

USS response to the Walker Report

17 August 2009

Introduction

Before putting forward our specific comments, we would like to reiterate the vital role effective regulation has to play in providing a framework in which responsible corporate stewardship can thrive. This paper does not deal with how the government could improve the regulatory environment, but it is important to emphasise that establishing a sound framework is a prerequisite for our proposals.

USS is broadly supportive of the recommendations put forward by the Walker Review on 16th July. Many of the recommendations are in line with those we put forward in our submission on the 5th June. However, there are areas where we have concerns. In this response we highlight:

- 1) recommendations we would like to see developed further; and
- 2) key issues we feel the Review has not dealt with.

1. Recommendations we would like developed further

1.1 Principles of Stewardship – establishing a “Gold Standard”

We strongly support the establishment of Principles of Stewardship (Recommendations 16-20), and agree that the ISC’s “Responsibilities of institutional shareholders and agents – statement of principles” is an appropriate starting point for developing these. We believe the proposals, however, would be strengthened if fund managers’ stewardship activities were independently assessed and ranked. Below we outline our thoughts on how this might be achieved, and details are provided in Box 1.

In brief, we propose that the ISC be asked to lead in establishing an independent panel of experts who are responsible for ranking fund managers according to their stewardship performance. Fund managers would choose to participate in the ranking exercise and submit evidence to the panel. The final ranking would be made public, and the top tier be certified as achieving the “Stewardship Gold Standard” until the next review is undertaken, ideally annually¹.

We believe this approach would provide a more powerful catalyst for change than a “comply or explain” model because it would independently vet participants, provide a public ranking and be regularly

¹ Such independent assessment systems already exist. An example is the UN supported Principles for Responsible Investment (www.unpri.org) which have at their core the requirement to be active owners. Signatories to the PRI – which represent more than \$15 trillion in assets - have to undertake a self assessment which then feeds into an evaluation and benchmarking process.

reviewed. To the extent that asset owners incorporate the Gold Standards into their selection of fund managers, it would provide a market-based incentive to improve stewardship standards. We believe this approach will avoid key difficulties we have identified with a differential share voting system (as proposed by both Sir David and Lord Myners in recent interviews), whilst achieving the key benefits, notably identifying a top tier of intrinsic investors².

Box 1: Objectives & features of a Gold Standard for the Principles of Stewardship

Objectives:

- *Differentiate a top tier of fund managers:* The ranking scheme, and associated “Gold Standard”, would provide a meaningful indicator of intrinsic investors who best fulfil their ownership responsibilities. For corporate management, this standard would provide a guide to which institutional investors are long term and well-informed partners who are committed to engaging constructively with management. For institutional investors, the standard would represent recognition of their efforts, and boost their voice in communications with investee companies. Greater influence would in turn support increased investment into engagement activities. For asset owners, the standard would provide immediate transparency as to which fund managers take their ownership responsibilities seriously, and allow them to allocate assets accordingly.
- *Standards with teeth:* Fund managers would be regularly reviewed by an independent third party who has the authority to rank investors. While participation would be voluntary, ranking would be made public and only the top tier permitted to declare themselves as achieving the “Gold Standard”. The minimum threshold would automatically adjust (and remain challenging) as standards improve across the industry.
- *Tackle internal conflicts of interest:* Institutional investors that are housed within larger insurance or other financial organisations face potential conflicts of interest and different client mandates. The scheme would explicitly address these conflicts with clear rules on establishing “chinese walls”.

