

Voting and Engagement Policy

1. Introduction

This is the second edition of USS Ltd 's (USS) voting and engagement policy guidelines which replaces an earlier edition published in December 2001. This edition takes into account the changes that have been introduced since the first publication with, inter alia, the revised Combined Code, the Institutional Shareholders' Committee (ISC) principles, the Higgs Review and the Smith Review.

Universities Superannuation Scheme is a global pension fund principally for academic and senior administrative staff in UK universities and other higher education and research institutions. As an institutional investor that takes seriously its fiduciary obligations to its beneficial and institutional members, USS aims to be an active and responsible long-term shareholder of companies and markets in which it invests. The Fund has a commitment to encourage responsible corporate behaviour which is based upon i) the view that management of such issues is good for long term corporate performance and ii) a duty to protect and enhance the value of the fund's investments. This approach is indeed widely recognised as one that greatly increases the likelihood of long-term value delivery and therefore to be in the long-term interests of pension fund beneficiaries.

USS therefore seeks to pay appropriate regard to relevant corporate governance, social, ethical and environmental considerations in the selection, retention and realisation of all fund investments. USS focuses its efforts on engagement, and thus seeks to use its influence as a major institutional investor to promote good practice by investee companies and by markets to which the fund is particularly exposed. USS sees engagement as a necessary and important part of responsible ownership.

While it is neither sufficient nor often the most effective form of engagement, USS recognises that voting is widely considered to be a basic license to operate. It will therefore cast proxy votes in line with its policy at FTSE All-Share UK listed company meetings in its internally managed fund and external fund managers' portfolios and seeks to ensure that voting actions are taken in an informed and constructive manner.

1.1. Application of voting principles

USS supports the 'comply or explain' principle as outlined in the Combined Code and will seek to take all issues into consideration in making a voting decision. While USS expects corporations to take all steps necessary to comply with the Guidelines, it is recognized that departure from the principles contained in this document may be justified in particular circumstances. In these situations, USS would expect a considered

explanation from the corporation when the situation arises and to be reported in full in the annual report.

Although USS expects all listed companies to adhere to the spirit of all the Principles outlined in this document, there are some recommendations which have been deemed to be unduly onerous on smaller companies. For this reason, exceptions have been highlighted in the various sections, where appropriate. A smaller company is one that is below the FTSE 350 throughout the year prior to the reporting year.

USS supports the Combined Code's recommendation that institutional shareholders have a responsibility to make considered use of their votes and will therefore approach its voting decision-making in a pragmatic and non-mechanistic manner. USS will pay due regard to companies' individual circumstances and bear in mind, in particular, the size and complexity of the company and the nature of the risks and challenges it faces.

In order to discharge its fiduciary obligations efficiently across a very large portfolio, USS uses the services of a third party specialist agency to analyse company reports. Clearly this analysis is only as good as the quality and transparency of the reports by the company and USS would therefore encourage companies to be comprehensive, strategic and transparent in these reports.

1.2. Responsibilities to investee companies

As a fund that seeks to be a patient and long-term provider of capital, USS takes seriously its responsibilities to companies in which it invests and seeks to engage in constructive communication and dialogue as a basis upon which it is appropriate to discuss and question management behaviour.

USS recognizes that as an institutional investor, it too has responsibilities to its investee companies, as outlined in the revised Combined Code and the ISC Guidelines, to ensure that they are aware of particular concerns that we may have. USS regularly monitors investee companies to determine when it is necessary to enter into an active dialogue with the investee company's board and senior management. This may involve the sharing of information with other shareholders and agreeing a common course of action. USS would encourage its investee companies to engage in dialogue with USS when necessary and particularly at major stages in decision-making processes such as prior to a new remuneration policy becoming live.

In addition, USS will endeavour to communicate with the company and provide an explanation, in writing, following an abstention or vote against a particular resolution, when practicably possible. Where possible, USS will aim to inform the company in advance of its voting intention and, if appropriate, provide an explanation and seek a response from the company.

1.3. The companies and issues that USS will engage on

USS will engage with companies in which it invests on occasions when it thinks it is in members' long-term interests and will endeavour to identify problems at an early stage to

minimize any loss of shareholder value. This approach may be adopted irrespective of whether the company is held in an active or passive fund or whether USS is underweight or not.

Instances when USS may intervene include when we have concerns about:

- The company's strategy
- The company's operational performance
- The company's acquisition/disposal strategy
- Independent directors failing to hold executive management to account
- Internal controls failing
- Inadequate succession planning
- An unjustifiable failure to comply with the Combined Code
- Inappropriate remuneration levels/incentive packages/severance packages
- The company's approach to corporate responsibility

1.4. Escalation of engagement strategy

USS will seek to engage with companies without publicity as we expect good management to reassure shareholders when faced with shareowners' concerns. However USS reserves the right to make public its concerns if the company fails to address adequately the concerns which have been raised.

If boards do not respond constructively to USS's intervention, then the Fund will consider on a case-by-case basis (based on background and investment strategy etc) as to whether to escalate its action, for example, by:

- Holding additional meetings with management specifically to discuss concerns
- Expressing concern through the company's advisers
- Meeting with the Chairman, senior independent director, or with all independent directors;
- Intervening jointly with other institutions on particular issues;
- Making a public statement in advance of or at the AGM or an EGM
- Submitting resolutions at shareholders' meetings
- Requisitioning an EGM
- Selling shares and possibly making public the reasons behind the decision

2. General principles

The primary responsibility of a board of directors is to foster the long-term success of the company consistent with its fiduciary responsibility to the shareholders. Good corporate governance systems do not guarantee superior corporate and investment performance but they do provide a balance between the rights of shareholders and the needs of the board of management to direct and manage the company's affairs free from non-strategic short-term influences.

Thus, the proper corporate governance of companies in which USS invests is of importance and, as part of its fiduciary responsibility, USS will vote on issues which may affect the value of any funds invested. The following policy statements are made to provide clarity on USS's position, which is based principally on the revised Combined Code.

