

# Our principles on executive compensation for North American companies



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# Introduction

Studies conducted by Morgan Stanley<sup>1</sup> provide evidence of a link between failed 'say on pay' votes and the underperformance of a company's share price against the S&P 500 over the following 12 months. The study, which was carried out in 2020, showed that companies with failed 'say on pay' votes in 2019 underperformed the market over the next year by an average of 20%. Two-thirds of these companies underperformed by 34% or more. Morgan Stanley has been carrying out this study since 2015, and evidence indicates that over the five years to 2020, companies with failed 'say on pay' votes underperformed the S&P 500 by an average of 15%.

As a long-term investor in North American companies, we believe that there are several important aspects of governance to demonstrate a well-governed and functioning board: LGIM's goal is to engage with companies to raise minimum standards across all areas of company governance, including board structure, such as joint chair/chief executive tenure; shareholder rights around one share one vote; social impact such as income inequalities, sick pay and environmental risks and impacts. We believe executive compensation is key to demonstrating how well a company is run.

LGIM believes that companies' management teams should be rewarded for delivering a strategy that is sustainable, profitable and creates value for both its long-term investors and society. However, at some companies, the total pay amount, pay that is poorly aligned with performance, or insufficient pay for those on the bottom quartile of workers are some of the factors that can lead to criticism and reputational damage.

The US Securities and Exchange Commission's (SEC) new 'pay versus performance' disclosure requirements, which came into effect in 2023, is an attempt to improve transparency but also to foster a culture within all companies to ensure that executive pay is commensurate with the overall performance of the company.

We produced this standalone document to help North American companies' compensation committees to better understand the evolving views on executive pay from a long-term shareholder perspective.

We hope you will find the guidance helpful when setting executive pay practices at your company.

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We have a responsibility to our clients to ensure the companies in which their funds are invested provide sustainable long-term value for shareholders and society.

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<sup>1</sup> Say-on-Pay 2020: Raising the Red Flag, Morgan Stanley, 6 May, 2020

## Compensation committee

We believe that a compensation committee should comprise only independent directors. Non-independent/ long-tenured directors should only attend meetings by invitation, as in certain cases they can be a source of valuable information to the committee's deliberations.

Historically, workforce pay was not part of the remit of the compensation committee. However, the tide has turned and investors such as LGIM believe that executive compensation should not be decided in isolation from workforce practices.

Therefore, we believe that the committee should be mindful of the pay practices adopted across the organisation, its country of listing, and if different, the place where the majority of the workforce is based.

LGIM would expect the committee to hold the CEO to account for the workforce pay policies introduced. The committee should question management on workforce pay policies if they consider them to lack alignment, or to be poorly structured, or if they believe they could be improved upon.

We expect all companies in which we invest to pay their employees at least the living wage.<sup>2</sup>

LGIM would therefore ask the remuneration committee to make itself aware of the living wage rates for key regions in which the company has employees and to hold management to account for not paying a living wage.

When using a compensation consultant to assist with the process of setting executive compensation, the committee should ensure that it is independent of the company and its executives, e.g. they are not used to provide other services to the company or its executives.

Compensation consultants should be encouraged to engage with key investors and relevant organisations to stay abreast of evolving best practices. As pass through voting becomes more prevalent, the historic support for 'say on pay' resolutions may reduce.

Peer groups should be selected carefully and be linked to the area of business in which the company operates – or a wider benchmark that is logical. We would expect the committee to explain any benchmark being used.

We expect all companies to put their 'say on pay' resolutions to a shareholder vote annually. Voting sanctions will be applied on companies that fail to do so.

LGIM may impose additional voting sanctions on companies that receive a high voting opposition for structural concerns that have not been addressed by the committee.

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<sup>2</sup> The minimum income necessary for a worker to meet their basic needs. Needs are defined to include food, housing and other essential needs such as clothing. The goal of a living wage is to allow a worker to afford a basic but decent standard of living through employment without government subsidies. It is therefore higher than the minimum wage set by US labour laws. For further information, we would direct readers towards the Platform for Living Wage Financials website: [Why living wage and income? – Platform Living Wage Financials](#)

# Our principles

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

## Structure

The compensation structure and the payments awarded should be fair, balanced and understandable. This means: fair in terms of the company's financial performance; balanced in terms of total pay to the executive when compared with employees and the shareholder experience; and understandable for the recipient, the board and its shareholders.

## Awards

Should promote long-term decision-making and be aligned to and support the company's values and the achievement of its business strategy.

