it has assessed the quality of the external audit and recommendations arising from the external audit, 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 into account 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 disclosures to investors.

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

### **Whistleblowing**

**We expect companies to establish a whistleblowing policy that is integrated into their code of conduct.**

The policy should be publicly disclosed and open to third party use. The whistleblowing reporting channels should be easily identified and sufficiently independent from management, with a direct line to the board or audit committee, Kansayaku / Kansayaku board, or audit and supervisory committee to allow for appropriate oversight and independent escalation where necessary. Companies should ensure their policy safeguards the identity of any whistleblower.

Companies should also report how the risks associated with bribery and other illegal behavior 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 regard appropriate remuneration levels as fundamental to recruit, incentivise and retain directors of the quality required to manage the company successfully. We seek disclosure and justification of chosen remuneration structures and levels.

In general, Japanese companies are less prone to excessive remuneration structures than companies in other markets. Due to the nature of the long tenure of employees in the same company, the interests of executives in Japan tend to be fundamentally long-term.

However, the Japanese disclosure requirements associated with executive pay are weak. The requirement for individual disclosure is limited to directors who receive ¥100 million per annum or more. Despite on-going debate to enhance requirements associated with individual disclosure, the 2019 revision of the Company Act did not introduce such requirements.

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

## Key pay principles

In order for investors to be able to appropriately assess directors' pay, we expect disclosure of the executive remuneration structure, including quantum (total pay) and a description of the metrics and targets used under incentive plans where applicable and within the limit of what the company is publicly allowed to disclose.

Whilst we are cognisant of the variations in executive pay practices globally, we expect companies to consider our principles below when setting pay policies for their executive board.

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 bonuses for directors and Kansayaku

Companies may choose to award annual incentives to inside directors. We believe that any annual incentive should be geared to delivering the strategy of the business. A 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 objectives or strategic objectives.

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.

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.

We consider that outside directors should not receive annual bonuses. These bonuses should be limited to insiders and be awarded on the basis of performance. Receipt of bonuses can erode independence, and negatively influence the veracity with which management is scrutinised.

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

- a) Recipients are outside directors;
- b) There is clear evidence of mismanagement on the part of the recipient; and/or
- c) The company's performance has been poor

### Retirement bonuses for directors and Kansayaku

**We expect the company to ensure that there have been no rewards for failure.** Therefore, we expect companies to put in place a remuneration committee to take into account 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.

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

Retirement bonuses are standard practice in Japan and comprise a significant portion of lifetime remuneration for directors and Kansayaku. The details of bonus proposals, such as the amounts paid and the status of recipients, are seldom disclosed. This prevents shareholders from assessing the merits of bonus proposals, and potentially undermines investor confidence in the company's capital management practices.

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

- a) Recipients are outsider directors;
- b) Neither the individual payments nor the aggregate amount of the payments is disclosed, or it is disclosed but it is not deemed appropriate; and/or
- c) There is clear evidence of mismanagement on the part of the recipient.

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

### Long-term Incentives plan (LTIP)

It is common for Japanese executive remuneration to be based on fixed compensation, which does not expose directors to the risks or rewards faced by shareholders. In general, stock option or long-term equity incentive plans should be promoted as a tool to better align the interests of directors with those of shareholders. Ideally, LTIPs should be introduced within the value of the total compensation that is currently on offer.

We believe that a company 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.

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.**

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

In order for investors to assess the appropriateness of long-term incentive arrangements, **we expect companies to disclose the metrics and targets used under the plan, within the limits of what they can disclose.**

We will oppose deep discounted option plans if:

- a) The total dilution from proposed plan(s) and previous option plans exceeds 5% for mature companies, or 10% for growth companies;
- b) Recipients include individuals who are not in a position to influence the company's stock price, including employees of business partners or unspecified "collaborators";
- c) The maximum number of options that can be issued per year is not disclosed; and/or
- d) No specific performance hurdles are specified

### Director and Kansayaku's compensation ceiling

Japanese companies are less prone to excessive or misaligned remuneration structures than companies in other markets. This notwithstanding, the management of Japanese remuneration requires structural realignment.

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

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

# Shareholder rights

Shareholder rights are a fundamental element of corporate governance as they ensure the protection of shareholders as well as allowing them fair access to a company. Below are the most relevant shareholder rights that are exercised within Japanese companies.

## Transparency

We encourage companies to allow investors to be able to appropriately identify and assess their performance on material environmental, social, and governance (ESG) issues.

**We expect companies to adopt an open approach to the public disclosure of information, within the limits of what they can disclose.** We would also encourage disclosures to be made in English to allow access to information by a greater number of investors.

Improved transparency facilitates informed voting, engagement and integration of ESG into investment. It allows investors, who sit outside board discussions, to have access to key ESG data and be able to appropriately assess the ESG performance of companies, taking into account the board's rationale in instances where the company does not comply with best practice.

Furthermore, to assist in developing high quality engagement, we would like to see companies disclose their attempts to engage with investors (including minority shareholders) and who at the company undertook that discussion.

## Article amendments

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

Bundling potentially undermines the value of shareholder votes and may be a source of confusion. We assess bundled resolutions on a case-by-case basis, examining those resolutions that may compromise current or future shareholder interests.

## Capital management

### Issuance of shares

Japanese boards have the discretion to issue shares within the authorised capital (a maximum of four times the current issued capital) on the condition that the issuance price does not constitute an advantage. In the event that a price is considered advantageous, shareholder approval will be required.

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

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

### Share repurchases

Share repurchases 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 & acquisitions).

