Submission to the Financial Reporting Council; Review of the Effectiveness of The Combined Code

9th October 2009

USS has a unique perspective

USS is the second largest pension fund in the UK. At the end of August 2009 we had circa £26 bn under management, with about 80% of this is 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, which we believe are potentially conflicted by their business links to large financial institutions. We take very 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 we identify problems. We believe shareholder activism is vital for ensuring we deliver long term value for beneficiaries.

Recommendations

Encouraging effective engagement: Institutional shareholders should be encouraged to engage with Boards going forward based on the Principles of Stewardship proposed by Walker and they should be independently assessed against these principles.

Board effectiveness and disclosure: Shareholders are currently constrained in electing directors due to the limited information available. A board should publicly justify its choice of directors and greater transparency is required on the skills and suitability of candidates and how they will contribute to the Board's performance. Shareholders require additional information on how nominations are made and the processes and outcomes of annual evaluations.

Alignment of pay with performance: In order for shareholders to accurately assess the remuneration schemes it is essential that remuneration committees disclose the rationale behind executive remuneration schemes, the selection of performance metrics, and how they have used their discretion in agreeing total remuneration payments.

Avoid a "tick-box" approach: We are not in favour of setting rigid corporate governance rules that might result in a "tick-box" approach to Board procedures. This could undermine directors' responsibility to provide sound judgement and robust oversight of management. We favour the Combined Code advocating an integrated reporting approach which links operational performance and Board decision making with governance structures and systems.

Comply or Explain: We support the current principles-based approach and the flexibility provided by the "comply or explain" reporting model.

Engagement between Boards and Shareholders

Recommendation:

- The Combined Code should encourage fund managers to adhere to the Principles of Stewardship and participate in the assessment process. These Principles should embody higher standards of institutional shareholders ownership responsibilities.
- Fund managers should be independently assessed and publicly ranked according to these standards on a voluntary basis.

We acknowledge that engagement between Boards and shareholders has not been as constructive or effective as it could have been leading up to the financial crisis. We have proposed that the Principles of Stewardship set out by Walker (Walker Recommendations 16-20) are an appropriate means to improve the effectiveness of engagement by encouraging asset owners and fund managers to engage constructively and collaboratively with issuers.

We believe this Standard would encourage investors to develop regular and proactive engagement with a long term focus and allow companies to identify those intrinsic investors[1] who are willing and able to engage on a constructive basis. The problem with standards set for all participants in the industry is that they tend to gravitate towards the 'lowest common denominator'. We favour setting a higher bar which is a reflection of the top performers in the industry. We believe the proposals can be strengthened by requiring fund managers' stewardship activities to be independently assessed and ranked.

Fund managers would voluntarily choose to participate in the ranking exercise. The final ranking would be made public; ideally reviews would be undertaken annually[2]. It is important that the validation process does not require compliance with a list of rigidly applied rules, but should reflect the overall level of resource dedication and delivery in terms of effective engagement. To the extent that asset owners incorporate the ranking system into their selection of fund managers, it would provide a market-based incentive to improve stewardship standards.

Board Balance and Composition

Director Nominees

Recommendation:

A Board should publicly justify its choice of directors, both collectively and individually. Additional information should be provided to investors as below:

- Skills and key competencies should be disclosed and discussed.
- An explanation of the value that directors are expected to add to the Board.
- An understanding of the directors' perspectives on key issues relevant to the company.
- A commentary should be provided as to how any additional appointments will contribute to the Board's performance.

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

[2] Such independent assessment systems already exist. An example is the UN supported Principles for Responsible Investment (www.unpri.org) which have at their core the requirement to be active owners. Signatories to the PRI – which represent more than $15 trillion in assets - have to undertake a self assessment which then feeds into an evaluation and benchmarking process.

The election of directors is one of shareholders' most important responsibilities. Without additional transparency over how nominations are made and the skill-set and suitability of candidates, shareholders will continue to be constrained in their ability to assess, challenge or support company appointments.

A Board should publicly justify its choice of directors, both collectively and individually. This should include details of their skills, key competencies, what value they can add to the Board (and how they will do so), and an understanding of their perspectives on issues relevant to the company. This should be in addition to the standard historical employment and independence data. The Board should also provide commentary as to how it believes the additional director(s) will contribute to and improve Board performance.

Please see annex 1 for an example of a template which outlines the information we are seeking to obtain from both the nomination committee and the individual director candidate. Although written for US companies, this information is also lacking in UK annual reports and notice of meetings.

