April 2022

2022 – Japan corporate governance and responsible investment policy

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Introduction

This document sets out Legal & General Investment Management (LGIM)'s expectations of investee companies in the Japanese 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 that 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. When developing our policies, we not only look at local market regulatory expectations, but also at broader global guidelines and principles such as those provided by the United Nations Global Compact, OECD guidelines and ILO conventions and recommendations.

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

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

Company board

The board of directors is responsible for the management and long-term success of the company, 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 ESG 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, commitment and are sufficiently diverse 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 inside-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[1], who is typically a former CEO, to be at the helm of the company. Nonetheless, from the perspective of an independent chair, we focus on the Gicho rather than the Kaicho for companies in Japan.

The case of the combined chair and CEO

Although 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-making 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.

While LGIM’s policy is to not support the election/re-election of any individual holding a combined role, this policy will not apply to Japanese companies due to unique features of the market. However, we do expect Japanese companies to appoint an independent director as board chair, to 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 here.

Senior or lead independent director

The position of senior or lead independent director may not yet be well established in Japan. We believe, however, that 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, available here.

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

Structure and operation

Board structure

Japan’s Companies Act offers listed companies three options for board structures. A vast majority of Japanese companies adopt the traditional structure with a statutory auditor (Kansayaku) board, followed by the structure with an audit and supervisory committee. 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, deciding methods for monitoring and investigating the company, auditing accounts, and reporting breaches of directors’ duties. Despite their important role, 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.

Three-committee model (one-tier model)

The three-committee structure consists of three committees, with each one responsible for either audit, nomination or 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 of executive officers appointed by the board.

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

Audit and supervisory committee structure (hybrid model)

Hybrid board structures with an audit and supervisory committee (Kansatouiinkai) (also referred to as the “supervisory committee”) have also emerged as an amendment to the Companies Act in 2015. A majority of the audit and 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 and supervisory committee is similar to that of the Kansayaku board under the two-tier model, this committee has rights to give its opinion on the nomination, removal and remuneration of directors who are not committee members.

Board committees

Audit, nomination, and remuneration committees

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

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 and supervisory committee model, where it is up to the discretion of companies to establish voluntary advisory committees on nomination and remuneration.

Given the important role of the nomination, remuneration and audit committees, we expect them to comprise independent directors. We believe that no inside or executive director should sit on any of these committees; this includes the president/CEO/chairperson. It is essential these committees are able to freely discuss and act on sensitive areas without an inside director in attendance. The president may still be invited to some or part of the meetings on occasion, if deemed necessary by the nomination committee. For this reason, we will vote against the president or chairperson if the candidate sits on the nomination, remuneration or audit committee[2].

For companies with a board structure where these committees are not a legal requirement, we continue to expect voluntary advisory committees to consist of independent members and for the board to uphold the committees' recommendations.

Additional board committees

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

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

Advisory committees

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

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

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.

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.

We believe 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 of directors to be independent and ask companies to outline the steps to be taken to increase independence in the future. Regardless of the board structure, we will vote against the chairman or most senior member of the board if, after the shareholder meeting, the board is not at least one-third independent. We additionally expect companies to comply with the 2021 Corporate Governance Code in instances where the code requires a higher level of board independence. For instance, companies with a majority shareholder; our expectation is that at least half of the board should comprise independent outside directors.

It should be noted that this target for board independence 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 whether 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. Our definition of independence goes beyond that of the TSE.

An outside director is generally someone who:

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

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

- Individuals who work or worked at major shareholders of the company;
- Individuals who work or worked at main lenders/banks to the company;

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

Advisory positions (Komon/Sodanyaku)

Advisory positions unique to Japanese companies, known as “Komon” or “Sodanyaku,” are usually held by the former company president or other senior executive.

They are not held accountable to shareholders as they do not serve on the board. Still, they can apply pressure on the board and are often referred to as “ghosts in the boardroom” or “corporate backseat drivers”. In cases where the former CEO remains as a senior adviser, they may exercise unreasonable influential power over incumbent management members, which could be detrimental to the board's functioning and dynamic.

With no basis in law, the roles of these positions will vary from company to company. Furthermore, companies are not required to disclose details of these positions, but are given the option to do so in the Corporate Governance Report required by the TSE. Based on this report, we will vote against the chairman or most senior member of the board when there is a lack of minimum disclosure on the presence of an advisory position.