The policy statements will be offered as a basis for discussion with senior corporate management with the objective of improving corporate governance and corporate responsibility practices. The statements represent USS's perspective on what it believes are important elements of good corporate governance and identifies its voting guidelines on specific issues. USS has compiled these guidelines after active discussions with other major investors to minimise conflicting requirements on corporations. Although the broad principles apply generally to UK public companies, USS is actively engaged in encouraging improvements in global standards of corporate governance and will, where appropriate, apply these policies to international investments. In addition, USS aims to make a positive contribution to the evolution of good practice standards in corporate governance across the board.

This will be an evolving policy document, subject to continuous revision.

2.1. Voting policy

- *USS will vote as stated for each policy statement unless there are exceptional circumstances for deviation.*
- *Where current holdings and/or new investments do not comply with the stated policies, USS seeks, through engagement, to influence changes in line with best practice and USS's stated policies.*
- *An abstention is a positive indication that USS will engage with a company to encourage a change in its corporate governance practices. It may be used on occasions where an issue is raised for the first time.*
- *In general, USS's decisions on voting are based on the interpretation of the facts disclosed to USS. This may result in voting in a manner that may not be in line with USS's stated voting policies.*

3. Executive Summary

This document provides guidelines on USS's engagement and voting policies in the following key areas:

Leadership – p.6

USS considers that company boards should display a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business and therefore requires the separation of the roles of chairman and CEO. USS is also generally opposed to a chief executive becoming chairman in the same company.

USS considers that company boards should appoint one of the independent non-executive directors to be the senior independent director. The senior independent director should be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or finance director has failed to resolve.

Board Sub-Committees – p.7

USS supports the Combined Code requirement for Audit, Remuneration and Nomination committees. Each committee should comprise a minimum of three members or in the case of smaller companies, two members. USS views the independence of the members as essential and supports the requirement that all members of the Remuneration and Audit Committees and majority of members of the Nomination Committee should be independent.

Board composition, independence and non-executive directors – p.8

Except for companies below the FTSE 350, USS expects that at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent (in accordance with the Combined Code's criteria). A smaller company should have at least two independent non-executive directors. The board should identify in the annual report each non-executive director it considers to be independent.

Appointments, Age and Contracts – p.10

There should be independence, rigour and transparency in the processes of the board and the Nomination Committee, which result in the proposals to nominate and appoint directors to the board. USS encourages companies in which it invests to disclose fully the nomination processes, including assessments used. Notice or contract periods for executive directors should be set at one year or less. USS supports the revised Combined Code's recommendations on age and commitment issues.

Re-election, succession planning and training – p.13

To ensure that there is a planned and progressive refreshing of the membership of the board, it is fundamental that all directors seek regular re-election by the shareholders, at least once every three years. USS encourages companies to disclose its processes for board succession and training, including the processes of skills evaluation.

Remuneration p.15

USS will only support remuneration policies that contain incentive and performance based schemes which are clearly aligned with business strategy and objectives, linked to progress in long-term value creation and are in line with ABI and NAPF guidelines. Executives should be compensated appropriately for their contribution to this process and not for market or industry wide rises in stock prices.

USS expects corporations to disclose what is being incentivised and requires companies to put the Remuneration Report to the vote of shareholders on an annual basis as a separate resolution. Upper limits and performance targets for all schemes should be set and disclosed.

Accountability and audit p.20

The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

USS requires that companies should explain the type of non-audit work undertaken and, where the level of non-audit fees exceeds the audit fees and/or is significant, a detailed breakdown of such fees.

The Board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems.

Corporate responsibility p.23

USS expects companies to provide appropriate information to shareholders on their management of extra-financial issues such as social, ethical and environmental (SEE) issues. In implementing this policy, USS will make reference to the Disclosure Guidelines on Socially-Responsible Investment developed by the Association of British Insurers (ABI). USS expects FTSE 100 companies, and progressively requires all other companies, to report on their policies, impact and progress on any material SEE issues to analysts and investors at least once a year.

Shareholders' Rights p.25

USS will not normally support resolutions which are inconsistent with rules and guidelines of the London Stock Exchange, the Listing Rules and those of institutional investors' representative bodies such as the ABI and NAPF.

Donations to political organizations p.26

USS considers that it is inappropriate that any of the return that rightfully belongs to shareholders should be diverted to political donations except in exceptional circumstances.

4. Leadership

4.1. Policy statement

Every company should be headed by an effective board, which is collectively responsible for the success of the company. The board should meet sufficiently regularly to discharge its duties effectively. There should be a formal schedule of matters specifically reserved for its consideration and decision. The annual report should include a statement of how the board operates, including a high level statement of which types of decisions are to be taken by the board and which are to be delegated to management. (Combined Code Principle A1 and Code Provision A.1.1.)

USS considers that company boards should display a clear division of responsibilities at the head of the company between the running of the board and the executive

responsibility for the running of the company's business. USS is generally opposed to a chief executive becoming chairman in the same company.

USS considers that company boards should appoint one of the independent non-executive directors to be the senior independent director. The senior independent director should be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or finance director has failed to resolve.

4.2. The role of Chief Executive Officer (CEO) and Chairman

For FTSE 100 companies, USS requires the separation of the roles of chairman and CEO. In mid-range companies USS encourages, through engagement, the separation of the roles.

However USS also accepts that in exceptional circumstances, there may be a need for the roles to be temporarily combined. In cases where the roles are combined, USS seeks to ensure that a Senior Independent Director (SID) will assume some of the chairman's responsibilities including heading some, if not all, of the various committees, evaluating the performance of the chairman and CEO, and will play a major role in setting the payment of performance related awards.