Implementation:

- *Stretching standards:* The problem with standards set for all participants in the industry is that they will tend to gravitate towards the “lowest common denominator”. We favour setting a higher bar that represents the industry “gold standard”, which is itself a reflection of the top performers in the industry. It will be important that achieving the standard does not require compliance with a list of rigidly applied rules, but it should reflect the overall level of resource dedication and delivery in terms of impacts on investee companies’ decision-making.
- *Third party validation:* For the standard to carry weight, performance needs to be rigorously vetted by an independent third party. This body would request supporting evidence from applicants to determine the effectiveness of their engagement and stewardship activities.
- *Regular monitoring:* It will be crucial that fund managers who have been ranked, are subject to regular reviews, ideally annually.
- *Oversight by a new independent panel under the ISC:* Oversight (setting standards, administering assessment and regular reviews) needs to be done by an independent panel with adequate resources and expertise. The Review proposes the FRC as a sponsor for these Principles. We have concerns relating to the FRC’s independence given that its staff is largely drawn from business, investment houses and accounting firms. We

² “Intrinsic” investors is a term coined by McKinsey, and referred to in the Walker Review’s para 5.30. Please also see our discussion of one share-one vote on p. 5.

believe the ISC is the more natural lead, and that it should be given responsibility for setting up an independent panel of experts. The experts could be drawn from the FSA, FRC, retired company directors and asset owners.

1.2 The MOU is likely to be unwieldy

While we are supportive of efforts to tackle investor uncertainty over “acting in concert” controls, we are sceptical that an MOU between institutional investors will be workable (Recommendation 21). The Review describes this MOU as being supported by a rotating “corporate governance executive” that would coordinate the engagement process³. Pervasive conflicts of interest within some of the largest institutional investors – a theme we emphasised in our original submission – will work against achieving an effective MOU. Moreover, the success of the group would depend to a large extent on the resources and skill set of the organisation that is managing the executive at the time. We also have concerns that the MOU could add an additional layer of bureaucracy to informal arrangements that already exist between like-minded investors. Finally, it is already possible for like-minded investors to draw up MOUs with respect to individual engagements that should allay regulatory concerns over working in concert⁴.

Rather, we would welcome clearer guidance from the Takeover Panel and FSA that explicitly sets out the circumstances in which collaborative action would be deemed “acting in concert”.

1.3 Remuneration disclosure should focus on structure, not amounts

We welcome the majority of recommendations relating to remuneration, and particularly the emphasis on creating a clear link to risk-adjusted performance. However, for investors to play their part in monitoring board performance, it is essential that remuneration committees disclose their rationale behind the adoption of executive remuneration schemes, the selection of performance metrics, how these have been adjusted for risk, and how they have used their discretion in agreeing final payments. It is not sufficient for companies to disclose the amounts of salary, bonus and other benefits without explanation (Recommendation 31). We would favour data on the structure of remuneration schemes to complement the absolute value of rewards.

1.4 Board independence and expertise

- *More expertise, but not at the expense of independence:* We are supportive of the Review’s emphasis on the importance of expertise and professionalism within Boards (Recommendations 1 - 5). We are concerned, however, that the recommendations may go too far, and encourage prioritisation of expertise over independence (see for instance apparent support for the CEO moving on to become Chair in para 3.7). We believe boards should have a balance of both independence and expertise.

³ See para 5.45

⁴ In Annex 1 we have included a recent example of such an agreement drawn up by USS and other institutional investors as the basis for protecting minority shareholder interests in the case of the potential merger between Cintra and Ferrovial.

- *Audit committees need at least two experts:* In our original submission, we proposed that audit committees be required to have at least two financial experts. This proposal has not been adopted, and we ask that this be reconsidered. Where only one financial expert is represented on an audit committee they may face little critical challenge to their opinions, and may find it difficult to stand up to other directors where disagreements arise.
- *Disclosure to shareholders must be improved:* Without more transparency over how nominations are made, and the skills and suitability of candidates, shareholders will be severely constrained in their ability to critically assess, challenge or support company appointments.

2. Issues not dealt with by the Review

2.1 The numbers have to be right

The Review is silent on the failure of the current accounting system to deliver reliable numbers for management, directors and shareholders. Given the centrality of accounts to corporate governance (a point we elaborated in our original submission, and summarise in the Box below), we worry that one of the most critical underlying drivers for the financial crisis (and associated remuneration scandals) is not being addressed. While the FSA and the Financial Stability Board have put forward clear recommendations regarding the need to revisit aspects of IFRS, it is not clear whether these recommendations will be acted on⁵.