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

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 can improve business decision making, minimise business risk, improve the sustainability of profit growth and therefore maximise long-term returns for investors.

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

To provide investors with a comprehensive understanding of their diversity strategy, we expect companies to be transparent regarding the procedures used to find new members for the board and at senior management level, and on how that process ensures a diverse board and senior executive pipeline. We expect all companies to disclose a breakdown of board directors, executive directors, managers and employees, at a minimum, by geography, main skill set, and gender.

Companies should ensure that candidates with appropriate skills and qualities are sought through the widest possible means, such as the use of recruitment consultants, public advertisements and the leverage of other relationships in the industry. Companies should also be prepared to look outside the usual pool of candidates to include those from a less traditional 'corporate board' backgrounds. They should also be willing to recruit those without previous board experience as incumbent board members will have sufficient previous board experience in aggregation to support less experienced members, and this approach will over time help to expand the candidate pool as well as be beneficial for the board's cognitive diversity.

In Japan, positive trends in board independence 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 very minimum we expect all companies in which we invest globally to have at least one woman on their board. In Japan, we currently vote against the appointment of the chairman or most senior member of the board or the nomination committee chair of TOPIX 500 companies that do not have a woman on the board[3]. Starting in 2023, we will pre-announce our votes against such companies with all-male boards. Given the importance of diversity for a well-governed board, we will continue to expand our policy to a greater number of Japanese companies and also look to require a higher threshold of board diversity over time. We also expect companies to seek to promote diversity below board level, namely at the executive and management levels as well as through the entire workforce. We expect Japanese companies to observe the provisions of the 2021 Corporate Governance Code and also to provide gender pay gap disclosures.

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

Succession planning

Succession planning is a vital function of an efficient board. It helps to avoid the dangers of group think and 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

[3] We do not count Kansayaku as board members.

to disclose this information in their 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 Companies Act. 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 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 show dissatisfaction. 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 that 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 Companies Act stipulates that at least half of the Kansayaku should be outsiders, but with no obligation for them to be independent. It is vital that true independence from the company is maintained in the Kansayaku board, 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 the Kansayaku board is composed of less than 50% independent directors.

Board effectiveness

Board tenure

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

While 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 directorship 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 reasons why 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 fewer than 75% of the board and committee meetings held. Where a director does not attend a board or committee meeting, the company should report to investors the reasons for non- attendance. We would not expect to see a trend of a director's non-attendance at meetings.

Board size

We consider that board effectiveness is optimised when membership sits at between five 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 member of the board standing for election when the board size exceeds 15 directors[4].

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

Culture

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

For investors to understand company culture, disclosure from the board is necessary, 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, and that they are 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 here.

Board effectiveness review – internal and external

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

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

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

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 here.

Employee voice

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

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

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

- Select a method that builds trust within the company, is valued by all employees and encourages participation;
- Ensure there is a clear mechanism for all staff to feed into the process, regardless of whether that is through a regular meeting with their designated workforce member/non-executive director/employee director or via email;
- Create clear action plans for issues that impact employees and distribute these to all staff via a newsletter or all-staff email. A dedicated page on the intranet with its existence made aware to all staff is also a good idea. Open and transparent communication is important to get employee buy-in to the process. "Town halls" should supplement written communication;
- Ensure there is 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.

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.

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

Board responsiveness

Voting at company meetings is part of a shareholder's escalation strategy to signal concerns with aspects of the governance of the company. Where 20% of more of votes have been case against a board recommended resolution, we expect the board to find out why. The board should disclose the steps they have taken to address shareholder concerns in their next annual report.

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.

Investor dialogue

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

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 here.

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 a true and fair view of the financial position of the company, as well as setting out its future capital management plans and near-term financial 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, are 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 the details of the assessment and any conclusions and concerns raised. These should be reported in the company's annual disclosures.

Compliance with regulations

The audit and risk committee should ensure that all laws and applicable regulations are complied with so as not to expose the company to undue risk of fines, censorships and reputational damage. We will hold the audit committee or its equivalent responsible for failing to detect breaches in accounting practices.

