

**Universities Superannuation Scheme (USS) Response to the FRC Consultation
on a Stewardship Code for Institutional Investors**

21 April 2010

USS has a unique perspective

USS is the second largest pension fund in the UK. At the end of March 2010 we had circa £29bn under management, with about 90% managed in-house. As a defined benefit and open scheme, USS's long term and universal investor perspective distinguishes us from many other institutional investors in the UK, who we believe are potentially conflicted by their business links to large financial institutions. We take seriously our role as a long term owner of companies, and devote substantial resources to monitoring company management and Boards. We have an in-house Responsible Investment team which works alongside our portfolio managers to engage with companies where appropriate. We believe shareholder activism is vital for ensuring we deliver long term value for beneficiaries.

1. Overview:

USS strongly supports the concept of a Stewardship Code (the Code) and agrees that the Institutional Shareholders' Committee (ISC) Code on the Responsibilities of Institutional Investors is an appropriate starting point for improving the effectiveness of engagement by asset owners and fund managers.

We believe the aim of the Code should be to encourage investors to strive continually towards meeting stewardship best practice in a 'race to the top'. Engagement activities should be fully integrated into the investment process to ensure continued and proactive stewardship with a long term focus.

The Code's monitoring system should be designed to:

- i) Assist asset owners in identifying fund managers which are best in class with regard to stewardship.
- ii) Allow companies to identify intrinsic investors¹ among their shareholder base who are willing and able to engage on a constructive basis.

2. Oversight of the Code:

USS Recommendation:

The FRC should have responsibility for setting up an *independent panel of experts* to oversee and monitor the implementation of the Stewardship Code.

We agree with the Financial Reporting Council's (FRC) proposed objectives with regard to the Code. We believe the FRC should 'contribute towards improved communication between shareholders and the boards of the companies in which they invest' by overseeing and monitoring institutional investors' stewardship activity.

The FRC indicated in section 5.17 of the consultation document that this was not a role it saw for itself, preferring independent alternative arrangements to be put in place. However, we contend the FRC is the most appropriate organisation to review the code and to monitor stewardship activities among institutional investors (see also final section of this submission).

¹ "Intrinsic" investors is a term coined by McKinsey, and referred to in the Walker Review's para 5.30.

We believe any oversight of the Code, including reviewing the standards and monitoring the extent of adoption and implementation, should be undertaken by an *independent panel of experts* (The Panel) with adequate resources allocated to it and composed of individuals with relevant expertise in this area. We believe the FRC should have responsibility for setting up such a committee, with experts drawn from the FSA, FRC, retired company directors as well as representatives from institutional investors. It is important that any such panel is properly constituted with representatives from asset owners as well as fund managers. The Panel should have the resources and expertise required to conduct informed regular reviews of the standards and monitor the extent of adoption of the Code among investors.

3. The Content of the Code

USS Recommendations:

- The Code should set a high bar, reflecting and encouraging best practice.
- The Code should encourage a culture of continued development and improvement in stewardship responsibilities.
- The Code should be as straightforward as possible.
- The Code should emphasise integrated stewardship over basic voting.
- The Code should focus on the quality and outcomes of engagements.
- The Code should not focus exclusively on engagement with UK equities but should also acknowledge that investors engage with, inter alia, sector specific and regulatory issues, overseas markets and alternative assets.

The key risk in setting standards for all participants in the industry is that standards could gravitate towards the lowest common denominator. We favour the Code setting a high bar which reflects the top performers in the industry and encourages institutional investors to continue to develop stewardship responsibilities. The Code should not require compliance with a list of rigidly applied rules but should focus on resource allocation, implementation and the intent to continually improve stewardship. It is therefore vital that the Code is regularly reviewed to ensure that it reflects best practice.

The Code needs to remain as straightforward as possible to ensure appropriate understanding of the responsibilities expected from the individual institutions and to encourage a high level of adoption among investors. Although, we consider the need for simplicity, this should not be at the expense of encouraging higher standards to be adopted.

We consider there to be differentiated levels of engagement that institutional investors can adopt with companies; ranging from the basic level of voting to more enhanced and strategic engagements. Therefore, we welcome the Code's focus on integrating governance issues into the investment process and encouraging the adoption of an intervention strategy. Integrating engagement with the investment process is essential to ensure engagements are of a higher quality and take into account operational and strategic issues. The Code should provide greater clarity on the differences between basic stewardship through voting and enhanced stewardship through engagement.

It should be acknowledged that, in many cases, investors will hold many securities in multiple jurisdictions and it will be unrealistic to expect the same standard of engagement to be applied across an investor's portfolio. The Code should focus on the quality, outcomes and success of engagements, rather than the quantity of engagements undertaken.

The Code currently focuses solely on engagement with individual companies. However, investors who are actively engaging with investee companies may also engage on thematic, sectoral or regulatory issues which could have a more significant effect on a larger number of companies than individual company engagements. Additionally, USS believes the responsibilities of ownership extend beyond listed equities. Institutional investors should also have the flexibility (and be encouraged) within the Code to engage with other asset classes which may be material to their portfolio or asset allocation. The Code should also refer to such types of collaboration and engagement.

4. The Monitoring and Verification Process

USS Recommendations:

- The monitoring process will need to consider the quality and outcomes of stewardship activities.
- Independent auditors (who would report to The Panel) should be used to assess stewardship activities measured against the Code.
- Fund managers should be independently assessed.
- The results of the assessments should be ranked and made public on a voluntary basis.

We understand the FRC are in discussions on the use of the IMA or PRI surveys as a potential mechanism to measure compliance with the Code. Although the use of such surveys provides a useful indicator of the resources allocated to stewardship activities, it is difficult to gain a sense of the quality of engagement activities on the basis of a survey alone. Many engagements with companies are undertaken in a private and confidential manner and the monitoring process will need to take this into account.

We are in favour of introducing an independent audit and ranking process rather than a self-verification model of compliance. Reporting as a compliance mechanism will not necessarily create the market forces necessary for continued stewardship improvements. We consider an independent assessment and verification process conducted by independent auditors reporting to The Panel (outlined in section 2 above) would be the most effective way to ensure a more objective assessment of the stewardship activities undertaken by institutional investors.

The Panel would rank fund managers who adopt and report on compliance with the Code on the basis of the quality of their stewardship activities. The Code and its monitoring process should encourage an aspiration to meet best practice by fund managers. We believe the ranking process should act as a catalyst, providing a market-based incentive for institutional investors to develop stewardship best practice. Fund managers would voluntarily choose to participate in the ranking exercise. The final ranking would be made public with reviews ideally undertaken on an annual basis.

In our view a ranking process would have a number of advantages:

- i) Asset owners could incorporate the ranking system into their processes for the selection of fund managers.
- ii) The ranking would enable asset owners to identify those fund managers who meet certain standards in terms of stewardship activities. It should, at a minimum, assess their commitment to the following:
 - Allocation of dedicated and appropriate resources towards stewardship activities.
 - Integration of engagements into the investment process.
 - Providing underlying asset owners in pooled funds with the ability to make their own voting decisions.
- iii) The ranking exercise will also provide assurance to existing clients that stewardship activities are being undertaken effectively on their behalf by their fund managers.
- iv) Finally, companies may wish to use the results of the ranking process to identify those shareholders who are intrinsic investors and willing and able to engage on a constructive basis. We believe companies should consult primarily with intrinsic investors. The term, which was coined by McKinsey, and referenced in the Walker report, refers to long term investors who have an understanding of a company's strategy, its current performance and potential to create long term value. Such investors may not be among the top 10 investors on the company register, but should be able to provide a more informed and constructive perspective to the board.