4.3. Voting policy

USS will:

- *vote against a resolution to appoint or re-elect a director to the joint position of chairman and CEO in a UK FTSE 100 company.*
- *vote against the adoption of the report and accounts, or take other appropriate actions, if a joint Chairman-CEO is not due, in a particular year, for re-election in a FTSE 100 company.*
- *vote against or abstain from voting on a resolution to appoint or re-elect a director to the joint position of chairman and CEO in all other companies.*
- *vote against a resolution to appoint or re-elect a non-executive chairman who is not considered to be independent.*
- *vote against a resolution to appoint or re-appoint a chairman who was previously the chief executive of the company.*

5. Sub committees

5.1. Policy statement

USS supports the Combined Code requirement for Audit, Remuneration and Nomination committees. Each committee should comprise a minimum of three members or in the case of smaller companies, two members.

As the committees are formed to deal with issues on which the executive directors may have a conflict of interest, USS views the independence of the members as essential. USS supports the requirement that all members of the Audit and Remuneration Committees should be independent NEDs, in accordance with the criteria described under Board Composition, and that the majority of members of the nomination committee

should be independent non-executive directors. It may be appropriate, however, for these committees to invite executive directors to be present to consult on certain issues.

Furthermore, to retain a balance of responsibilities amongst the NEDs, the company chairman should not chair the Remuneration or Audit Committees nor should the chairman chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship.

In the case of the Audit Committee, the board should satisfy itself that at least one member has recent and relevant financial experience.

The terms of reference of all the committees should be available to shareholders on request.

Reference should also be made to the following sections for further references on:

Remuneration Committee – Remuneration.

Audit Committee – Accountability and audit.

Nomination Committee – Appointments, age, contracts, re-election, board evaluations, succession planning and training.

5.2. Voting policy

USS will

- *vote against or abstain from voting on a resolution to appoint or re-elect an executive director or NED who is also a member of a committee where the presence of that director is considered by USS to have an undue adverse influence on the committee, or to diminish its independence.*
- *vote against the resolution on the remuneration report if the composition of the remuneration committee is considered to be insufficiently independent.*
- *vote against the resolution to adopt the report and accounts, or take other appropriate actions, if the audit committee is considered to be insufficiently independent or does not consist of at least one member who has recent and relevant financial experience.*
- *vote against the resolution to adopt the report and accounts, or take other appropriate actions, if a nomination committee or process has not been established.*

6. Board composition, independence and non-executive directors

6.1. Policy statement

The board should be of sufficient size that the balance of skills and experience is appropriate for the requirements of the business. The board however should not be so large as to be unwieldy. (Combined Code Supporting Principle A.3)

USS considers that company boards should display a clear division of responsibilities at the head. USS therefore considers the independence of Non-Executive Directors (NEDs) as an essential element of the board's composition in ensuring that they scrutinize the

performance of management in meeting agreed goals and objectives, monitoring the reporting of performance and providing a system of checks and balances on the board.

Except for companies below the FTSE 350, USS expects that at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent. A smaller company should have at least two independent non-executive directors.

Irrespective of any constitutional requirements to appoint shareholder representatives to a board, the overriding issue is that the balance of the board composition should demonstrate a strong independent influence such that no individual or small group can dominate the board's decision taking.

The role of the NEDs is viewed as ensuring that the board as a whole concentrates on maximising long term shareholder value. NEDs should be accountable for:

- bringing independent judgement to strategic decision making;
- providing skills and experience that may not otherwise be readily available to the company;
- acting on behalf of the executive directors in situations where executives may face a conflict of interest, e.g. issues of pay or takeovers;
- ensuring governance compliance through the adoption and monitoring of best practice policies;
- determining appropriate levels of remuneration of executive directors;
- appointing, and where necessary removing, executive directors and in succession planning;
- ensuring that financial, operational and material extra financial risk management policies adopted are adequately monitored and assessed.

6.2. Independence criteria

The board should identify in the annual report each non-executive director it considers to be independent. The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement, both in terms of the nature of the individuals and how they work in practice.

‘A NED should be independent of management and free from any business or other relationship that could materially interfere with the exercise of their independent judgement.’

(The Cadbury Committee)

USS will generally adopt the following criteria as a guideline for independence in as much as NEDs will not be regarded as independent if the individual:

- has been an employee of the company or group within the last five years;

- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a contributing member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than nine years from the date of their first election.

(Combined Code, Provision A.3.1)

6.3. Voting policy

USS will:

- *vote against or abstain on a resolution to appoint or a re-appoint a NED who is not considered by USS to be independent, particularly if the appointment would significantly diminish the relevant independence of the composition of the board or any subcommittee.*
- *vote against or abstain on a resolution for the appointment of a non-executive chairman who is not considered to be independent.*
- *vote against or abstain on a resolution to adopt the report and accounts, or take other appropriate actions, if there is an insufficient proportion of independent directors on the board and particularly if there is a joint Chairman-CEO.*

7. Appointments, Age and Contracts

7.1. Policy statement

USS considers that the following board processes are critical in supporting the role of an effective working board: the recruitment of directors; planning for succession; and regular assessment of the performance of directors, including the chairman. There should be independence, rigour and transparency in the processes of the board and the Nomination Committee, which result in the proposals to nominate or re-elect directors to the board, the appraisal of board and individual director performance, training and succession planning.

7.2. Nomination Committee

USS recommends that all companies establish nomination committees which should lead the process for board appointments, inductions, evaluations, training and succession planning and removal of directors – both executive and non-executive directors - and make recommendations to the board.

Boards should not reinstate directors automatically, as the nominating process should be viewed as a continuing opportunity to evaluate the strategic composition of the board.

USS therefore encourages a continual evaluation of the core competencies that the board needs to function at optimum level. The nomination committee should therefore regularly evaluate the balance of skills, knowledge and experience on the board – both individually and collectively – and take the necessary action to maximise the board’s effectiveness.