## Transparency

We expect a full explanation of how compensation was set for that year. Information on why rewards were delivered, how targets were set, what sorts of adjustments were made to accounting measures, and the relevance of those targets to meeting the long-term goals of the company is vital.

## Shareholder alignment

Executives should have a meaningful direct equity holding while employed and thereafter; buying shares is one of the best ways of aligning management and shareholders.

## Discretion

Boards should retain ultimate flexibility to apply discretion and 'sense-check' final payments to ensure they align with the underlying long-term performance of the business.

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Executive compensation should be set at an appropriate level to drive positive corporate behaviour and performance.

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## Quantum

As the executive compensation landscape continues to evolve to meet the needs of modern businesses, companies must consider the current social sensitivities around pay inequality.

We entrust companies' boards to ensure that executive compensation is set at an appropriate level to drive positive corporate behaviour and performance. In doing so, the board should consider the wider impact of total executive compensation levels.

LGIM does not generally support one-time grants. We believe compensation packages are sufficient to motivate management. Succession planning is the preferable way to deal with retention issues.

We encourage the compensation committee to consider the effect that an increase in each component of pay will have on the total value of the package. The committee should consider whether the total package is appropriate for a role of this nature, given the size, complexity and performance of the business, preferably without solely relying on benchmark data.

The committee should set a compensation cap and ensure that all variable incentive plan rules permit downward discretion to reduce the value of vested awards if the cap is reached. When setting a cap, the committee should consider the pay ratio and the potential for reputational damage that excessive compensation can create.

We would also like to understand what changes to pay and benefits were offered to the general workforce. This will help us to understand the alignment of compensation practices within the organisation and their link to performance. It is our belief that it takes more than one person at the top of an organisation to drive value; therefore, all employees should be rewarded for the success of the company through cash and equity.

LGIM's principles on executive compensation has been based on performance-based pay, however, we view pay inequality as a potential source of risk to our investment portfolios. Therefore, we have created a new policy that aims to link both these issues. From 2024, we will vote against the say on pay resolution of any S&P 500 company whose CEO to median employee pay ratio is greater than 300 *and* the company's total shareholder return relative to the S&P 500 has underperformed when measured over a three-year period.

## Fixed compensation

Fixed compensation practices, which vary by company, are valued by executives and can form a significant part of the overall compensation package. Executives should not expect to receive base pay increases each year, particularly in years of poor performance. When performance justifies a raise, it should be commensurate with increases offered to the rest of the workforce. Therefore, LGIM will vote against a base pay increase of 10% or more unless there is a compelling reason provided by the company's compensation committee for such an increase.

### Potential benefits

#### Tax gross-ups

We will not support the provision of tax gross-up benefits for bonuses or other one-time payments such as severance. We believe that individuals should be responsible for meeting their own tax expenses. We do not consider this to be a good use of shareholder funds. Tax gross-ups to meet relocation expenses will only be supported for a maximum of two years if a similar benefit is offered to all employees.

We will vote against any compensation policy that allows tax gross-up payments, excluding relocation (see above).

#### Relocation packages

These should be for a limited period of two years and be commensurate with what is offered to other employees.

#### Use of company aircraft

LGIM has been asking companies to remove this benefit from CEO compensation packages for a number of years. From 2024, LGIM will vote against the pay policy of those companies that continue to provide this benefit.

## Variable compensation

### Annual incentives

We expect companies' compensation policies to be aimed at rewarding for the delivery of sustained long-term performance. Therefore, the level of compensation offered for the delivery of short-term performance should not only be capped as a percentage of salary, but it should be capped at around one third of total compensation.

Any uplift to the target or maximum level of annual compensation should be explained to avoid a negative vote. Where the target bonus has been increased by more than 20% and there is no explanation, LGIM will not support the company's 'say on pay' resolution.

The delivery of the annual incentive should be linked to quantitative financial/non-financial performance targets that are geared to the delivery of corporate strategy.

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.

Achieving a threshold level of financial performance should be a pre-requisite for the delivery of any bonus, including the delivery of personal performance objectives. The exception being in a turnaround situation when changes to non-financial strategic targets may take priority for a few years.

Under circumstances where a company has raised fresh capital and the company had to suspend dividend payments to shareholders, LGIM would not expect an annual incentive to be paid. If an annual cash incentive is paid under these circumstances, we would expect the compensation committee to explain why they consider such a payment to be in the best interest of shareholders.

The performance targets that are set and what is subsequently achieved should be disclosed to investors.

