USS
INVESTMENT
MANAGEMENT
LIMITED

24 April 2015

Dear Sir/Madam

Consultation on changes to the Investment Regulations following the Law Commission's report: 'Fiduciary Duties of Investment Intermediaries'

We welcome the opportunity to respond to the DWP's consultation on changes to the Investment Regulations following the Law Commission's report: 'Fiduciary Duties of Investment Intermediaries'.

By way of background, Universities Superannuation Scheme (USS) is one of the largest pension funds in the UK, with assets of approximately £45 billion. As an asset owner with an internal investment team which manages the majority of the fund's assets, we have a unique perspective compared to many other institutional investors which allows our investment approach to be tailored to the fund's requirements.

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 to both protect and enhance the value of the Scheme's investments in the long-term.

This approach stems from the recognition that with a) a robust covenant b) liabilities stretching to the end of the century and c) positive net cash flow from investment income and contributions, the fund is characterised as a long-term investor. 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.

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In its Statement of Investment Principles, the Trustee Company sets out its requirement for its investment managers to integrate all material financial factors, including corporate governance, environmental, social, and ethical considerations, into the decision making process 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.

Specifically, the Trustee Company has instructed USS Investment Management as its internal investment manager to follow good practice and to use its influence as a major institutional investor and long-term steward of capital to promote good practice in the investee companies and markets to which the fund is exposed.

The Trustee Company also expects the Scheme's internal and external investment managers to undertake appropriate monitoring of current investments with regard to their policies and practices on all issues which could present a material financial risk to the long-term performance of the Fund such as corporate governance and climate change.

Effective monitoring and identification of these issues can enable engagement with boards and management of investee companies to seek appropriate resolution of potential problems at an early stage. The Trustee Company tasks its wholly owned subsidiary USS Investment Management Limited to provide oversight of external managers in this respect. The Trustee Company also aims to use its voting rights as part of its engagement work, in a prioritised, value-adding and informed manner. Where collaboration is likely to be the most effective mechanism for encouraging issues to be addressed, the Trustee Company expects its investment managers to participate in joint action with other institutional investors as permitted by relevant legal and regulatory codes.

The Trustee Company's 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.

Our legal advice over the years, which was referenced in the Law Commission's report, 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.

USS was therefore generally supportive of the Law Commission's position outlined in their final report and made the following points during the consultation process:

- The fiduciary duties of trustees of pension plans are generally clearly understood.
- Trustees generally understand that their duty is to act in the best interests of members.
- The members' interests in the pensions' context will be primarily, but not solely, financial.
- There is scope under the current law as generally understood for trustees to take a longer-term view.

- The problems cited in the Kay review are not likely to be resolved through extension or redefinition of fiduciary duties.
- Much of the short-termism seen in investing is due to other factors such as accounting standards (IAS19).
- It is wholly consistent with a trustee's fiduciary duty to take ESG considerations into account, when financially material, in making investment decisions; a position which is in line with the legal advice USS received in 2006 from DLA (cited in the Law Commission's consultation document).
- USS does not believe it would be appropriate to impose a more explicit duty to consider specific factors when devising an investment strategy.

We provide our answers below to the specific questions raised in the consultation document but would be very happy to discuss our views further with you as you deliberate on the proposed way forward.

Yours faithfully,

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Responses to questions

Question 1: How could regulation 2(3)(b) of the Investment Regulations be amended so that it more clearly reflects the distinction between financial and non-financial factors?

USS agrees with the Law Commission's position that the current wording of the Regulations governing the content of the SIP may not help trustees to understand which factors they should consider in their investment decisions, particularly with regard to environmental, social or governance (ESG) issues. USS also accepts that the current wording of 2(3)(b)(vi) uses language that might create confusion as to what constitutes a) financially material ESG factors and b) non-financial moral or ethical considerations. This in turn has often led to a miscommunication of expectations between pension funds and their investment managers.

We are therefore supportive of any initiative which seeks to encourage trustees to consider all of the risks which may have a material impact on the scheme's investments over the time horizon in which it is investing and ensure they are being addressed by their investment managers. In addition, by separating out non-financial factors into a separate clause this should enable a scheme to articulate more clearly the approach it may or may not take to considering non-financial factors.

We would therefore propose that the following wording is considered when drafting the amendments to regulation 2(3)(b) of the Investment Regulations 2005:

Trustees should state their policies in relation:

- To directly or indirectly evaluating longer-term risks, including from environmental, social or governance (ESG) and other factors, which may become financially material to the performance of their investments.
- To the extent (if at all) to which they may consider making investment decisions on the basis of non-financial factors.
- How the fund either directly approaches its stewardship responsibilities or oversees how stewardships activities are applied by external fund managers across all asset classes and in all markets in which the scheme invests. (see response to question 2).

Question 2: Do you agree that amending the Investment Regulations to require trustees to comply with the current requirements in the Stewardship Code or explain why they have not done so, is the most appropriate way to implement the Law Commission's recommendation?

If not, what would be more appropriate to encourage trustees to consider their approach to stewardship?

USS has been a long-standing and vocal supporter of the Stewardship Code and was one of the first signatories to the Code. Over time, it has become increasingly evident that there are a number of signatories who are not necessarily adherents to the Principles in the Code, as recently highlighted in a report by the FRC. We also believe that the Code does not necessarily reflect the increasing diversification of assets and markets to which funds are now exposed.

We are therefore very supportive of initiatives such as the Tomorrow's Company 20:20 Stewardship Project which aims to enhance stewardship capability as well as the Stewardship Disclosure Framework by the NAPF which seek to provide a range of tools to enable funds to more easily compare and contrast the varying approaches of different managers towards stewardship.

Notwithstanding our continued support for the Code, our participation in various initiatives to take the Code to the next stage of its development as well our view of the importance of stewardship as a concept for pension fund oversight, we are not convinced that the Code, as it stands, is applicable to the majority of pension funds who do not have in-house investment capabilities.

USS is therefore not supportive of amending the Investment Regulations to require trustees to state their policy with reference to the Stewardship Code for two key reasons:

- The majority of funds will not be appropriately resourced to undertake asset stewardship themselves and, in most cases, will be reliant on fund managers to undertake this activity on their behalf;

- The Stewardship Code is written mainly for the institutions that discharge this area of responsibility (i.e. asset managers) and not for the majority of pension funds.

We believe it would be preferable for pension funds to disclose under the amended Regulation 2(3)(b) of the Investment Regulations their policy, if any, with respect to the consideration of stewardship activities when selecting investment managers and reviewing their performance. This would be particularly pertinent in the context of pension funds' evaluation of long-term risks, including from ESG and other factors which may be financially material to the performance of their investments - which was raised in the first section of this consultation.

Question 3: What steps would trustees need to take to comply with any amendments to the Investment Regulations, as set out in Chapter 2? What, if any, costs would be involved in meeting any new requirements?

It is our view that in most cases the potential cost and resource implications of complying with the new regulations, as per our suggestions, would not be significant and would likely to be incurred as a one off cost at the outset of the process. The monitoring process could be introduced as part of the reporting cycle and the general oversight of a fund manager's performance. There are an increasing number of tools which are available to assist trustees in this area.