Box 2: Why the numbers have to be right – extract from original submission

Accurate figures are vital to corporate governance

Accurate financial reports underpin effective corporate governance. They provide the basis for decision making and remuneration for management, directors, investors.

- Institutional investors formulate views of banks' performance - including risk taking – based on the audited numbers.
- The numbers are relied upon by directors in their oversight of management, and subsidiaries.
- They affirm to whether the business model is working, and they incentivise executives.

IFRS fails to deliver

We feel that IFRS – particularly aspects of fair value accounting, loan loss provisioning and netting for financial instruments – have:

- seriously weakened the accounts ability to reflect a “true and fair view” of banks' underlying business,
- undermined management stewardship by misleading them,
- ailed to provide a reliable basis for assessing future cash flows, and
- provided very serious perverse incentives through their impact on remuneration.

Specifically, we have concerns with the following standards (this list is not intended to be exhaustive):

- IAS 1 – failure to explicitly identify “prudence” as an objective. Prudence was central to Accounting Principles

⁵ See FSA. “The Turner Review – a regulatory response to the global banking crisis”. March 2009; and FSF. “Report for the Financial Stability Forum on Addressing Procyclicality in the Financial System”, April 2009.

as defined in the 1985 Companies Act.

- IAS 37 – the tight requirements for the recognition of a provision (see IN2) restricts executives’ ability to act prudently, particularly with respect to loan loss provisioning. This has supported an incurred loss provisioning model (in the place of an expected loss provisioning model) for bad debts, allowing banks to push true costs of lending into the future, and recognise inflated profits today (which in turn boosts equity and more lending).
- IAS 39 – fair value accounting of trading assets incentivises misclassification of assets into this category in upward moving markets, generating unrealised gains which feed overstated earnings and boost equity, thereby fueling excessive loan growth (and remuneration payouts).
- IAS 39 – permission of netting, e.g. with respect to monoline wrapped collateralised debt obligations, allowed banks to hide what they were really holding and related exposures.

Achieving change will be difficult

We believe it is imperative that an independent review is undertaken to assess whether all areas of IFRS are consistent with the basic principle of presenting a “*true and fair view*” as required under UK Company Law. We recognise, however, that there are very powerful forces pushing against the UK taking any corrective action. Most importantly, the IASB’s determination to achieve further convergence with US GAAP, despite the very serious concerns that exist over the weaknesses of US accounting framework, looks difficult to challenge. The potential to channel our concerns via the FRC also appears limited based on comments by the FRC’s CEO in favour of fair value accounting in July⁶.

As long term investors, we believe this Review is seriously weakened by its decision not to address one of the most important barriers to effective corporate governance: the failure of accounts to provide a “*true and fair view of the assets, liabilities, financial position and profit or loss*”, as required under the Companies Act 2006.

2.2 One share-one vote is preminent

Following the release of the Walker Review, both Sir David Walker and Lord Myners have expressed interest in giving long term shareholders greater voting rights than short term traders⁷. While these comments do not form part of the Review, we feel it is important to respond given their potential impact on the final report.

USS strongly agrees with the need for long term investors to have a greater voice in dealing with investee companies. We do not, however, believe that the introduction of differential voting rights is an attractive route to achieving this. There is considerable evidence from Europe that differential voting rights create perverse incentives, and can lead to an undesirable concentration of power. Nor do we agree with the idea that investors who sell shares in underperforming companies are failing in their ownership responsibilities. Fund managers’ fiduciary duty to their clients is paramount. Where companies continue on a value-destructive path and engagement efforts have failed, investors have

⁶ Paul Boyle, “Chief Executive’s Remarks to the Financial Reporting Council’s Annual Open Meeting”, 16th July 2009, pp 7-8.