External audit

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

High-quality audits are valued by investors and should be considered an asset rather than a cost to the business. It is important that 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 audit provides independent assurance of the financial statements of a company to its investors. The role of the auditor is to provide reasonable assurance that the financial statements give a true and fair view of the financial health of the company and that they have been prepared in accordance with appropriate accounting standards. Any significant audit matter raised by the auditors should be fully explained by the board, including how these have been addressed.

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

The board is responsible for appointing the company's external auditor. The company is expected to clearly disclose the audit firm used, the 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.

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

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

Starting with audits for the year ending on 31 March 2021, auditors will be required to communicate "key audit matters" (KAM) in the auditor's report. Clear and accessible communication of KAM will provide greater insight to investors of the auditor's assessment of the accounts and is also expected to (a) facilitate deeper communication between the auditor and company's management as well as those charged with governance related to the financial statements, and (b) push companies to enhance their reporting, in particular on the business risks and management discussion and analysis (MD&A) sections of the annual securities report.

While the communication of KAM is currently only required for audits based on the Financial Instruments and Exchange Act[5] (where the report is commonly provided after the AGM), best practice would be for the KAM to be made available to shareholders before the AGM. Please also see the section on AGM timing, which outlines how LGIM encourages Japanese companies to change the record date and move their AGMs to later in the year.

The fees for the external audit should be disclosed in the annual disclosures. Where the external auditor provides non-audit services, these should be fully explained and disclosed in the appropriate annual disclosures. We expect non-audit services provided, to be incidental to the audit, with the primary purpose of improving the quality of the financial accounts. We do not expect excessive non-audit work to be conducted by the company's external auditors, as this will bring into question the independence of their judgement. Non-audit-related services are not expected to exceed 50% of the value of the audit services in any given year.

We believe auditor liability is an important and proportional approach to supporting a high-quality audit. We are not supportive of fixed auditor liability or restrictions on that liability.

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

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

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 should be summarised in the annual disclosures to investors.

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

Whistleblowing

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

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 and reputational 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 when 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. As a result of 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 ongoing debate to enhance requirements associated with individual disclosure, the 2019 revision of the Companies 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 believe that Japanese companies should adjust their executive remuneration structures to align with company performance and shareholder value creation. Accordingly, remuneration disclosure should focus on the structure of incentive arrangements.

Key pay principles

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

- The structure of remuneration and the payments awarded should be fair, balanced and understandable. This means: fair in terms of what the company has achieved; balanced in terms of the amount paid to the executive, employees and investors; and understandable for the recipient, the board and investors.
- Awards should incentivise long-term thinking by management and be aligned with and support the achievements of the business strategy and objectives.
- Executives should have meaningful direct equity holdings while employed and thereafter; buying shares is one of the best ways of aligning the interests of management and investors.
- Boards should retain ultimate flexibility to apply discretion and 'sense check' final payments to ensure that they are aligned with the underlying long-term performance of the business.
- Companies should be transparent on why rewards have been transferred to the executive, setting out targets, their relevance to meeting long-term goals, which targets were met and 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 function as an immovable 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 the 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. Measures such as health and safety should be used as a reducing feature rather than a compensating feature because ensuring the health and safety of employees should be embedded in the philosophy and values of the company and a normal expectation of running a successful business.

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 (malus and clawback).

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. Receiving a bonus can erode independence, and negatively influence the veracity with which management is scrutinised.

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

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

Retirement bonuses for directors and Kansayaku

We expect the company to ensure that there 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, e.g. 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:

- Recipients are outsider directors.
- 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
- 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 incentive plans (LTIP)

It is common for Japanese executive remuneration to be primarily based on fixed compensation, which does not expose directors to the risks and 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 that will align their interests with those of long-term investors. Incentives should be structured to motivate management to build a sustainable business that will generate positive returns 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 that would complicate the remuneration structure.

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

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 deeply discounted option plans if:

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

- Recipients include individuals who are not in a position to influence the company's stock price, including employees of business partners or unspecified "collaborators";
- The maximum number of options that can be issued per year is not disclosed; and/or
- No specific performance hurdles are specified.

Directors and Kansayakus' compensation ceiling

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

This notwithstanding, the management of Japanese remuneration still requires structural realignment. Performance-based remuneration 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 and bondholder rights

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

Transparency

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

We expect companies to adopt an open approach to the public disclosure of information, within the limits of what they can disclose. We would also encourage disclosures, in particular the annual securities report (yukashoken hokusho), to be made in English and disclosed well before the AGM to allow access to important information by a greater number of investors.

