Financial Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS

March 2019

Dear Sir / Madam,

Proposed Revisions to the UK Stewardship Code

USS Investment Management welcomes the opportunity to respond to the Financial Reporting Council's (FRC) consultation on the proposed revisions to the UK Stewardship Code.

By way of background, Universities Superannuation Scheme (USS) is one of the largest pension schemes in the UK, with total fund assets of over £65 billion. The scheme's trustee is Universities Superannuation Scheme Ltd, a corporate trustee which provides scheme management and trusteeship. USS Investment Management Ltd (a wholly owned subsidiary of Universities Superannuation Scheme Ltd) is the principal investment manager and advisor to the scheme.

USS's investment team directly manages the majority of the scheme's assets which allows our investment approach to be tailored to the scheme's requirements and provides us with a unique perspective compared to many other institutional investors. As an institutional investor that takes seriously its fiduciary obligations, USS aims to be an active, engaged and responsible owner of the companies and assets in which it invests. We devote substantial resources to implementing an active approach towards stewardship, an approach which the trustee company expects both to protect and enhance the value of the scheme's investments in the long-term. Notwithstanding the fact that the Code was not originally designed for pension funds, USS was an early supporter and signatory, signaling to the market the importance of stewardship in generating sustainable returns throughout the investment chain.

We have provided our views below on the key focus areas of the consultation on which we believe improvements could be made and/or we have specific views which may be useful in your deliberations.

Please feel free to contact me should you require any clarification or additional information on our comments.

Yours sincerely

David Russell

Head of Responsible Investment

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USS response to the FRC's Proposed Revisions to the UK Stewardship Code

Executive Summary

We welcome the FRC's comprehensive review of the Stewardship Code to ensure it remains fit for purpose and continues to promote improvement in the quality of stewardship in the UK. The UK led the world in the development of the original Stewardship Code in 2010. However, it was becoming increasingly difficult for asset owners to differentiate between asset manager signatories based on the quality of their stewardship capabilities.

The new draft Code as proposed is a step up from the previous version, and as such it will be more challenging to implement, particularly for smaller asset owners.

Key points:

- We are supportive of the proposed definition that recognises the mutually reinforcing link between investors, the economy and society. The FRC should ensure the draft Code establishes consistency between this concept and fiduciary responsibility.
- The change in the scope of the Code, including expanding coverage to all asset classes and to markets beyond the UK, is welcome.
- We support the differentiation proposed between asset owners and asset managers in the draft Code. However, consideration needs to be given as to how to encourage smaller pension funds which lack resource to support the Code without having to comply with its more detailed requirements. More generally, a concept of proportionality is needed: asset owners and investment managers will need to prioritise and target their stewardship resources where they believe these will achieve the greatest benefit.
- We support a focus on outcomes rather than policies and processes, including the reporting requirements.

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Definition of Stewardship

In recent years, there has been increasing departure from the [short-term] shareholder primacy model to a greater focus on the role of investors in ensuring companies create sustainable value and that this generally supports rather than conflicts with outcomes for a wider set of stakeholders. In some respects, this is not a new concept: Section 172 of the Companies Act 2006 requires directors to have regards to other stakeholders when promoting the success of the company for the benefit of its shareholders. In addition, the 2018 revision of the UK Corporate Governance Code introduced the concept of the "*promotion of the long-term sustainable success of the company, generating value for shareholders and contributing to wider society*."

The proposed changes to the Stewardship Code redefine stewardship as "*the responsible allocation and management of capital across the institutional investor community to create sustainable value for beneficiaries, the economy and society*". We welcome the recognition that investors, and investment returns, are inextricably linked with the success of the broader economy and society as a whole: Investment returns do not exist in isolation from the economy and society. We believe that it would be difficult to generate sustainable investment returns without having a strong economy and a society.

Indeed, we have long advocated that stewardship for institutional investors and particularly asset owners should capture the entire investment chain and all processes and outputs entailed in the creation of value for beneficiaries. Our positioning on value creation (from our web site) extends beyond pure financial benefits and focusses on two additional concepts in our pursuit of protecting and enhancing the value of the Scheme on behalf of the trustee:

1. **Promoting the proper functioning of markets, from which we benefit as a universal investor**. We seek to ensure that externalities and market failures, such as pollution or systemic weak corporate governance, do not affect market wide, long-term economic performance. Universal investors are those who, like USS, have holdings that are so diversified that their investment returns are impacted by the returns from the economy as a whole, as much as any specific industries or companies.
2. **Ensuring our assets contribute positively to our members' futures.** The assets we own and the oversight we wield as a responsible owner play an important role in determining the wider future our members face and, therefore, the real value of their retirement income. We believe that our members want to retire into a world characterised by a healthy environment, vibrant economy and peaceful society, so we also take into account factors which further this aim.

