USS
UNIVERSITIES SUPERANNUATION SCHEME LIMITED

Universities Superannuation Scheme (USS) Response to the BIS Consultation 'A Long-Term Focus for Corporate Britain: A Call for Evidence''

January 2011

USS has a unique perspective

USS is the second largest pension fund in the UK. At the end of November 2010, the value of the Fund was circa £30 billion with about 90% of assets 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. We take seriously our role as a long-term owner of companies and other assets, and devote substantial resources to monitor the management of those assets, including company management and Boards. We have an in-house Responsible Investment team which works alongside our portfolio managers to engage with companies and other asset classes where appropriate. We believe shareholder engagement and active oversight of our assets is vital for ensuring we deliver long-term and sustainable value for our beneficiaries.

Stewardship in the UK:

We believe the rights of shareholders are fundamentally important to ensure effective and efficient capital markets are maintained. The UK has some of the most advanced shareholder rights and protection in the world, which together with an open and transparent market, has meant that the UK is widely considered a global leader in corporate governance best practice.

For shareholders to hold management to account and address the inherent weaknesses of the principle-agent relationship, shareholders require:

- appropriate disclosure of the requisite information upon which investors can make informed decisions and;
- rights which afford shareholders adequate protection, including the ability to hold management to account for the actions which they undertake on our behalf.

We believe the recent developments in corporate governance and investor responsibility in the UK, such as the revised Corporate Governance Code and the creation of the Stewardship Code, enhances the ability of shareholders and board directors to facilitate active and effective dialogue.

As a pension fund looking for long-term returns, USS takes its ownership rights seriously and having publicly endorsed the Stewardship Code, has published a statement of adherence on the USS website[1]. Our approach to investing allows us to take a long-term approach to the stewardship of

[1] http://www.uss.co.uk/news/Pages/USSandthenewUKStewardshipCode.aspx

our assets. USS' trustees believe there are long-term benefits to stewardship activities and we dedicate substantial time and resources to ensure our assets are being managed effectively and in our beneficiaries' best interests.

We disagree with the assertion that engagement is more important in the UK than in other markets (para 2.6). USS believes the responsibilities of ownership extend beyond listed UK equities. In our submission to the FRC regarding the introduction of the Stewardship Code[2], we strongly advocated the extension of the Stewardship Code to encourage engagement with other material asset classes such as property, private equity and hedge funds. We believe that the Stewardship Code presents a market-based solution for stewardship improvement in the UK. However, it should not be viewed as a panacea for conflicts and perceived weaknesses in the current principle-agent structure of public companies.

Boards of Directors:

The definition of directors' duties is well defined in UK corporate law and was recently reviewed in the Corporate Governance Code. We therefore do not consider the role of the board requires further review.

The appointment and removal of directors is one of shareholders' most important responsibilities. We agree that effective boards draw on broad pools of talent with varied and complementary skill-sets. Diversity of board skills is important to ensure the board of directors does not adopt 'group-think' and to encourage the continued effective oversight of management and corporate strategy. However, we do not believe such diversity can be achieved through mandatory quotas. We believe effective succession planning by the board of directors ensures that the board has the requisite breadth and depth of knowledge, skills and experience to optimise its effectiveness. Disclosure of material information to shareholders on board composition and detailed rationale behind the appointment or re-appointment of a director is essential to enable investors to make informed decisions on the suitability of director candidates.

Transparency of the Shareholder Register

USS believes strongly in the need to facilitate effective communication between shareholders and the board of directors. In order for such communication to occur, issuers need to be able to identify their shareholders, and shareholders need to be able to evidence their holding. One of the difficulties in identifying shareholders is the layered ownership structure between the issuer and the ultimate owner. Even in a relative flat ownership structure, the use of pooled fund management and custody accounts and stock-lending further complicates the ability of issuers to identify their ultimate beneficial owners. Although section 793 of the Companies Act tries to address this issue, we believe other solutions to ensure enhanced transparency of the shareholder register should be explored.

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[2] http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/Responses_to_Jan_2010_consultation/USS.pdf

We believe further transparency on the shareholder register could aid issuers in identifying their long-term intrinsic investors[3] and the underlying beneficiaries who may have a longer-term attitude to investment than their intermediaries. The term, intrinsic investor, was coined by McKinsey and referenced in the Walker report, refers to those long-term investors who have a fundamental understanding of strategy, its company performance and potential to create long-term value. Such investors may not be among the top ten investors on the share register, but should be able to provide a more constructive and unique insight to the board of their long-term thinking.