USS encourages companies in which it invests to disclose fully the nomination processes, including assessments used and succession issues addressed. USS therefore supports the Combined Code recommendation that a separate section of the annual report should describe the work of the Nomination Committee, including the process it has used in relation to board appointments. An explanation should be given if neither an external search consultancy nor open advertising has been used in the appointment of a chairman or a non-executive director.

7.3. Appointments

Appointments to the board should be made on merit and against objective criteria based on the role and capabilities required for a particular appointment, having assessed and identified the gaps in experience, background, knowledge and balance of skill-sets around the boardroom.

The process for recruiting non-executive directors should be as thorough, methodical and transparent as the recruitment process for executive directors.

The Nomination Committee should ensure that potential candidates for the role of chairman and non-executive directors have sufficient time to meet what is expected of them, recognising the need for availability in the event of crises. USS supports the Combined Code’s recommendations that i) no individual should be appointed to a second chairmanship of a FTSE 100 company ii) the board should not agree to a full time executive director taking on more than one non-executive directorship in a FTSE 100 company iii) the board should not agree to a full time executive director taking on the chairmanship of a FTSE 100 company.

The names of directors submitted for election should be accompanied by sufficient biographical details and any other relevant information to enable shareholders to take an informed decision on their election. The board should set out to shareholders in the papers accompanying a resolution to elect a non-executive director why they believe an individual should be elected.

USS recognises that unless the pool of talent for non-executive directors is expanded, it will become increasingly difficult to find people of a suitable calibre. USS therefore encourages nomination committees to instruct their headhunters to cast their net more widely when recruiting new non-executive directors.

7.4. Age

Whilst it is accepted that directors, of any age, can continue to contribute effectively to board management, USS considers that in the interests of the company, generally executive directors should retire at age 65, and NEDs should stand down at age 70.

However, where a director can, in the opinion of the board as a whole, still provide an active contribution to the company, the director should offer themselves for re-election on an annual basis upon reaching, or remaining on the board over the age requirement. The board should disclose the basis of assessment used for its recommendation for the re-election of a director. There is no suggestion that directors over the age of 70 are incapable of fulfilling such a position. However, the inclusion of older directors on a board may raise questions in respect of succession and independence, especially where there are several older directors or where a director is significantly older than 70.

7.5. Contracts

Notice or contract periods for executive directors should be set at one year or less. However, USS will consider supporting executive directors appointed with a rolling contract in excess of one-year that subsequently reduces to a one-year rolling contract within a three-year period. The board should disclose the basis of the decisions used to justify the increased term upon appointment. USS does not support appointments with contracts that contain provisions such as termination payments exceeding normal contractual provisions in specific circumstances, e.g. a change of control (See section 9.4. on compensation awards).

7.6. Voting policy

USS will:

- *vote against or abstain from voting on a resolution to appoint a director with a contract containing unacceptable provisions and/or with a rolling contract in excess of one-year, unless the term reduces to one year within a three-year period and USS is satisfied that there is a business case for the longer term upon appointment.*
- *vote against or abstain from voting on a resolution to appoint or re-elect an executive director aged 65 or more, or a NED aged 70 or more unless USS is satisfied that there is a business case for the re-election.*
- *vote against or abstain from voting on a resolution to appoint or re-elect an executive director or NED who is also a member of a committee where the presence of that director is considered by USS to have an undue adverse influence on the committee, or to diminish its independence.*
- *vote against the appointment or re-appointment of a chairman of a FTSE 100 company if that person is a chairman of another FTSE 100 company.*
- *vote against the appointment of an executive director if that person is a non-executive director of more than one FTSE 100 company or is a chairman of a FTSE 100 company.*
- *vote against the resolution to adopt the report and accounts of a company, or take other appropriate actions, if the nomination process as described above is undisclosed or deemed insufficient.*

8. Re-election, succession planning and training

Policy statements:

8.1. Re-election

To ensure that there is a planned and progressive refreshing of the membership of the board, it is fundamental that all directors seek regular re-election by the shareholders, at least once every three years. USS also encourages companies to provide a narrative, on the occasion of the re-election of a director, which clearly discloses the process of skill re-evaluation that has taken place, and which results in the recommendation by the Nomination Committee or board for the re-election of a director confirming that the individual's performance continues to be effective and demonstrates commitment to the role.

USS supports the Combined Code's recommendation that any term beyond six years (eg two three year terms) for a non-executive director should be subject to particularly rigorous review. Non-executive directors serving longer than nine years should be subject to annual re-election but will no longer be considered independent, as outlined above.

8.2. Succession planning

The Nomination Committee should give full and regular consideration to succession planning in the course of its work, taking into account the challenges and opportunities facing the company and what skills and expertise are therefore needed on the board in the future. The committee should satisfy itself that processes and plans are in place for orderly succession for appointments to the board and to senior management to maintain an appropriate balance of skills on the board.

8.3. Induction and continuing professional development (CPD)

USS considers a formal induction policy for new directors with specialist training where appropriate for membership to the various sub committees, and continuing development programmes to be also of importance.

The chairman should also ensure that the directors continually update their skills and their knowledge and familiarity with the company required to fulfill their role both on the board and on board committees. The company should provide the necessary resources for developing and updating its directors' knowledge and capabilities.

The board should also ensure that directors, especially non-executive directors, have access to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors. Committees should be provided with sufficient resources to undertake their duties.

USS encourages companies to disclose its processes for board succession and training, including the processes of skills evaluation.

USS is supportive and endorses initiatives such as the IoD's Chartered Director professional qualification which aims to set a benchmark for directors, including non-executive directors, and to raise their professional standards.

8.4. Board evaluations

USS supports the Combined Code's recommendation that the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

There is an increasing focus on the fact that effective boards depend as much on behaviours and relationships of board members as on procedures and structures.¹ USS therefore encourages companies in which it invests to place more attention in ensuring that 'hard' mechanisms of performance criteria, processes and measurement are used and disclosed by companies.

Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment (including commitment of time for board and committee meetings and any other duties).