These shares should be subject to clawback/malus being applied to reduce the number of shares that are eventually delivered under certain circumstances, e.g. accounting irregularities, profit warnings etc.



## Long-term incentives

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 for investors and make a positive contribution to society.

In general:

- The policy requires that at least 65% of the value of long-term compensation is subject to performance
- Performance conditions should be explained in terms of the delivery of strategy and the targets to be achieved; we would expect most of the performance conditions to be disclosed
- Retrospective changes to performance targets that were previously set are not supported, except in extreme exceptional circumstances.
- When awards vest, an explanation of the extent to which performance was achieved and whether any discretion was applied should be disclosed to investors
- Evergreen features – which allows for automatic share replacement without the need for share shareholder approval – will not be supported.

### Quantum

Long-term incentives should be capped in terms of overall value or as a percentage of salary. Annual shareholder disclosures should provide an explanation for any variation in the value of long-term incentives that were awarded during the year compared with prior years. Increasing compensation purely based on a benchmarking exercise is no longer acceptable to shareholders.

### Omnibus plans

Many companies use 'omnibus plans' that allow the company flexibility to select the type of incentive medium to offer each year e.g. restricted share units, incentive share options, performance shares, stock appreciation rights and phantom stock.

To reduce complexity in compensation policy, we would encourage companies to move away from this type of plan to one or two specific plans. However, we expect companies that continue to operate omnibus plans to be more explicit in their approach to the type of award that is granted each year, setting out the maximum size of the award that is permitted under each type and the total remuneration to be granted each year and to be mindful that we expect at least 65% of total long-term incentive pay to be performance based.

### Time-based remuneration – restricted stock units (RSUs)

If awarded as part of the long-term incentive offered to executives, we would expect these to be held for a minimum of three years before they become transferable. We would expect these to form a smaller proportion of the total long-term incentive proposition.

The vesting of RSUs should be subject to compensation committee discretion based on management and company performance over the preceding three years.

We will vote against the 'say on pay' resolution where an RSU is permitted to vest annually. We do not consider one year to be long-term.

### Incentive stock options

Although the delivery of value from stock options requires share-price appreciation, we do not consider share-price appreciation on its own, particularly as options are released annually to constitute appropriate long-term performance. In addition, share-price changes can be driven by market factors rather than management action.

However, where at least 50% of the total LTIP opportunity is in the form of performance share units that assess multiple financial and non-financial measures, we will consider stock options to be performance-based long-term incentives if they are held for a minimum of three years prior to release.

Stock options should be market-priced and there should be no scope for re-pricing, replacing or a buy-out for cash once issued.

We will vote against compensation policies that allow or create flexibility to issue non-market priced options and/or repricing.

### Performance shares – performance shares units (PSU)

Our current expectation is that performance-based pay makes up at least 65% of the total long-term compensation package. Therefore, we will vote against companies' 'say on pay' resolutions where the overall weighting of performance-based incentives within the total value of long-term incentives granted is not at least 65%.

Delivery of any long-term awards should be in the form of shares and should not be cash settled.

### Performance conditions

We expect a company to select performance conditions that drive its strategy and to ensure that management action takes account of the business's impact on all relevant stakeholders. Performance conditions should be a mix of material financial and non-financial measures and measured over three years.

Performance conditions should be transparent and based on generally accepted accounting principles (GAAP) measures/key performance indicators (KPIs) that drive the business performance. If non-GAAP-adjusted measures are used, we would expect a full reconciliation to GAAP, so that we can understand how the adjustments have impacted compensation. This should include an explanation of why an adjusted measure was used in the compensation plan.

Many companies use total shareholder return (TSR) as a metric to demonstrate alignment with shareholder interests. However, many companies choose to reward their management teams for delivering performance that is below the median of their chosen peer/benchmark group. LGIM does not support this practice, and we will vote against any company's 'say on pay' resolution where below median relative TSR performance has resulted in awards still being vested. Where relative TSR is used as a performance modifier, we expect no additional reward to be delivered unless performance is at or above median.

We support the use of material non-financial measures; however, if used, they should be measurable, and the company's committee must explain how they are integrated into the company's purpose and/or strategy.

Companies exposed to high levels of environmental, social or governance (ESG) risk should include relevant targets that are meaningful, measurable and aligned to the company's strategy. Environmental and social targets should be subject to third-party verification.