Remuneration:

The remuneration system is a critically important strategic control mechanism at all levels of the corporation as a well-planned system is essential in attracting, focusing, motivating and retaining the right people.

Over the years, USS has developed a set of guiding principles for evaluating director and executive remuneration schemes. This guidance emphasises the need for performance to be evaluated over sufficiently long periods, to discourage short-termism and excessive risk, and is measured against performance metrics that are closely tied to the company's long-term strategy. We believe compensation performance targets and metrics that exhibit a close link to strategy, strategy execution and value drivers provide a clear signal to investors about what behaviours are being incentivised to achieve long-term company performance.

Shareholders have an important responsibility in approving board remuneration, and since the introduction of the annual advisory vote on the remuneration report in 2002, there has been a notable increase in the dialogue between shareholders and issuers on remuneration. Since 2003 there has been a clear reduction in director notice periods, an increase in at-risk variable remuneration, and increased use of performance metrics for option schemes and share plans.

Through engagement, investors have the ability to influence remuneration policies, including the payments upon loss of office. Confidentiality remains a key consideration to ensure discussions are open and candid in nature, and such discussions are not reported publicly. We do not believe additional voting rights on specific types of remuneration, such as severance payments would add value for long-term shareholders.

We believe that a culture of alignment is best fostered through directors holding a substantial portion of personal wealth in shares of the company, a practice which is already becoming widespread in the UK. The movement from fixed salary, to a high proportion of at-risk variable remuneration, over the longer-term also creates alignment between shareholders and directors.

Although there are still laggards, we believe that reporting of remuneration practices has improved significantly since the introduction of the advisory vote in 2002. However, scope for improved reporting and disclosure remains, particularly regarding the rationale for the selected performance criteria and how these relate to strategic objectives and the company's key performance indicators.

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[3] McKinsey article 'Communicating with the Right Investors', Spring 2008.

We believe remuneration is more aligned to shareholder interests when the targets are closely aligned with corporate strategy and within the control of management. Remuneration reporting should not be viewed as a silo section of the annual report, but also integrated within the discussion of strategic, operational and financial performance.

Remuneration committees generally have the power to hire their own advisers and usually have direct access to both management and shareholders. We do not believe the widening of the membership of the remuneration committee would further benefit shareholders. We do not support the inclusion of employees or management on the remuneration committee. The remuneration committee should consist of independent non-executive directors. The UK Companies Act 2006 already requires companies to take into account pay elsewhere in the company when setting executive pay. We do not believe disclosure of pay ratios between board and employees' pay would add significant value when shareholders analyse company remuneration arrangements.

Longer Holding Periods:

Short-term trading by some investors creates liquidity and reduces the cost for longer-term investors and should not necessarily be detrimental to long-term strategic planning by the board of directors.

We strongly support the need for long-term investors to have a greater voice when engaging with investee companies, which is why we support companies when they engage outside their top ten shareholders and seek the views of their intrinsic shareholders. However, we do not believe any additional rights or benefits should be provided for long-term owners. Each share should be treated equally, irrespective of the investment style adopted by the asset manager or asset owner or their holding period. We believe the existence of differential rights and benefits, such as exist in some European countries, create perverse incentives and can lead to an undesirable concentration of power.

Shareholder Engagement:

Although we acknowledge that engagement between boards and shareholders was not as effective as it could have been in the lead up to the financial crisis, we continue to believe engagement between shareholders, directors and company management remains an essential tool to create and protect long-term value for our beneficiaries. In most cases, our starting point is to support management and the strategy which they present unless there are clear reasons for not doing so.

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. At the most basic level of engagement, concerns are conveyed to companies through voting on corporate governance related matters at the general meeting. It is investors' responsibility to inform the company of their concerns and how this impacted the voting decision. Without follow-up communication the impact of the votes will be less effective as companies may not know why such votes were actioned, or which investors have voted against management recommendations. USS is committed to transparency and discloses its voting records on the fund's website.

In our experience, engagement is most successful and effective when it is fully integrated into the investment process and strategic and financial issues are considered alongside extra-financial performance. Effective dialogue, on an ongoing basis, requires a strong understanding of the business in order to engage on the same level as management. We believe integrated engagement, which includes strategic, financial and extra-financial issues requires a strong understanding of the business. We welcomed the Stewardship Code's focus on integrating governance issues into the investment process and encouraging the adoption of an intervention strategy, when appropriate. However, as an in-house pension fund manager, we do maintain our right to sell if considered in the best interests of the fund.

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