The process should be overseen by the chairman and should be used, inter alia, to:

- Ensure there is an appropriate balance of skill-sets and experience on the board
- Identify skill shortages on the board
- Assess each director's contribution
- Manage the succession planning process
- Ensure that non-executive directors are genuinely independent
- Ensure that directors are not over-stretched with other external commitments
- Ensure the board composition matches the needs of the business

The chairman should act on the results of the performance evaluation by recognizing the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors.

The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.

The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted.

¹ Jeffrey Sonnenfield, an Associate Dean at Yale University, refers to the importance of the "human element." He adds that just by following good-governance regulatory recipes doesn't necessarily produce good boards – the key isn't structural, it's social. What distinguishes exemplary boards is that they are robust, effective social systems. ('What Makes Great Boards Great' *HBR*, September 2002, p.4). Derek Higgs in his review on independent directors also asserts that "people are the key." (*Review of the role and effectiveness of non-executive directors*, January 2003).

8.5. Voting policy

USS will:

- *vote against a resolution to disapply re-election requirements for all or certain directors, e.g. the CEO.*
- *vote against a resolution to extend the period of re-election beyond three years.*
- *vote against or abstain from voting on a resolution to re-elect a director with a contract containing unacceptable provisions and/or with a rolling contract in excess of one-year, unless the term reduces to one year within a three-year period and USS is satisfied that there is a business case for the longer term upon appointment.*
- *vote against or abstain from voting on a resolution to re-elect or appoint a director to boards which do not undertake effective board evaluations.*

9. Remuneration

9.1. Background

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. The current system of executive remuneration prevalent in the UK is, in general, considered to be better than that in some other countries (notably USA and France). However, there are on-going weaknesses including the continuing focus on options, a strategy which has been widely criticized for fostering a culture of short termism with little or no link to individual performance and for aligning executive and investor interests on managing share price. There is growing awareness that the systems and relationships between corporate management and analysts/fund managers now make it almost inevitable that executives will feel under some pressure to generate short-term gains even if they put long-term performance at risk. The current remuneration debate, however, has tended to avoid addressing these systemic issues directly and has instead focused on curbing high-profile symptoms (ie excessive rewards for underperformance or failure). USS's remuneration policy is based on the premise that companies should introduce remuneration systems that genuinely incentivise directors to deliver durable shareholder value by deconstructing that metric into component parts related to the corporation's long-term strategy and value growth which, in turn, is used as a basis to reward executive directors.

9.2. Policy statement

Levels of remuneration should be sufficient to attract retain and motivate directors of the quality required to run the company successfully but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance. (Combined Code Principle B.1.)

USS will support companies whose remuneration policies and payments are compatible with the long-term interests of shareholders. USS will not support policies and payments which merely reflect short-term market trends and/or an upward ratchet of remuneration levels with no corresponding improvement in performance. Corporations should also be

sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.

The chairman of the board and/or chairman of the remuneration committee should ensure that the company maintains contact as required with its principal shareholders about remuneration in the same way as for other matters.

USS requires that the Remuneration Committee has the responsibility for appointing external remuneration consultants who should be accountable to the Committee.

9.3. Performance related remuneration

USS will only support remuneration policies that contain incentive and performance based schemes which are clearly aligned with business strategy and objectives and linked to progress in long-term value creation. Executives should be compensated appropriately for their contribution to this process and not for market or industry wide rises in stock prices. USS encourages companies to focus on specific responsibilities by linking individual rewards more materially to their performance in advancing the corporation's strategy with a particular focus on their specific responsibilities and personal targets.

The Remuneration Committee should consider whether the directors should be eligible for annual bonuses and long term incentive schemes. If so, performance conditions should be relevant, stretching and designed to enhance long-term shareholder value and reflect the company's objectives and value creators. Performance criteria should govern both the granting and exercise of such awards.

As required by the Directors' Remuneration Report Regulations 2002, USS expects corporations to disclose what is being incentivised and requires companies to put the Remuneration Report to the vote of shareholders on an annual basis as a separate resolution.

Upper limits for all schemes should be set and disclosed. The total rewards potentially available should not be excessive and no scheme should exceed 100% of base salary.

The performance targets should also generally be disclosed in the Remuneration Report.

USS will not support transaction bonuses which reward directors and other executives for effecting transactions irrespective of their future financial consequences.

USS encourages corporations to significantly decrease their emphasis on stock options for the reasons outlined above. Restricted shares granted under conditions relating to executive tenure and performance should make up a significant proportion of performance related remuneration. USS would expect that directors be encouraged to hold their shares for a further period after vesting or exercise.

Where there is any type of matching arrangement or performance-linked enhancement in respect of shares awarded under deferred bonus arrangements, there should be a separate

shareholder vote. USS will not support arrangements whereby shares or options may, in effect, be granted at a discount and would expect that satisfaction of further performance criteria will be required in order for the matching element to vest.

9.4. Process and evaluation

USS supports the recommendation of the Combined Code that the Remuneration Committee comprises a minimum of three directors all of whom are independent NEDs. *(See board composition section for definition of independence).*

USS considers it is the role of the Remuneration Committee to:

- set the policies, pay levels and performance criteria by which the executive directors and senior management at the level below board level are rewarded;
- fully disclose these to shareholders in the Remuneration Report;
- be fully transparent in disclosure of remuneration policies and payments to enable shareholders to evaluate the fairness of the decisions of the Remuneration Committee;
- put the remuneration report to the vote of shareholders annually as a separate resolution.

