USS

Catherine Horton
Financial Reporting Council
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28 February 2018

Dear Ms Horton

Proposed Revisions to the UK Corporate Governance Code

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

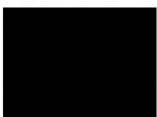
By way of background, Universities Superannuation Scheme (USS) is one of the largest pension schemes in the UK, with total fund assets of over £60 billion. The scheme's trustee is Universities Superannuation Scheme Ltd, a corporate trustee which provides scheme management and trusteeship. USS Investment 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.

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



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EXECUTIVE SUMMARY

- **We welcome the FRC's comprehensive review of the Code to ensure it remains fit for purpose and continues to promote improvement in the quality of governance in the UK.**
- **We also support the FRC intention to retain flexibility in the Code to allow a company's specific circumstances to be taken into account whilst aiming to shorten and sharpen the revised code.**
- **We are supportive of initiatives to ensure stakeholder views are taken into account by boards. However, we believe that boards should have the flexibility to decide how best to engage with the workforce and which stakeholders are most relevant for their business without being overly-prescriptive.**
- **We agree that companies benefit when considering all stakeholders. To convey this in the Code we would advocate greater emphasis on the enlightened shareholder value concept reflected in Section 172 of the Companies Act 2006. USS believes that the current directors' duties are appropriately drafted in law and should be used in the new code rather than the proposed wording.**
- **It is important to recognise in the new Code that stakeholder engagement goes beyond workforce engagement. The focus in Section 1 on the workforce risks neglecting the importance of other stakeholders – including customers, suppliers and the community.**
- **USS has long advocated the need for boards to set out the rationale for appointment or re-appointment of directors and supports Provision 18 in the revised code. We call on the FRC to strengthen this section to include further guidance on the disclosure of board biographies, to allow shareholders to assess how director appointees' skills and competencies could contribute (or have contributed) to board performance.**
- **We are supportive of the extension of the remuneration committee's remit to be cognisant of "workforce policies and practices" but we would advise caution against it being expanded too extensively with the proposed move towards an oversight function.**
- **We are supportive of the code's efforts to broaden diversity in the boardroom in all aspects to avoid group-think and encourage challenge.**

Section 1 – Leadership & Purpose

Strengthening the employee, customer and wider stakeholder voice

Principles: A & C; Provisions: 1, 3 & 4

- USS recognises that companies do not work in isolation from society and stakeholders and support the inference in Section 1 that companies should contribute to the wider society in order to be successful.
- We are, however, concerned that the proposed wording in the revised Code in Section 1 goes further than the current emphasis in directors' duties under Section 172 of the Companies Act 2006, which requires directors to promote the success of the company for

the benefit of its members and, in so doing, to have regard to stakeholders' interests. There is potential ambiguity in Section 1, Principle A in which there is an ostensible stronger emphasis on the board's role in its contribution to the wider society. As a result, USS believes that the current directors' duties are appropriately drafted in law and should be reflected in the new code rather than the proposed wording.

- USS is of the view that boards should pay attention to other stakeholders in order to deliver long-term shareholder value. We also postulate that S.172 of the Companies Act 2006 – which requires directors to have regards to other stakeholders when promoting the success of the company for the benefit of its shareholders – may not be fully understood and/or implemented in all UK boardrooms, nor are directors held to account effectively in this area of their duties.
- The revised Code should also recognise that stakeholder engagement goes beyond workforce engagement. The current focus in Section 1 on the workforce risks boards neglecting the importance of taking into account other relevant stakeholders including customers, suppliers, the environment and the community, as appropriate.
- We support initiatives such as the joint project by the Investment Association and ICSA which drafted practical guidance on how boards can enhance their understanding of the interests of employees and other stakeholders, in accordance with their duties. Companies should also be encouraged through the Revised Guidance to communicate to shareholders how they are aligning their business with the UN Sustainable Development Goals.
- Whilst the three options outlined in the revised Code for gathering the views of the workforce may seem overly prescriptive, we welcome the FRC's recognition that these are not the only possible methods. Companies should indeed have the flexibility to decide how best to engage with their workforce and other stakeholders. We are not convinced that the appointment of individual workforce representatives to company boards or assigning a specific director with this task will have the desired effect of focussing directors' attention on stakeholders' interests as this is the responsibility of the board as a whole and each director.
- We recognise the benefit of creating stakeholder advisory panels and other fora to inform boards in the discharge of their fiduciary duties. For this to work effectively, it is essential that the chairman meets frequently and consults appropriately with the panel. It is for individual companies to decide how to compose such panels, which are their material stakeholders and the requisite governance arrangements.
- We also refer to our recommendation below to increase the level of disclosure regarding the rationale behind the board's recommendation to shareholders to appoint or re-appoint a director. This will enable shareholders to determine if there is an appropriate and diverse range of skills, experiences and backgrounds on the board to take account of wider stakeholder interests.

