Department for Work and Pensions
Strategy Policy and Analysis Group
Private Pensions and Arm's Length Bodies Directorate
Ground Floor North
Quarry House
Leeds LS2 7UA

Sent by email: pensions.fiduciaryduty@dwp.gsi.gov.uk 16 July 2018

Dear Ms. Donnelly and Ms Bird

Re: DWP's Consultation on clarifying and strengthening trustees' investment duties

We welcome the opportunity to respond to the DWP's consultation on the draft regulations to amend the required content of the Statement of Investment Principles and the requirements to disclose how the SIP has been implemented.

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

USS is a hybrid scheme, offering both Defined Benefit and Defined Contribution sections. Members are automatically enrolled into the DB section and accrue set benefits on salary up to a given threshold. The employers contribute a percentage of any salaries above this threshold and members may transfer other pension savings into the separate DC part of the scheme.

1. **USS's approach to ESG**

In its Statement of Investment Principles, the Trustee Company sets out its requirement for its investment managers to integrate material financial factors, including corporate, environmental, social, governance and ethical considerations, into the selection, retention and realisation of all fund investments. The Trustee Company expects this to be done in a manner which is consistent with the Trustee Company's investment objectives, legal duties and other relevant commitments e.g. the UN-backed Principles for Responsible Investment and the UK Stewardship Code.

As an institutional investor that takes seriously its fiduciary obligations, USS therefore aims to be an active, engaged and responsible steward of the companies and assets in which it invests directly, through its FCA authorised and regulated subsidiary investment manager, USS Investment Management, and through the external asset management services we procure. We devote substantial resources to implementing an active approach towards stewardship across all the

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scheme's assets – an approach which the trustee company expects both to protect and enhance the value of the scheme's investments in the long-term.

With this outlook, we therefore seek to ensure that long-term opportunities and risks are identified and appropriately managed – including environmental, social and governance (ESG) factors – across all asset classes. These factors should be integrated into the investment process for most effective implementation.

USS monitors and, when appropriate, engages and seeks to improve the governance of investment vehicles or investee companies. USS aims to ensure that they are run in the long-term interests of their investors or owners and other stakeholders and that the full range of risk factors is considered. We seek similar vigilance and application in our external managers – their governance and stewardship activities are considered when their suitability for USS is assessed.

The investment committee monitors this activity on an ongoing basis with the aim of maximising its impact and effectiveness. The Trustee Company's governance, social, ethical and environmental policies are also reviewed regularly by the board and updated as appropriate to ensure that they are in line with good practice.

2. Legal Advice

Our legal advice on the investment duties of trustees of a defined benefit scheme over the years has confirmed that our approach to stewardship and ESG considerations is "wholly consistent" with the duties of the Trustee Company (and consistent with the trust law and Pensions Act duties of the Trustee Company) which is to act in the best financial interests of present and future beneficiaries of a pension fund in the context of investment. Moreover, the advice suggests that the inclusion of ESG issues in investment decision making is acceptable, if not necessary, when these issues are deemed material. This is evident in the following areas:

a) Where any ethical, social, environmental, corporate governance issue can be regarded as having a current or potential impact on an actual or contemplated investment, whether from the point of view of the return to be expected of that investment, its liquidity and/or its underlying capital value,
b) In the policy of constructive engagement USS adopts and requires to be adopted on the part of its external fund managers,
c) When selecting investments with a particular ESG profile as part of building a balanced and properly diversified portfolio eg:
    - 'screening in' investments that are expected to yield an attractive financial return by virtue of their ESG credentials particularly if they are seen as having a long term sustainability potential.
    - screening out investments that are expected to yield a poor financial return by virtue of their ESG credentials.

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More recently, we have been advised, as per the Law Commission's guidance, that non-financial factors (such as ethical issues) may however only be taken into account in limited circumstances, namely where the Trustee Company has reason to believe that the membership shares its view and there is no risk of significant financial detriment to the Scheme. It is clear that non-financial factors should not drive the investment decision.