9.5. Voting policy

USS will:

- *vote against a resolution to adopt the report and accounts, or take other appropriate actions, if the company does not put the remuneration report to the vote.*
- *vote against a resolution to approve the report of the Remuneration Committee and to appoint or re-elect a director who is also a member of the Remuneration Committee where USS considers the board's management of remuneration issues is unacceptable in the context of USS's policy.*
- *vote against or abstain from voting on a resolution to appoint or re-elect an executive director or NED who is also a member of a committee where the presence of that director is considered by USS to have an undue adverse influence on the committee, or to diminish its independence.*
- *vote against a resolution to approve the report of the Remuneration Committee if the composition of the Committee does not conform to the Combined Code guidelines.*
- *vote against a resolution to approve the remuneration report if there is insufficient disclosure on performance related pay.*

10. Remuneration II: Long Term Incentives and Share Option Plans ('PLANS')

10.1. Policy statement

USS's policy is to examine PLANS on a case-by-case basis with a view to ensuring that the interests of shareholders and directors are closely aligned. USS supports PLANS which set out genuinely to improve the competitiveness of companies and which comply with the ABI Principles and Guidelines on Executive remuneration (December 2003)

and the guidelines issued by the NAPF on voting on Executive Share Schemes (September 2001).

PLANS should be approved by shareholders before initial implementation and before any amendment takes effect. New PLANS should replace, not supplement, existing PLANS. Executives should not benefit simultaneously from multiple long-term PLANS.

USS will consider the elements of PLANS in line with the ABI's and NAPF's guidelines. USS therefore expects corporations to adhere to the following best practice guidelines:

- Awards in share-based PLANS should be phased.
- Chosen criteria for performance measures should demonstrate achievement of a level of performance which is demanding in the context of the prospects of the company and the prevailing economic environment.
- Performance criteria should be structured on a sliding scale rather than a single target and not be waived on change of control of the company.
- There should be no award for below median performance and the award at or above median should not be excessive.
- Options should not be issued at a discount or repriced downwards. Relinquished 'underwater' options should still be included in dilution limits.
- The percentage of salary that can be awarded in PLANS should be reasonable.
- The cost of share based PLANS should be disclosed according to ABI guidelines and in line with the ASB's requirements (FRS 20) which will take effect for accounting periods beginning on or after 1 January 2005.
- Bonuses should not be pensionable.

10.2. Performance criteria

USS expects Remuneration Committees to consider carefully the appropriate performance criteria to be used against which the corporation's performance is to be assessed. USS considers other quantifiable measures to be more appropriate than Earnings per Share. One option is Total Shareholder Return relative to a relevant index or peer group.

USS would also encourage corporations to consider employing the 'cash value added' principles and, in particular, cash flow return on investment (CFROI), as it is seen as an indicator of ability to withstand unexpected shocks, such as economic downturns, more effectively.

The Remuneration Committee should satisfy itself that the recorded TSR or other criterion is a genuine reflection of the company's underlying financial performance, and explain its reasoning.

10.3. Vesting of awards

USS expects performance conditions to be measured over a period of three or more years. USS also encourages remuneration committees to use longer performance measurement

periods of more than 3 years and also to introduce deferred vesting schedules which require directors to hold on to a proportion of their shares, at least, for the duration of their tenure. Corporations should consider restricting the sale of a significant portion of the executive directors' stock awards for a period beyond the end of his/her tenure to ensure the focus is on the creation of long-term value and that effective succession planning is undertaken.

10.4. Compensation awards for loss of office, retirement or any other ex-gratia payment

USS does not support any payment to an executive or a NED, which is paid in excess of shareholder approved contractual rights and/or is not related to a performance target. USS expects corporations to adhere to the guidelines as outlined in the joint statement by the ABI and NAPF on Best Practice on Executive Contracts and Severance (December 2003).

In particular, USS expects boards:

- to calculate and take account of all the material commitments which the company would face in the event of severance for failure or underperformance;
- to take a robust line on reducing compensation to reflect departing directors' obligations to mitigate loss, particularly in the event of a disciplinary procedure;
- to consider introducing phased payments which continue for up to one year until the departing executive finds fresh employment or for dismissal for financial failure;
- to ensure that executives will not be paid in excess of one year's *basic pay* in the event of a termination of contract.

10.5. Change of control provisions

USS will not support a scheme or plan that allows for automatic waiving of performance conditions either in the event of a change of control or where subsisting options and awards are 'rolled over' in the event of a capital reconstruction and/or the early termination of the participant's employment.

USS expects that the underlying financial performance of a company that is subject to a change of control should be a key determinant of what share-based awards, if any, should vest for participants. In the event of change of control, share incentive awards should vest on a pro-rata basis i.e. applying the performance criteria for the vesting period that has elapsed at the time of change of control.

10.6. Dilution limits

USS expects shares issued and commitments to issue new shares under all employee share schemes should not exceed an amount equivalent to 10% of the issued ordinary share capital of the company in any rolling 10-year period.

Within the 10% limit, USS expects that shares issued and commitments to issue shares under any discretionary or executive scheme should not exceed an amount equivalent to

5% of the issued ordinary share capital of the company in any rolling 10-year period, unless exceptional circumstances apply.

10.7. Non Executive Director's remuneration

Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role.

USS supports NEDs being paid wholly or partially in shares as this aligns their interest with those of shareholders generally. This support would not normally extend to the provision of share options issued under any PLANS as this could be relevant to the determination of a non-executive director's independence.

10.8. Voting policy

USS will:

- *consider resolutions for approval or amendment to PLANS on a case by case basis, but will generally vote against or abstain if the issues are unacceptable in the context of USS's policy. USS will also vote against the resolution to approve the report of the Remuneration Committee in such situations.*
- *generally vote against a resolution to pay awards which are not contractual or performance linked.*

11. Accountability and audit

11.1. Policy Statement

The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

11.2. Audit Committee

The Audit Committee should comprise a minimum of three directors, or in the case of smaller companies, two members, all of whom should be independent NEDs. The committee should keep under review the scope, results and cost effectiveness of the audit and the independence and objectivity of the auditors. The review should also specifically address the nature and the extent of non-audit services provided by the company's auditors.

The board should satisfy itself that at least one member of the Audit Committee has recent and relevant financial experience.