However, the benefits of using this approach is dependent on a number of factors including the price at which shares are bought back, the company's individual financial circumstances and wider market conditions at the time.

When utilising this authority, we expect companies to take into account its impact on other issues. For example, on remuneration, performance conditions governing incentive schemes may be impacted as a result of a company undertaking a buyback. Furthermore, given the reduction in the number of shares in the market, the holdings of large shareholders will also increase, giving them more control.

Since 2005 when the Company Law was amended, Japanese companies have had the option of waiving the requirement for shareholder approval for share repurchases provided they meet certain conditions.

We generally support share buyback policies that deliver shareholder value.

### Debt issuance

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

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

### Cross-holdings

While cross holdings where listed companies hold the shares of other listed companies in Japan are in gradual decline, the practice is still prevalent. Cross-holding may serve a strategic objective and enhance shareholder value but can also increase risks. **Therefore, management should be prepared to engage in an open dialogue with shareholders to demonstrate the value created through cross-holdings.**

We expect companies to fully comply with the 2018 Corporate Governance Code's provisions on cross-holdings, which call for companies to disclose their policy with respect to cross-holdings, including their policies regarding the reduction of such holdings. The Code further requests companies to annually assess whether or not to hold each individual cross-shareholding and to disclose the results of this assessment.

We encourage companies to disclose the nature of the relationships in their top 30 cross-holdings and any position that exceeds 1% of its capital.

Cross-holdings should not be used as a device to protect the company from the possibility of an unwelcome takeover bid.

### Mergers and Acquisitions (M&A)

We will normally support a proposal that will create shareholder value, provided the financial terms, quality of management and benefits to synergy are superior. In a majority of cases we will support management if the deal is value-creative for shareholders, makes strategic sense, and is considered beneficial to both parties.

To make an informed assessment, we expect management to be transparent on the terms of the merger, and its financial and cultural integration implications on the long-term business strategy. We expect all 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 the company chair and the independent directors to hold separate meetings with investors without management present**, and to have an open and 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.

### Takeover defence plans – poison pills

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

It is vital that this process is controlled by a fully independent board that is more concerned with investor value than with protecting its own position. **We will not expect a poison pill to entrench management and protect the company from market pressures, at the expense of investors' best interests.**

Japanese companies have frequently adopted powerful takeover defences. Well-designed poison pills may strengthen the board's negotiating position and allow it to obtain more favourable terms from an acquirer. However, it is vital that this process is controlled by a fully independent board that is more concerned with shareholder value than with protecting its own position.

We will assess each case carefully and will oppose all takeover defence plans unless management presents a robust case that the plan will not allow management entrenchment and is structured to provide an unbiased assessment of shareholder interests in any proposed deal or transaction. We will also examine if there is sufficient independent board oversight in the use of such a mechanism. It should be noted that the lack of independence within many Japanese boards means that it is difficult to achieve a poison pill that is unaffected by bias.

For more details, please refer to our board guide on the topic available at: [http://www.lgim.com/files/\\_documentlibrary/capabilities/a-guide-to-mergers-and-acquisitionsboard-oversight.pdf](http://www.lgim.com/files/_documentlibrary/capabilities/a-guide-to-mergers-and-acquisitionsboard-oversight.pdf)

### 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 therefore 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 therefore be authorised by the board of directors. We also expect the company to set up a fully independent committee which ensures that such transactions are conducted on the basis of an independent and disinterested valuation.

In addition, we expect companies to disclose sufficient information about such transactions in annual disclosures to ensure shareholders remain informed and are able to make informed voting decisions. Disclosure should extend to the level of support offered by the independent outside directors.

### Shareholder proposals

We consider all shareholder proposals tabled at a company's AGM in the wider context of the corporate governance practices at the company, and also in relation to the long-term benefits for investors. We expect companies to provide a meaningful discussion of the proposals to enable shareholders to make an informed judgment.

We expect majority supported shareholder proposals to be adopted. And where there has been significant support (25% or more) then we would expect the company 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 full 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 of direct and indirect lobbying activity on policy and legislative proposals etc.
- A clear explanation of how each of the above associations, contributions and actions etc. benefit the causes the company supports and align with the strategy of the company
- A public statement from the company outlining where it disagrees with the associations of which it is a member on a particular issue, and the reasons why it believes it is beneficial to remain a member
- Disclosure of where responsibility sits within the company for the oversight of such relationships

### Allocations of dividends and profits

Dividend yields in Japan do not adequately reflect the high cash holdings in many Japanese companies. Increasingly, however, companies are starting to define their dividend pay-out ratios, which should be well balanced between the interests of shareholders and the capital investments required for the business to maintain competitiveness in the market.

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

# Sustainability

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

## Sustainability 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.

## 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.

## Policies to mitigate key risks

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

## Management systems to mitigate key 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 ESG rating and research agencies, and 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.

### **Public policy engagement**

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 ESG 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 board chair and/or the chair of the nomination committee (for Japan-listed companies, this will initially apply to TOPIX 100 companies but the scope will be reviewed annually and expanded accordingly). Where companies fail to meet minimum standards of globally accepted business practices, as set out in LGIM's Future World Protection List, we will vote against the election of the chair of the board, across our entire equity holdings.

## Contact us

For further information on anything you have read here or to provide feedback, please contact us at:

 [InvestmentStewardship@lgim.com](mailto:InvestmentStewardship@lgim.com)  [www.lgim.com/corporategovernance](http://www.lgim.com/corporategovernance)



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