⁷ We are referring specifically to an article in the Sunday Times (“City Doyen Sir David Walker wants shareholder reform”) on 19th July 2009, and an interview Myners held with the BBC on 1st August 2009.

little option but to sell their shares. It is vital to remember that public equity investors do not control companies and cannot, therefore, be held accountable for poor decision making by corporate management.

We believe, however, our proposal for an enhanced “Principles of Stewardship” above offers a more attractive approach to raise long term investors’ ability to influence by creating an accredited top tier of intrinsic investors.

Annex 1: Copy of Agreement on voting between shareholders of Cintra



RAILPEN *Investments*[®]



DATED: 24 June 2009

Agreement on voting in respect of potential merger of Cintra with Ferrovial

Whereas:

- A. We, the undersigned (being CP2 Limited, Universities Superannuation Scheme, New Jersey Division of Investment, Magellan Asset Management (the "Original Parties") and Railways Pension Trustee Company Limited and Gartmore Investment Limited (the "New Parties")), are shareholders of Cintra Consesiones de Infraestructuras de Transporte, S.A. ("Cintra" or "the Company") and, collectively, we control approximately four per cent of the Company's issued share capital;
- B. Grupo Ferrovial S.A. ("Ferrovial") and Cintra in respective public filings dated 19 December 2008 and 28 January 2009 have referred to a potential merger of the companies;
- C. The Original Parties have expressed their opposition to such a merger in a letter dated 13 February 2009 to the Board of Directors of the Company and a subsequent letter dated 27 March 2009 to the Secretary of the Board of Directors of the Company;
- D. The New Parties also oppose such a merger and agree with the arguments, and the requests to strengthen the integrity and fairness of the merger evaluation process, that were set out in the letters referred to in C above;
- E. The Company's responses to the letters referred to in C above have not addressed the serious concerns detailed therein; and
- F. We have received limited comfort from the independent directors of the Company as to whether they are considering minority shareholder interests appropriately.

We, the undersigned, agree and undertake to each other and among ourselves the following:

1. to work together to identify an appropriate person to join the Board of Directors of the Company as an independent director and, should such person be identified and be willing to be act in such capacity:
 - i. to requisition a general meeting of shareholders ; and
 - ii. to vote in favour of the appointment of such person to the Board of Directors of the Company.

2. to vote against any proposal for such a merger which may be put to a general shareholders meeting of the Company; unless
 - i. the proposal for such a merger operates on the basis of an exchange ratio of 1 share in Ferrovial for 1.5 shares in Cintra or better; and
 - ii. in the opinion of all parties, any proposal for a merger offers shareholders in Cintra adequate value for their shareholdings and does not expose them to an unacceptable level of financial risk in connection the financial structure of the merged entity, taking in account *inter alia* the borrowings of Ferrovial.

Where a party to this Agreement acts as an investment manager in respect of a client portfolio and ultimate voting decisions rest with its client, the party undertakes to recommend to such client to vote in accordance with paragraphs 1. and 2. above.

Any of the parties to this Agreement shall be free, subject to providing written notice to the other parties, to withdraw from this Agreement at any time; whereupon the Agreement shall remain in force as between the remaining parties. If all of the parties withdraw, then the Agreement shall terminate immediately. For the avoidance of doubt, a party to this Agreement shall be entitled to sell part of or all of its shareholding in the Company at any time without prior notice to or consent from any one or more parties to this Agreement.

The parties may agree to terminate this Agreement at any time, failing which the Agreement shall terminate automatically on 31 October 2009, or, if earlier, immediately after a general meeting of shareholders of the Company which approves a merger which complies with subparagraphs 2(i) and 2(ii) above.

This Agreement represents the entire agreement of the parties in connection with the matters covered in it and supersedes all prior written or oral agreements between the undersigned, the Original Parties or the New Parties with respect to the subject matter.

This Agreement may be executed in any number of counterparts and all of which taken together will be deemed to constitute one and the same agreement.

We acknowledge that this agreement is legally binding.

Yours sincerely,

Peter Doherty
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