The Audit Committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The Audit Committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

The Audit Committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the Audit Committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

The Audit Committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors.

The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded. USS requires that companies should explain the type of non-audit work undertaken and, where the level of non-audit fees exceeds the audit fees and/or is significant, a detailed breakdown of such fees.

The Combined Code Guidance on Audit Committees

C.3.2. The main responsibilities of the audit committee should be set out in written terms of reference and should include:

-to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;

-to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors or by the board itself, the company's internal control and risk management systems;

-to monitor and review the effectiveness of the company's internal audit function;

- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, reappointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;

-to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;

-to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm;

and to report to the Board, identifying any matters in respect of which it considers that action or improvement is needed, and making recommendations as to the steps to be taken

11.3. Internal controls and risk controls

The Board should maintain an effective system of internal controls to safeguard shareholders' investment and the company's assets.

The Board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems.

Turnbull Guidance on Internal Control

17. In determining its policies with regard to internal control, and thereby assessing what constitutes a sound system of internal control in the particular circumstances of the company, the board's deliberations should include consideration of the following factors: the nature and extent of the risks facing the company; the extent and categories of risk which it regards as acceptable for the company to bear; the likelihood of the risks concerned materialising; the company's ability to reduce the incidence and impact on the businesses of risks that do materialize; and the costs of operating particular controls relative to the benefit thereby obtained in the managing the related risks.

11.4. Voting policy

USS will:

- *vote against a resolution to appoint (or re-appoint) a firm of auditors or re-elect a director who is also a member of the Audit Committee where USS considers the board's management of internal control issues is unacceptable in the context of USS's policy. USS will also consider voting against the appointment or re-appointment of the firm of auditors in this situation.*
- *vote against the resolution to adopt the report and accounts and the appointment or reappointment of auditors, or take other appropriate actions, where an adequate² statement in respect of internal controls is not produced.*
- *vote against or abstain from voting on a resolution to appoint or re-elect an executive director or NED who is also a member of a committee where the presence of that director is considered by USS to be an undue adverse influence on, or diminish the independence of the committee.*
- *vote against a resolution to appoint (or re-appoint) a firm of auditors or re-elect a director who is also a member of the Audit Committee if a detailed breakdown of non-audit fees is not provided.*

² An adequate statement includes a) a statement that the process is ongoing and evaluates significant risk b) confirmation that the process was in place throughout the year and at the date of the report and accounts c) that regular reviews take place d) that the Board retains overall responsibility.

12. Corporate responsibility

12.1. General Policy Statement

Good corporate governance includes the management of the company's impact on society and the environment. USS believes that the willingness and ability of companies to adopt the highest standards of corporate responsibility is increasingly important to long-term growth in the value of their businesses. Conversely, companies that fail to manage in an adequate manner their material social, ethical, and environmental (SEE) risks or opportunities, are vulnerable to business impacts that can result in higher operating costs, reputational damage and subsequent loss of confidence and / or action by shareholders.

Therefore, USS will seek to use its influence to encourage the companies in which it invests to operate at good practice standards of SEE management in order to protect and enhance the value of its investments.

In undertaking assessment of companies in relation to these issues, USS will consider companies in context, in relation to their own past performance, the performance of their peers, and with consideration for the particular circumstances, industries and locations in which they operate. USS expects companies to provide appropriate information to shareholders on their management of extra-financial issues such as SEE issues. In this context, USS Ltd also supports the proposed introduction of the Operating and Financial Review (OFR) and believes that the provision of material extra-financial information as described in the OFR is a positive step for shareholders.

USS considers it is the role of the board to:

- Appoint a named board member or members to have overall responsibility for this function;
- Make a strategic assessment of the impact of SEE issues on the long and short term value of the business, looking to both areas of both risk and opportunity, and to provide details of these assessments in annual reports and an OFR;
- Have SEE policies by which the business operations should be managed, together with clear standards which should be in line with national or international laws and standards (including the OECD Guidelines for Multinational Enterprises) and industry best practice standards, whichever are higher;
- Have clear targets and timetables for improvement with appropriate resource allocation;
- Ensure that implementation and ongoing compliance with the policies is audited and, where appropriate, independently verified;
- Be fully transparent in disclosing its material SEE risks, actions and impacts to enable shareholders to evaluate the decisions of the board, such disclosure being made at least once a year with key issues covered in the annual report and in an OFR.

12.2. USS Policy on SEE disclosure

USS expects FTSE 100 companies, and progressively require all other companies, to report on their policies, impact and progress on any material SEE issues to analysts and investors at least once a year. This information can be provided to shareholders via a number of routes: inclusion in annual reports, the proposed Operating and Financial Review, via separate freestanding reports or via the Internet.

USS expects all companies to report to shareholders SEE extra-financial risks and opportunities in their Operating and Financial Reviews (as currently proposed by the DTI), following the guidance provided on these issues. If issues of the types identified in the draft OFR (for example, those outlined below) are not included by a company in its OFR, the company should comply or explain as under the Combined Code.

In addition to the OFR, USS expects companies to provide additional and more detailed information of SEE performance in separate SEE reports. Where a FTSE 100 company does not have such a report and does not have plans to produce one in the near future, USS will vote against accepting the company's report and accounts or take other appropriate actions.

Company management is best placed to decide what is considered material for a particular company at a particular stage of development and there are many sources of professional guidance. USS is of the view that, in general and when considering FTSE 100 companies in particular, there should be a presumption in favour of reporting on policies and performance with regard to the following:

- employee relations (including health and safety, core labour standards and human capital issues);
- major environmental issues (including environmental pollution, use of natural resources, and carbon exposure);
- major reputational issues (including bribery/corruption, corporate political influence and environment, social, human rights or economic impact on local communities).

It may well be that company management do not consider one or more of these to be material risks, in which case USS expects companies to explain their reasoning.