3. **USS' Approach to Members' views on ESG**

We take seriously the views of our members. Where the law allows and where we are persuaded of the case and the practicalities, we take action. For the defined benefit section, our legal duty to act in the best financial interests of our members drives our investment decisions. We protect our members' pensions by acting as engaged stewards of the investments we make on their behalf, promoting positive boardroom action on environmental, social, governance and ethical issues. We believe that holding a stake and having a seat at the table is one of the most effective approaches to directly affecting beneficial change at a company level.

When we launched the DC section of the scheme, it was designed around the needs of our members, based on extensive research. The two ethical investment options reflect what members said to us about their ethical preferences.

USS has developed ethical guidelines for use in these specific ethical DC products which members can select as part of their DC offering. These guidelines are used in the portfolio construction and manager selection of those products. They have been developed to take into account the views we've heard from our members, what we've seen in other UK pension offerings and advice from our investment consultants. Specifically, we have considered:

- Feedback from members through:
  - Our member engagement survey results,
  - Additional comments in relation to ethical investments that we've received from members in recent years
- A review of market practices within our peer group
- Input from two independent investment consultants, Hymans Robertson and Mercer.

In developing our guidelines, we have aimed to reflect the beliefs of our members while still enabling us to offer quality investment options. These guidelines are reviewed from time to time, to ensure they continue to reflect the views of our membership and take account of the latest developments in the market. These ethical investment guidelines are in addition to the USS Statement of Investment Principles (SIP), which set the expectation that managers of the entire USS Investment Builder (DC) fund range and the USS Retirement Income Builder (DB) investments will act responsibly as stewards of the assets and actively engage with the companies they invest in.

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4. Consultation responses

In response to the questions asked in the consultation document, we would like to make the following points:

1. We are supportive of the general thrust behind the proposed regulatory changes for both defined benefit and defined contribution schemes and the aim to help dispel trustee confusion on the current investment regulations regarding the reporting on their policies towards financially material considerations, including ESG issues.
2. USS is pleased to note that the government continues to respect trustee independence and is not seeking to direct trustees' investment or divestment decisions nor is it seeking to dictate to trustees which opportunities and risks they should consider to be financially material.
3. We agree with the DWP's proposals to require trustees to disclose in their SIP how they take account of financially material considerations including, but not limited to, those arising from ESG considerations, including climate change.
4. We agree with the DWP's proposals that SIPs should set out the fund's policies in relation to the stewardship of the investments including engagement with investee firms and the exercise of voting rights. We also welcome DWP's acknowledgement that for many smaller schemes, their stewardship will involve assessing potential external fund managers' capabilities in implementing an appropriate ESG approach. This will need to be undertaken during the mandate tendering process and should continue after appointment through effective oversight and monitoring of the fund manager's performance in stewardship.
5. It is important, however, to recognise the diverse range of assets in which pension funds now invest and the corresponding diversity of approaches to stewardship which may be required beyond voting and engagement. For example, a comprehensive due diligence process may be the requisite stewardship approach to a large infrastructure investment prior to investment. There needs to be greater acknowledgment of the diversity of asset classes within pension schemes' portfolios in the final regulations.
6. We support the proposal for schemes to publish their SIPs on a website which is accessible to members and the public.
7. We acknowledge the importance of understanding members' views in relation to the matters covered in the SIP whilst recognising the parameters within which trustees can take these views into consideration (see legal advice section above). USS agrees with the DWP's position that trustees are never required to act on any particular scheme member concern and trustees retain control of investment decisions and their prime focus is to deliver a return to members over an appropriate investment horizon.
8. We also agree that there are various methods to gauge members' views other than surveys, a point we urge the DWP to reinforce and expand upon.
9. On this point we believe that expectations will therefore need to be very clear from the outset, in addition to the evidence in the proposed annual implementation report. On the latter, we firmly believe that further guidance will be required on drafting such a report.

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10. We recommend that the DWP in any proposed regulation acknowledges the different considerations that apply in defined contribution schemes where members have a choice in where their funds are invested. This is particularly pertinent when it comes to taking account of members' views.
11. We agree with the DWP's proposal **not** to set out any requirements in legislation around trustee consideration of social impact investment. This is in line with our legal advice outlined in section 2c above described as 'screening in'.

I hope that we have provided helpful input into your deliberations on this important issue and would be happy to discuss any issue further if the opportunity or need arises.

Yours sincerely

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