Companies within sectors that can have a significant effect on climate change should link part of their pay to delivering on their climate mitigation goals. The performance targets should be linked to SBTi approved/or equivalent transition plans aimed at achieving net zero by 2050 or sooner. Targets could also be set to create new opportunities that not only improve revenue, but also have a positive impact on climate.

By 2025, companies will be five years away from reaching their 2030 climate change transition goals. By this time, we expect a majority of companies to have a clear idea of what must be done to hit these crucial targets. Therefore, from 2025, LGIM will be escalating its policy on climate change. To gain LGIM's support for any 'say on pay' vote or new long-term incentive plan being put to shareholders from January 2025, we will expect to see climate targets within the long-term plan. These targets should be in line with stated transition goals to reaching net zero and across the full value chain (scope 1-3). Ideally, they should be SBTi approved.

This will apply to companies in the following sectors: Airlines, Aluminum, Apparel, Autos, Aviation, Banks, Cement, Chemicals, Food, Forestry, Glass, Insurance, Logistics, Mining, Oil and Gas, REITs, Shipping, Steel, Technology, Telecoms and Electric and Multi-Utilities.

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

The use of gender or ethnic diversity targets would be relevant for sectors that struggle to recruit a sufficiently diverse workforce.

LGIM discourages the use of employee engagement targets, as we believe this is something a well-governed company with an inclusive culture should be doing. Financial incentives should not be necessary to drive such a programme. A better metric for companies, especially those that have a high level of staff turnover, would be to set targets around employee retention to gauge whether efforts to improve staff retention are working.

For companies in high-risk sectors, where the health and safety of employees is key, we expect a health and safety modifier to be introduced to the annual bonus and/or long-term incentive. LGIM expects to see awards reduced by at least 20% or more if there have been fatalities and the company is considered responsible.

At oil and gas companies, remuneration should prioritise financial value over fossil fuel production volumes. The use of measures that directly encourage volume growth (such as reserve replacement ratios or production targets) risks incentivising over-investment at a time when growth in demand seems increasingly uncertain and should therefore be avoided. LGIM prefers financial measures (relating to total shareholder return, balance sheet strength) or other strategic metrics. The use of volume growth targets may result in a negative vote.

## One-time awards

### Golden parachutes/handshakes/sign-on bonuses

Acceptance of these practices by shareholders has changed. Investors no longer believe this to be an appropriate use of shareholder funds. There is no guarantee that the new appointment is going to deliver the right cultural values, strategy, or performance.

We will not support any recruitment award that is excessive, without explanation and is not linked to the delivery of future performance. The exception being where such awards are granted to replace forgone incentives from a previous employment. We expect this to be awarded on a like-for-like basis and explained to shareholders.

### Retention awards (shares or cash bonuses)

There is no guarantee that any retention awards will deliver value to stakeholders. Historically, retention awards have not been effective in retaining the individual. We believe that a well-structured compensation package should be sufficient to motivate and retain a director.

We will vote against the payment of retention awards.

## Departing directors

We expect the compensation committee to ensure there have been no rewards for failure.

Except with 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.

Change of control should not automatically accelerate the vesting of all equity awards not yet earned/vested. Allowing for this in compensation plans may create conflicts of interest in senior management/executives. Why work hard and create shareholder value if I can sell the business and be paid early?

### Severance compensation

#### Change of control compensation (CIC)

We expect any payments to be triggered only if change of control results in termination (double trigger). Compensation should be limited to two times salary and an average bonus paid over the past two years.

We will vote against any compensation policy that allows CIC compensation without a double trigger.

#### Non-CIC compensation

The multiples of salary offered to an executive as compensation to leave their post raises concern. In most cases, departure is as a direct result of an orderly succession plan or poor performance.

Compensation should be limited contractually to salary, benefits and an estimated bonus for the year. Anything that exceeds 2x salary and target bonus should be subject to a shareholder vote.

## Newly appointed directors

When setting the remuneration of a new executive who lacks experience of the company and/or the role, we would encourage the compensation committee to consider placing the individual on a lower salary than their predecessor, with a view to increasing their pay over an extended period (subject to performance).

Newly appointed executive directors should be encouraged to purchase shares in the company. Additional benefits such as assistance to relocate should be time-limited with a maximum of two years.

The use of 'golden hello'/sign-on bonus payments is not supported (see above on one-time awards). Where a buy-out of existing awards from a previous employer is necessary, it should only cover the expected loss of value, and should be awarded predominately in shares and subject to performance and highlighted as such in disclosures.