Improved transparency facilitates informed voting, engagement and the integration of ESG into investment. It allows investors, who sit outside board discussions, to have access to key ESG data and to 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 the accepted 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. Our expectations are discussed in the sustainability section below.

AGM timing

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

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

Virtual/electronic general meetings

We believe that 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 their shareholders, both institutional and retail.

Shareholder meetings provide an invaluable opportunity to raise concerns with a board in a public forum, and investors are able to use this mechanism as part of their stewardship activities. For example, they could be utilised as an escalation tool that enables shareholders to make statements and ask 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 must be publicly accountable to all its shareholders. The attendance of the board at that meeting is a demonstration of its commitment to hear and understand the views of shareholders.

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

Since June 2021, a new law allows a listed company in Japan to hold a virtual-only meeting ("Shareholders Meeting without a Designated Location"), provided that the company obtains the confirmation of both the Minister of Economy, Trade and Industry and the Minister of Justice and that such provisions to hold virtual-only meetings exist in its articles of incorporation. LGIM will only support company proposals regarding article amendments to conduct virtual-only AGMs if the articles specify the situations (e.g., during a pandemic or major natural disaster) in which the company intends to hold a virtual-only AGM. (For the period of two years from 16 June 2021, a company which has obtained confirmation from the relevant Ministers may hold a virtual-only AGM without shareholder approval to amend the articles of incorporation.)

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.

We expect these changes to be clearly outlined and disclosed in the notice of meeting. Approval at the general meeting should also be sought as separate resolutions, not bundled. Although we assess bundled resolutions on a case-by-case basis, we initially view them negatively as they could potentially undermine the value of a shareholder vote and may be a source of confusion. We do not support changes to a company's constitution that are introduced to curtail or reduce shareholder rights.

Capital management

The board has a key responsibility in ensuring a company has sufficient capital; overseeing the capital management of the company; ensuring efficient capital allocation; and, when additional capital is required, ensuring 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 in managing its capital structures. Such rights protect shareholder interests while balancing the need for board flexibility; e.g. where share issuances are not dilutive and capital is being raised in the long-term interests of investors.

Issuance of shares

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

this in mind, we believe that issuances should be limited to what is necessary to maintain business operations and should not expose minority shareholders to excessive dilution of their holding in the company's shares.

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 do not expose minority shareholders to excessive dilution of their shares.

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

Share repurchases

Share repurchases 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 acquisitions).

However, the benefits of using this approach are 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 affected 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 Companies Act 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 ongoing 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 but can also cause problems including poor corporate governance. Therefore, management should be prepared to engage in an open dialogue with shareholders to demonstrate the value created through cross holdings, and to share plans for such holdings to be reduced.

In addition to providing disclosures in English, we expect companies to fully comply with the 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 also take into account cross holdings when we determine if an outside director is independent. From 2022, we will vote against the chairman if companies allocate 20% or more of their net assets to cross holdings with no clear rationale and the appropriateness of the use of shareholder capital is questionable. We will continue to review this threshold and look to tighten our policy over time.

Mergers and acquisitions (M&A)

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

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

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. 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 that it 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. Japanese companies have frequently adopted powerful takeover defences, but the number of such measures has decreased in recent years due to opposition by institutional investors.

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

Related-party transactions

Related-party transactions (e.g. between a controlling shareholder and an issuer) are 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 their 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 judgement.

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

Political donations

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. would benefit the causes the company supports and align with its strategy;
- A public statement from the company outlining where it disagrees with the associations of which it is a member on a particular issue, and the reasons why it believes it is beneficial to remain a member; and
- Disclosure of where responsibility sits within the company for the oversight of such relationships.

Allocations of dividends and profits

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 proposals that would remove the right for shareholders to approve dividend payments. Particular attention will be paid to cases where a company proposes to pay a dividend exceeding its net profit, 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 governance, process and operations

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

Risk identification and management

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

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

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

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

Governance and accountability

Responsibility for managing a company's societal and environmental impact and the related risks to the business is shared across all business functions. However, accountability should sit at the board level. We expect the fulfilment of sustainability targets and commitments to be the responsibility of the CEO and the board. Companies should disclose the governance processes 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 specific material issues, such as climate change, are identified, whether over the short, medium or long term, we expect companies to have sufficient expertise and experience on the board to ensure effective strategic and operational oversight. More information can be found here.