Having such information available on each individual and for the Board as a whole would provide shareholders with the information required to make more informed voting decisions on director candidates. Better disclosure could lead to less of a 'tick-box' mentality towards determining director suitability, by analysing independence issues such as tenure alongside skill sets and competencies.

Nomination Committee

Recommendation:
Guidance in the Combined Code on succession planning, policy and reporting should be enhanced to include:

- Disclosure of the principles underpinning a company's succession planning process.
- The provision of evidence of succession planning in action (the proportion of key vacancies filled by internal hires, for example).
- Greater disclosures of the processes, analyses and outcomes from annual evaluations.

Succession planning is critical to the present and future needs of the company. Disclosure of the principles underpinning a company's succession planning process can go a long way to reassuring shareholders that the long-term interests of the company are being managed effectively. In the absence of a succession planning and selection policy, shareholders are unable to appraise the process by which future directors are identified and developed. This creates uncertainty in the market and may, in our opinion, impact upon long term shareholder value. It also deprives shareholders of the opportunity to identify failures and promote best practice.

The role of the nomination committee is to ensure the Board has the requisite knowledge, skills and diversity to work effectively and enhance collective intelligence. One way for the nomination committee to assess this is through annual Board and committee evaluations. Greater disclosures of how the nomination committee operates, including the processes, analysis and outcomes of annual Board evaluations, would allow shareholders greater understanding and insight as to why the decisions on Board composition and structure were taken.

We believe the enhanced disclosure on the processes and outcomes of the Board evaluations and the individual nominees would also provide a way of assessing the ability of a nominee to carry out their duties. We would support additional disclosure to enable shareholders to formulate their own conclusions on the effectiveness of a director, rather than Walker's recommendation of a minimum time commitment by directors.

Independence and Expertise

Recommendation:

- Expertise should not be prioritised at the expense of independence within the Combined Code.
- Enhanced disclosure requirements on individuals would allow shareholders to assess the balance between independence and relevant experience.
- Director independence (or not) - evidenced by individual behaviours rather than by status - should be a critical factor in the Board's annual evaluation and in disclosure of its evaluation process and outcomes.

We are supportive of Walker's emphasis on the importance of relevant expertise and professionalism within Boards. However, we believe that expertise should not be prioritised at the expense of independence. We believe the Board should have a suitable balance of independence and expertise. The suggested enhanced disclosure requirements would ensure shareholders have the information available to assess candidate suitability.

Director Elections

Recommendation: The wording in the Combined Code regarding director elections should remain unchanged.

We fully support the current system of Board re-election. We believe having an annual re-election could engender a short-term outlook amongst both shareholders and directors. Triennial elections provide an appropriate balance between holding directors to account and ensuring directors have a long term outlook. Appropriate engagement tools already exist for shareholders to remove directors in the period between elections.

Remuneration

Strategy

Recommendation: Remuneration metrics should exhibit a close link to strategy.

We believe the primary responsibility of senior executives is to deploy capital in the best interests of shareholders. This requires executives to develop strategies that optimise durable business performance, characterised by sound economics, which ultimately underpin the stock market valuation of the business. Accordingly, we expect Boards of directors to establish performance standards and executive remuneration arrangements that motivate management to deliver such performance.

Compensation performance targets and metrics exhibiting a close link to strategy, strategy execution and value drivers would provide a clear signal to investors about what behaviours are being incentivised to achieve long-term company performance.

Transparency

Recommendation:
In the remuneration report the Combined Code should promote:

- Disclosure of the philosophies and goals which underpin the remuneration process.
- Additional explanation and disclosure on the underlying rationale of the remuneration structures.
- Details of how performance metrics are set, how discretion is or could be applied, the impacts on motivation and the management of any unintended consequences.

We would welcome greater disclosure of the philosophies and goals which underpin the remuneration committees decision making process. Some remuneration committees already disclose this information, which allows shareholders to fully understand how remuneration structures are decided. We would also like the Combined Code to include a recommendation for remuneration committees to explain how they set performance metrics, how they use their discretion in determining awarded remuneration, the impact on motivation and how they manage the unintended consequences of particular remuneration arrangements. As well as disclosure of additional amounts paid, as proposed in Walker, we would look for remuneration committees to disclose the underlying rationale of the structure of schemes.

Current Code and Reviews

Recommendation: The Combined Code should reflect the conclusions of other major codes and reviews where the recommendations are applicable.