## Malus/clawback and discretion

We expect companies to adopt appropriate policies that allow all forms of variable pay to be clawed back if evidence indicates that payments were made based on inaccurate or misleading information.

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

We expect malus/clawback provisions to be written into any contract offering performance-based incentive arrangements.

We define discretion as anything that alters the monetary outcome of total remuneration. Discretion should be used to reduce as well as increase incentive outcomes. However, where discretion is applied, we expect a full explanation to be provided including disclosure of the additional benefit gained/lost as a result of applying discretion.

## Stock ownership guidelines

Executive directors and senior executives should be encouraged to purchase shares in the company. The compensation policy should encourage directors and senior executives to build up and to retain a meaningful interest in the shares of the company they manage. This is an essential part of aligning directors' interests with those of investors.

The level of shareholding required while employed with the company should be material. As a minimum it should mirror the value of the reward under all incentive arrangements offered each fiscal year.

Although we understand this is not standard practice in North America, we would like to encourage companies to require executives to maintain at least 80% of their shareholding guideline for two years following their departure from the company. This will reduce the likelihood of short-term risk-taking to boost short-term performance at the expense of long-term value creation.

Any shares purchased by the director are not required to be held post cessation. Any shares required to be held under the stock ownership guidelines should not be used for any hedging or pledging activity.

Unexercised stock options and any other share-based award that has not been released by the company should not be used to count towards a company's shareholding guideline. Doing so, many result in a vote against the 'say on pay' resolution.

Stock ownership should be encouraged throughout the organization as it promotes employee loyalty and retention. Schemes such as profit share can benefit the entire workforce, offering a mixture of cash and shares, as they are directly linked with the performance of the business.

## Pensions

Pensions are a significant cost and risk for a company as well as an element of compensation that is not linked to performance. Therefore, the cost of providing a pension should be considered when evaluating a compensation package.

We will not support pension enhancement payments at retirement or when a contract is terminated early. Additionally, we will not advocate an individual being compensated for changes in tax.

Companies should ensure that pension provisions are aligned throughout the organisation.

## Equity considerations

### Equity dilution

Equity dilution guidelines should be adhered to in relation to the issuance of shares for incentive schemes. As a rule, we expect no more than 10% of a company's equity to be used for all share schemes over a 10-year period.

### Hedging of equity shares

Executives using their shares as hedging instruments severs the alignment of interests of the executive with those of shareholders. We believe companies should adopt strict policies to prohibit executives from hedging the economic risk associated with their share ownership in the company.

### Pledging of equity shares

We believe investors benefit when employees, particularly senior executives, have 'skin in the game'. Therefore, we recognise the potential benefits of measures designed to encourage executives to buy shares and to retain shares that they have been granted through incentive programmes.

However, if not properly managed, the practice of pledging shares, particularly to secure loans or the purchase of other assets, can create a risk.

Therefore, we will only support the use of pledging if it relates to shares purchased by the individual. Once the shareholding requirement is reached, any excess shares earned above this level may also be pledged.

## Outside director fees

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

## Pay ratios

In 2015, the SEC adopted a rule mandated by the Dodd Frank Wall Street Reform and Consumer Protection Act, 2010, that requires public companies with a fiscal year ending on or after 31 December 2017 and with a market capitalisation of US\$75 million and over to disclose the ratio of CEO compensation to that of the median employee at

that company.<sup>3</sup> The company must disclose the methodology for determining the median employee and any assumptions used. Foreign private issuers were excluded from this provision, and certain exemptions were made for emerging growth companies with less than US\$1.07 billion in revenue and smaller companies with less than US\$100 million of revenue.

We encourage companies to use their total employee population and to identify the median by using annual total compensation as determined under existing executive compensation rules. We encourage this so that the information provided is consistent and therefore comparable between companies.

We expect a company's compensation committee chair to share their concerns with the level of pay disparity with the management team and to ensure that its employees are earning at least a living wage. Furthermore, we expect the compensation committee to communicate with investors any actions it has taken to address this disparity.

LGIM's principles on executive compensation is based on pay for performance, however, we view pay inequality as a potential source of risk to our portfolios. Therefore, we have created a new policy that aims to link both issues. From 2024, we will vote against the 'say on pay' resolution of any S&P 500 company whose CEO to median employee pay ratio is greater than 300 and the company's total shareholder return relative to the S&P 500 has under-performed when measured over a 3-year period.

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<sup>3</sup> <https://www.sec.gov/rules/final/2015/33-9877.pdf>

## Important information

### Key risks

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

### Important information

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