Engaging with Shareholders

Principle C; Provisions 5 & 6

- There is a practice among some companies to engage only with their top shareholders or investor representative organisations. Such firms represent a number of different investment styles and a consequence of this may be that companies are not listening to the message that best reflects a long term owner's perspective. Often the largest

shareholders are passive investment houses that are managing index funds who, with some notable exceptions, may not necessarily formulate a view on company strategy based on fundamental analysis, and/or do not seek to influence companies.

- We therefore recommend that the FRC encourages companies to identify their long-term, fundamental investors and ensure they also consult with intrinsic investors who are long term investors and have an understanding of a company's strategy, its current performance and potential to create long term value. Intrinsic investors may not be the top 10 investors on the company register, but their investment approach should be able to provide an informed, constructive and long term perspective to the board.

- We support, in principle, the proposed requirement for a company which receives more than 20 per cent of votes cast against a resolution to outline its course of action to engage with shareholders. However, we would not want this proposal to hinder innovation in the boardroom, particularly with regard to new thinking on issues such as executive remuneration. It is therefore important to engage effectively and regularly with intrinsic investors during the course of the year to gauge support for new ideas.

<u>Section 3 – Composition, succession and evaluation</u>

Appointment and re-appointment of directors

Principles I, J & K; Provisions 17, 18, 22 & 23

- In previous submissions to the FRC on potential revisions to the Corporate Governance Code, we have focussed on the appointment and re-appointment of directors as one of shareholders' most important responsibilities. However, shareholders are only able to make informed decisions on the suitability of a nominee (or re-appointment) to the board if sufficient information is available at the time of the vote.
- Currently enhanced disclosures on director appointments are rarely provided by companies despite the current Code's emphasis on skills, experience, independence and knowledge (under B1). Disclosure of brief biographical details of the board members – as is the prevalent practice – is not sufficient for investors to make an informed voting decision.
- Having enhanced information available on each individual and on the board as a whole (such as a board skills matrix) would provide shareholders with the information required to make more informed voting decisions on director candidates and the opportunity for more effective stewardship.
- We acknowledge and support the revised Code's proposed emphasis under Principle 18 on the board's responsibility to specify reasons why a candidate's contribution is and continues to be important for the company's long-term success.
- We would, however, like to see more information provided on the skills, experience, independence and knowledge of each director as public disclosure in this area is still too limited. For each nominee to the board, we advocate for the disclosure of their skills and competencies, previous and/or planned contribution to board performance and an understanding of their perspectives on key issues relevant to the company. The board

should also provide commentary as to how it believes the additional director(s) will contribute to and improve board performance.

- By gaining a better understanding of individual and collective skills sets at board level and a greater insight of potential contribution to the board and its committees (for new appointees) and actual contribution (for current directors), shareholders would be able to vote and engage in a more informed manner. This could be addressed through Provision 23 with an expectation that the nomination committee provides more information on these issues.
- We support the move towards increased diversity within UK boardrooms in all aspects including cognitive, skill-sets, gender and social backgrounds. This should also be addressed by companies at the senior management level as well as in the pipeline for succession through a widening of the pool of potential candidates. However, we believe that the proposed wording in Principle J should be refined to reflect the text in section 82 of the Guidance which covers all aspects of diversity. This is necessary to avoid boards being composed of 'like-minded' individuals and the ensuing risk of group-think and lack of challenge even if there is an increased number of females and individuals from different social and ethnic backgrounds.