We are supportive of ensuring all guidance and codes send the same message to companies. We welcome the majority of recommendations relating to remuneration in the Walker review although recognise some are not applicable to non-financial institutions, particularly the recommendations which specify the structures and payout of compensation plans.

Role of Shareholders

Recommendation: Remuneration committee chairmen should be encouraged to consult with investors.

Although it is ultimately the remuneration committee's responsibility to choose a structure which is most appropriate for the company, shareholders ought to have a greater role in their discussions. Therefore remuneration committees should be encouraged to consult with intrinsic investors (see above) on major changes to the remuneration structure. We favour remuneration structures which are clearly linked to strategy and value creation with the disclosures and explanations as described above. We believe fund managers and asset owners who are highly ranked against the Principles of Stewardship, as explained above, would be in the best position to provide constructive feedback and engagement with remuneration committees.

Annex 1: Copy of the Nominating Committee and Director Candidate Information Requests (sent to US companies and the SEC)

Nominating Committee Information Request:
Selection of Director Candidates

Introduction and Instructions

We are requesting information about the process of selecting director candidates. Shareholders can exercise their voting rights in a more informed manner if they understand the dynamics of the Board of directors and the process for nominating director candidates. Please respond to the below listed questions. We do not expect a detailed response but would appreciate clear and concise information.

Information Request

1. Nominating Process. Please describe the process the Nominating Committee adopted in order to develop selection criteria and identify the director candidate(s).

2. Independence. Please describe the role (if any) that the Chief Executive Officer played in determining non-management director candidates.

3. Criteria for Selection. Describe the criteria developed for use by the Nominating Committee in selecting the director candidate and briefly explain how those criteria apply to the candidate. For example, what knowledge, skills and experiences would the candidate bring to the company in regard to:

    - Achieving company strategic objectives;
    - Representing shareholder interests;
    - Supplementing competencies and skills of other Board members;
    - Providing diversity of perspective and background relevant to the company's business;
    - Providing expertise required on specific committees;
    - Evaluating the company's long-term business plans, capital structure, risk exposures and organizational design; and
    - Recruiting, developing, compensating, evaluating and coaching executive talent.[3]

[3]These criteria are listed only as an example and should not be substituted for what was actually used by the Nominating Committee.

4. Shareholder Questions. If applicable, how and when will the candidate be available to respond to shareholder questions, and how can shareholders participate, submit questions and receive all responses?

Director Candidate Information Request

Introduction and Instructions.

We are requesting information about new director candidates. As shareholders, the election of directors is one of our most important responsibilities. In order for shareholders to cast votes in an informed manner, please respond to the questions listed below. The responses should include current, personal views and are not intended to preclude a candidate from exercising future discretion. Attention to quality, rather than quantity, of information in responses is appreciated.

Information Request.

1. Effectiveness. Why do you believe you would be an effective director at the company?

2. Independence. Please tell us about any financial, business, family or personal relationships with members of the company's senior management or Board that are not disclosed in the proxy (if any) and, if you are a non-management candidate, explain how they might/might not affect your independence.

3. Company Issues. If there are particular issues you would like the company to address or goals you would like to achieve as a director, please comment on them.[4] You may include longer-term concerns, such as environmental risks and other extra-financial issues, as you deem appropriate.

4. Corporate Governance.

   (a) To help shareholders understand your views on key corporate governance and investor responsibility issues, if not previously described, please comment on any changes or improvements in governance practices you would like to see made at the company, if any.

   (b) Please briefly summarize your general views on key corporate governance issues, regardless of whether they are applicable to the company. Some of the areas you might want to comment on are set out below. Feel free to add explanatory comments on additional issues.

      - The appointment of an Independent Board Chair
      - Requiring that director candidates receive a majority of shareholder votes to be elected
      - Shareholder access to the proxy for nomination of director candidates
      - Communication between shareholders and independent directors on governance matters
      - Company use of, and shareholder approval of, anti-takeover devices
      - Shareholder advisory votes on selection of company auditors
      - Board consideration of shareholder resolutions which have been approved by a majority shareholder vote

[4] These questions are not intended to imply that candidates should have a particular agenda or platform. They only seek information about any personal views or priorities a candidate would bring to the Board.

- Company reporting and disclosure of environmental and other major risk exposures
- The disclosure and use of company-related political/campaign contributions
- Advisory shareholder votes on executive compensation
- Independence of the Board's executive compensation consultant

Any Additional Governance-Related Comments:

5. <u>Other Matters.</u> If there are other comments that you would like shareholders to know when voting their proxies, please provide them.