Sustainability strategies

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

Reporting and disclosure

Target-setting

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

Public disclosure and transparency expectations

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

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

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

We expect the following public disclosures at a minimum.

- ESG reporting standards
- Verification of ESG reporting
- Scope of greenhouse gas (GHG) emissions

- Tax disclosure
- Director disclosure
- Remuneration disclosure

Companies not adhering to this will be sanctioned in line with our increased commitment to greater ESG transparency. LGIM votes against companies that score poorly on transparency within our LGIM ESG and show no improvement after engagement. The list of companies voted against will be published on our website from 2023. For further information on each of these key criteria, please see our public ESG score methodology document available on our website here.

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

Financial impact quantification

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

We encourage companies to demonstrate a commitment to best sustainability practices and, where possible, seek to quantify the impact in financial terms in order to internalise the associated costs and benefits. To the extent that they are material[6], companies should explain how climate-related matters are considered in preparing their financial statements.

Industry collaboration

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

Lobbying transparency

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

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

Sustainability themes

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

Below we highlight our expectations in relation to some of these key issues: climate change, biodiversity and deforestation. More information and articles on our position on broader themes can be found here.

Climate change

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

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

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

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

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

Please see more on LGIM's policy on climate change here.

Biodiversity

Biodiversity loss is currently happening at a rate greater than at any other time in human history. This matters to investors as biodiversity loss presents a major global systemic risk, with more than half of the world's gross domestic product (GDP) – around $44 trillion – dependent on nature[7].

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

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

Deforestation

LGIM recognises the importance of ending commodity-driven deforestation to tackle climate change, reduce biodiversity loss, and support food security. We are proud to be a signatory to the Deforestation-Free finance commitment and fully support the call for financial institutions to take ambitious measures within their control to eliminate commodity-driven deforestation within their investments.

LGIM's expectations of investee companies are focused on high impact sectors. Within the apparel sector, we expect companies to demonstrate how they are improving the circularity of materials and eliminating deforestation from supply chains. In the food sector, we expect a shifting away from high-impact products and progress on decarbonising agricultural supply chains. The lack of a comprehensive deforestation policy constitutes one of our 'red lines' when deciding LGIM's priority engagement companies. Our minimum voting standards also consider the presence and application of a deforestation policy and programme.

Please see our climate impact pledge (here) for more information on LGIM's sector-based deforestation expectations and examples of our previous engagements with companies on the topic.

Human capital management

Employees are the greatest asset a company can have. We believe that the value they bring to the long term sustainability of the company should not be underestimated. LGIM is looking at human capital management using a number of different lenses:

Diversity & Inclusion – We believe a suitably diverse mix of skills, experience and perspectives is essential for a board to function and perform optimally. We expect boards to embrace different forms of diversity: gender, ethnicity, neurodiversity. This is discussed in greater detail above.

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[7] World Economic Forum, 2020.

Employee Voice – The value placed on employees can be measured by the effort a company places on receiving and acting upon employee feedback. This is discussed in more detail above.

Employee Welfare – companies should ensure that their employees have adequate training to equip them with the appropriate skills to carry out their jobs effectively. They should provide a safe working environment and annual training on safety within the workplace. Companies should be mindful of and comply with the principles of the United Nations Global Compact, the International Labour Organization conventions and recommendations; OECD guidelines for multinational enterprises and all local and national laws and regulations relating to the protection of employees.

Fair Pay – We expect all companies to be paying their direct employees at least a real living wage. This wage is usually higher than any local government/state mandated minimum level. The living wage should be sufficient to afford a decent standard of living for the worker and their family. Elements of a decent standard of living include food, water, housing, education, health care, transportation, clothing, and other essential needs including provision for unexpected events. In addition, we expect companies to ensure that employees within their supply chain are also being paid at least a living wage.

Modern Slavery – Companies should ensure that they are not permitting modern slavery to take place either within their own operations or within their supply chains. Putting in place a code of conduct is not sufficient to ensuing modern slavery does not exist within the supply chain, and we expect companies to carry out due diligence investigations to ensure any such practices are eradicated.

Why adherence to these principles is important for LGIM

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

Important information

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