Where companies do not fully disclose their material strategy, policies and practices or where USS has questions or concerns about the approach management is taking, USS will engage in a prioritised manner, to re-assure itself that there are no grounds for concern or to encourage good practice standards.

In implementing this policy, USS will make reference to the Disclosure Guidelines on Socially-Responsible Investment³ developed by the Association of British Insurers (ABI). These take the form of indicative criteria detailing the types of SEE information that

³ The ABI's Disclosure Guidelines on Social Responsibility are available at http://www.abi.org.uk/Display/File/85/SRI_Guidelines.doc

shareholders should expect to be disclosed, and dictate that key aspects of such disclosure should be made in the company annual report. The ABI itself assesses standards of corporate compliance with the guidelines, undertaking evaluations of annual reports to ensure that appropriate levels of information are supplied.

USS will vote against the report and accounts, or take other appropriate actions, at those companies failing to achieve appropriate levels of disclosure with reference to the ABI guidelines, taking into account the ABI evaluation of company reports when voting on this disclosure. In complying with the ABI disclosure guidelines, different sectors will be expected to provide different levels of detail as the SEE risks and opportunities facing different sectors vary. Thus, companies in high-risk or high impacts sectors are expected to achieve higher levels of disclosure than companies in low risk sectors. Further information on this is provided on the USS internet site.

The policy is also evolving: USS expects the quality of SEE disclosure by companies to improve over time, and as such the fund will expect improved disclosure on SEE issues by companies in low risk / low impact sectors and smaller companies. As a result, the indicative voting guidance vis à vis the ABI guidelines will evolve over time to reflect these increased expectations. The USS internet site will provide details of the latest expectations for disclosure on these issues. This policy will also be updated in light of the content of Operating and Financial Reviews proposed for introduction in 2005.

12.3. Voting policy

USS will:

- *consider resolutions relating to social, environmental and ethical issues on a case by case basis, taking into account the need for a resolution and the relative performance of the company vis à vis its competitors. In making this decision, USS will be guided by national and international law, voluntary codes of good practice developed by authoritative bodies, and the indicative proxy voting criteria developed by USS for voting shareholder resolutions filed against US companies on SEE issues.*
- *vote against the report and accounts, or take other appropriate actions, at those companies which, in reference to the ABI Disclosure Guidelines, fail to disclose SEE information to an appropriate level.*
- *vote against the report and accounts, or take other appropriate actions, at FTSE 100 companies which fail to provide separate SEE reports.*
- *vote against the report and accounts, or take other appropriate actions, at FTSE 100 companies which fail to provide appropriate disclosure of extra-financial issues in their OFR, when it is introduced.*

13. Shareholders' Rights

13.1. Policy statements:

Resolutions

USS supports the principle that shareholders should have the opportunity to vote on separate issues and will encourage companies to ensure that such proposals are not 'bundled' into combined resolutions.

Pre-emption right for issues of new capital

USS does not support resolutions that are inconsistent with rules of the Pre-emption Group of the London Stock Exchange.

Article changes

USS does not support proposed changes to Articles of Association and/or constitutional documents that reduce shareholder rights or do not reflect good governance practices.

Restricted Voting Rights

USS does not support issues of shares with restricted voting rights, nor any action which effectively restricts the voting rights of shares held by USS.

Repurchase of stock

Companies should adopt equal financial treatment for all shareholders. USS supports ‘fair price’ provisions and measures to limit the company’s ability to buy back shares from a particular shareholder at higher-than-market prices. USS will normally vote in favour of an authority for share repurchases provided that it complies with the Listing Rule guidelines (eg limit of 15% of issued share capital) and that directors demonstrate that this is the most appropriate use of a company’s cash resources.

Hostile takeover bids

Companies should seek shareholder approval on any action which alters the fundamental relationship between shareholders and the board. This includes anti-takeover measures.

Mergers and acquisitions

USS supports mergers and acquisitions which enhance shareholder returns in the longer-term. USS encourages companies to disclose fully relevant information and provide for separate resolutions on all issues which require the shareholders to vote, for example the effect of a merger on the compensation and remuneration packages of the individual board members.

13.2. Voting policy

USS will

- *consider resolutions relating to shareholder rights on a case by case basis.*

14. Donations to political organisations

14.1. Policy statement

USS considers that it is inappropriate that any of the return that rightfully belongs to shareholders should be diverted to political donations except in exceptional circumstances.

USS fully supports the right of companies to take a full part in the public policy process in a transparent and accountable manner - indeed, without such informed corporate input, political decision-making will be sub-optimal. Recent experience, however, makes clear

that companies that give donations and are not transparent about their lobbying policies and activities are at serious reputational risk since they can be easily portrayed as buying influence and distorting the democratic process. Of even greater fiduciary importance to owners of assets like USS, however, are the economic distortions. As a pension fund with a highly diversified portfolio which is effectively invested in the economy as a whole, USS has an interest in ensuring that individual corporations or sectors do not adversely affect wider portfolio interests, in particular when using market-distorting means. Indeed, whilst the short-term interest of a particular company may be best served through buying political influence, this strategy has in-built risks to durability and the general economic interests are likely to be best served by rational and long-term political decision-making. Therefore, USS is of the view that any short-term loss of benefit to particular companies should be more than offset by the medium to long-term performance of the portfolio as a whole and is therefore, as a matter of investment principle, against donations of shareholders' money by corporations to political entities.

USS will, however, in certain circumstances, consider approving donations to be paid to potentially politically related entities such as membership of industry representative bodies or attendance at political fora, provided that USS considers the amounts to be reasonable and in the long-term interests of the business. Companies should disclose the amounts to be paid, the organisations to receive the donations, and the business reasons for the payment.

Donations shall include all donations not just monetary donations. Donations to charities are acceptable within reason.

14.2. Voting policy

USS will:

- vote against the adoption of report and accounts, or take other appropriate actions, if there are payments to a political party in the UK or overseas for which there is no rationale.*
- consider all other related resolutions on a case by case basis.*