Section 5 – Remuneration

Remuneration committees' role

Principle O & Q; Provision 33

- We are supportive of the principle that remuneration committees should be sensitive to pay and employment conditions elsewhere in the organisation as outlined in D1 in the current Corporate Governance Code and supported by the provisions of the Government's remuneration regulations 2013 and directors' duties under company law.
- We are supportive of extending the remuneration committee's remit to be cognisant of "workforce policies and practices".
- However, we would advise caution against the role of the remuneration committee being expanded too extensively – as proposed in Provision 33 - to include oversight of "workforce policies and practices" and then "taking these into account when setting the policy for director remuneration". This would, in our view, stray into an area for which senior management, together with HR, are responsible and is beyond the remit of remuneration committees. In addition to blurring the distinction between the responsibilities of the board and senior management, the review of these policies would require a significant amount of time and might distract boards from their core responsibilities.

Remuneration structures

Principle P; Provisions 36, 37 & 40

- USS is of the view that there is no one-size-fits-all solution or structure which would result in the development of incentive plans that are better aligned with the long-term interests of quoted companies and shareholders. Nor do we believe that the solutions to

the perennial challenge of setting executive pay to achieve this objective can be achieved through legislation.

- That said, it is also clear that the current system for long-term incentive plans is not fit for purpose at many UK companies and, in the main, does not incentivise management to deliver long-term shareholder value due to a lack of appropriate metrics and structures used.
- USS is of the view that the complexity and multiplicity of awards, with varying performance conditions, does not motivate executives effectively as it fails to give them a clear line of sight over what they need to achieve.
- In a joint publication, which USS produced with Hermes, BT Pension Scheme, RPMI Railpen and PLSA in September 2015 and in our Global Stewardship Principles, we call for:
  - Remuneration committees to require executive management to make a material long-term investment in shares of the businesses they manage. USS also considers that pay should be aligned to long-term success and the desired corporate culture throughout the organisation;
  - Pay schemes should be clear, understandable for both investors and executives, and ensure that executive rewards reflect long-term returns to shareholders. Remuneration committees should use the discretion afforded to them by shareholders to ensure that awards properly reflect business performance;
  - The setting of a long-term course and measuring, explaining and incentivising progress annually, which may be a more effective way to encourage long-term value creation than the current prevailing system.

- For example, in some circumstances, it may be better to have a single bonus scheme – with no long-term incentive plan – using a balanced scorecard of metrics based on KPIs, over which the remuneration committee may use its discretion, and which pays out predominantly in shares which must be held for the long-term (at least five years, if not longer).
- The significant component of the reward is accrued over time through being a share owner thus replicating the experience of an investor in the company by having meaningful 'skin in the game'.
- We agree with the FRC's proposed emphasis in the new Code on the need for the board to exercise judgement and discretion and to make provisions to override remuneration outcomes which are derived through formulaic outcomes but would not pass muster with shareholders.

UK Stewardship Code

- We also welcome the opportunity to respond to the initial consultation on the future direction of the UK Stewardship Code.
- We recognise and acknowledge the improvements in the understanding, quality and quantity of stewardship in the UK since the Code's introduction.
- Despite a recent review of the quality of reporting and a corresponding tiering exercise, it is still very challenging for a potential asset owner client to differentiate between the quality of the stewardship activities of the signatories to the Code.

- We believe the time is ripe for a fundamental review of the Code to ensure that it is fit for purpose and continues to meet the needs and requirements of its stakeholders, and we look forward to responding to the full consultation in due course.
- USS does not believe that a separate code is required to accommodate different constituents in the investment chain, but it needs to reflect, in its next iteration, many of the developments that have taken place across the industry in recent years including:
    - Increasing diversification into different asset classes and the need for the revised Code to recognize that the concept of stewardship applies equally to all investments irrespective of ownership rights.
    - A move towards more globalized portfolios and an increased expectation that investment managers apply their stewardship approach in their international markets as well as in their domestic jurisdiction.
    - An increased focus on environmental and social matters in addition to corporate governance issues which should be referenced in the Code.
    - A more discerning asset owner client base who want to be able to differentiate between the quality of stewardship being offered by different managers.
    - A focus on an integrated approach towards stewardship from the point at which an asset or company is being assessed for potential investment and throughout the holding period.