We believe the proposed definition recognises that there is a change in direction of travel in meeting society's expectations of the investment sector. We are already seeing large investors, both as owners and asset managers (including some signatories to the Stewardship Code), recognise, through their statements and actions, the importance of the link between companies, investors, and their role in society. USS believes that these concepts are not mutually exclusive: With its focus in creating "*sustainable value for beneficiaries, the economy and society*" the new definition recognises that these are linked. If we, as asset owners, have regards to sustainable value creation in the discharging of our stewardship responsibilities, this will in aggregate create a virtuous circle from which our members will benefit. We believe that our fiduciary duty (where the long-term financial interest of our beneficiaries are primary) is consistent with the related benefits thereby accruing to the economy and society.

We are therefore supportive of the general thrust of the new definition of Stewardship.

<u>Suggested changes to the definition of stewardship / supporting text</u>

i. We would recommend that the expanded definition of stewardship reflects the fiduciary responsibility of funds to act in the best interest of their members, customers or beneficiaries. As noted, we believe there is a strong link between such performance and the health of the economy and society in general, and as such support the Code explicitly making this link.

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ii. The Code should also be strengthened to recognise that stewardship requires the active oversight of investee companies, including engagement with the management of these investments.

iii. We would suggest the deletion of "allocation" from the revised definition, and the insertion of "oversight", and recognition that the wider economy and society would benefit in consequence. Our proposed definition would then read as follows: "*the responsible management and oversight of capital across the institutional investor community to create sustainable value for beneficiaries, recognising the interdependence with the economy and society*". We believe this better reflects the concept of stewardship.

We welcome the extension of the Code to encourage stewardship beyond a focus on corporate governance. The explicit additional focus on environmental and social issues brings the Code in line with leading proponents of stewardship who already address these issues. We would however, note that Stewardship has become synonymous with a focus on engaging with companies on ESG issues: we feel that this view falls short of how fiduciaries should be interacting with their assets. It should therefore be reinforced in the Code that stewardship is about creating sustainable value (from the definition) in all its facets and, for the avoidance of doubt, that engagement to this end should also include financial and strategic factors associated with the asset.

Extension of stewardship Code scope

We support the extension of the Stewardship Code beyond UK public equities: as a pension fund and asset owner, USS's invests across multiple asset classes. Similarly, as a global investor, we should be expected to be stewards of our assets in all markets in which we invest, recognising that proportionality and prioritisation of stewardship resources will vary across asset owners and the asset managers we use.

These are both changes to the Code that USS has long called for and we welcome this reference in the revised Code.

In terms of additional asset classes, the current draft Code seems to focus on Credit. Whilst we agree that credit is an obvious focus for stewardship, we would argue that asset managers and asset owners should consider their stewardship of all investments irrespective of asset class. We would therefore suggest that the FRC enhances the Code to include a greater emphasis on other asset classes.

Outcomes focus

We also welcome a renewed focus on the outcomes of signatories' stewardship activities rather than simply an emphasis on process. The focus of stewardship discussions and reporting has traditionally been on the actions taken not the outcomes of any action. We therefore support a focus on reporting outcomes of stewardship in addition to policies and processes. This will enable asset owners to differentiate better between asset managers on their stewardship activities as we will be able to discern the impacts of those activities rather than just that they took place.

Mandates

We note that the Code also requires that "*signatories should explain how they integrate stewardship expectations in the tender and selection process, and how they design mandates for managers and service providers …*". The Code or its guidance should clarify that this is for new rather than existing mandates: it is difficult to retroactively change mandates to include new requirements.

We also note the Code highlights the role of asset owners in actively monitoring the implementation of stewardship related activities of both their external asset managers and other service providers. Such monitoring should encourage investment intermediaries to improve the effectiveness of their stewardship activities.

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The use of collaborative engagement should be reinforced

We welcome the inclusion of collaborative engagement in the draft Code (noting the change in terminology from collective): we support collaboration as an effective fool for engagement. We would, however, suggest that rather than simply being a reporting requirement, the Code be redrafted to recommend collaborative engagement as an effective stewardship tool.

Asser owner adoption of the Code

We welcome the adaptation of the Code to explicitly encourage pension funds to become signatories. Asset owners play an important role in the investment chain, and their signalling of expectations on stewardship will be an important catalyst in encouraging asset managers and service providers to sign up and adhere to the new version of the Code.

The FRC should consider how it encourages pension funds with limited resource to sign up to the new Stewardship Code when it is finalised. Indeed, the requirements in the Code, whilst appropriate for asset managers and larger and well-resourced pension funds, will simply be beyond the ability of most smaller funds to deliver. More generally, a concept of proportionality is needed: asset owners and investment managers will need to prioritise and target their stewardship resources where they believe these will achieve the greatest benefit.

As a result, whilst there should be an expectation that larger, better resourced funds should become signatories to the new Code, the FRC should consider a membership level which permits all pension funds to demonstrate their support for the Code without having to comply with its more detailed requirements and instead explaining how it has been applied given their circumstances. An alternative could be a pared down version of the Code applicable to pension funds of a certain size who will ensure that their asset managers who are signatories to the Code adhere to the Code's principles.

The Universities Superannuation Scheme
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