

re^o Report

F&C Investments

1st Quarter 2007



In this issue...

- Crystal ball gazing: F&C charts the hot governance issues of 2007
- 'Show me the money – Give me a say': beyond disclosure, investors want a vote on executive pay
- As the polar ice cap melts, a thaw hits the **ExxonMobil** boardroom
- From Africa, to Hollywood, to Wall Street: How human rights play havoc with mining investments
- Letters from China: F&C talks governance with Chinese banks, oil companies and others
- The Principles for Responsible Investment: How grand ideas translate into day-to-day investment practice

F&C
Investments

Expect excellence

Our philosophy

reo® stands for responsible engagement overlay

The objective of reo® is to use the influence that F&C has through the share ownership of its clients to encourage investee companies to enhance their business performance by adopting better corporate governance, social, and environmental practices. F&C believes that it can better serve its clients, and

protect the value of their shareholdings, through sustained and constructive dialogue with companies as well as the judicious and transparent use of its votes, thereby ensuring that companies respond prudently to the emerging expectations of shareholders and other stakeholders.

Why this report?

Our obligations to you

F&C represents you: we have been appointed either to manage your pensions and investments, or to represent your interests to the companies in which you are a shareholder, even if your portfolio is managed by other fund managers.

As your representative, we have important obligations to you. These are to be vigilant about how companies 1) plan their future growth with the capital you have entrusted to them; 2) manage and minimise business risks; and 3) protect financial returns over the long term.

What does this mean in practice?

This means that as your representative, we take the time to communicate our concerns to the managers of the companies in your portfolios. It also means that we expect full transparency from companies, so that we know what is being done with the money you have invested with them.

In addition, where F&C is your fund manager, this means exercising our voting rights – **your** voting

rights – at the annual and extraordinary shareholders' meetings of over 3,000 companies around the world.

Transparency: It cuts both ways

If we expect transparency from companies, you should expect no less from us: we believe that as investors, you are entitled to know what company managers are doing in your name with the money entrusted to them. At F&C, we take this responsibility very seriously. With this quarterly report, we outline how we have asked questions and spoken up in your name to ensure that companies are made aware of the concerns of their shareholders.

What could we do better?

We hope we have accurately reflected your concerns about good governance, environmental responsibility and the protection of basic employment and human rights.

Still, we want to be sure we get it right.

An electronic copy of this report can be found at: www.fandc.com/governance

Feedback: Your money listens

Your input is valuable to us. Thank you for telling us how your money should talk. Please mark your comments 'reo report feedback', and e-mail them to eve.crush@fandc.com

Or send to: Eve Crush, Governance & Sustainable Investment, F&C Management Limited, Exchange House, Primrose Street, London EC2A 2NY

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Introduction

The first quarter of 2007 saw F&C gear up for another peak voting season, which looks set to run to over 4,000 companies in some 50 countries. In preparation for this, F&C wrote to all its portfolio companies to reacquaint them with its suite of country and region-specific voting guidelines, which are updated annually to reflect emerging good practices. We also sent our 2006 *Annual Voting & Governance Report*¹, which provides an overview of key voting trends and outlines the hot issues of 2007 and beyond.

With corporate governance and sustainability featuring ever more prominently in investment circles around the globe, F&C is increasingly turning its attention to the opportunities that lie within emerging

markets to effect change and extract value. As the world's attention has turned to China's breakneck growth, ecological crisis and soaring appetite for raw materials, this report chronicles our visit to China, where we met with several financial, oil and industrial companies to discuss emerging standards of good practice and highlight key areas of concern.

This report also features an update on F&C's engagement in the area of Human Rights and Mining – an area where, not coincidentally, the pressure from China's growing overseas presence poses particular challenges to companies seeking to compete while investing for the long-term in healthy local community relations.



Karina Litvack – Director,
Head of Governance &
Sustainable Investment,
F&C Management Limited

Engagement programmes

Governance



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Country focus



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Initiatives



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¹ Available on www.fandc.com/new/aboutus/Default.aspx?id=63889

Companies featured in this report

Corporate Governance & Voting

pages 6-7

Company	Countries	Company	Countries	Company	Countries	Company	Countries
Bank of Montreal	CA	Cisco Systems	US	Pfizer	US	Vinci	FR
Bank of Nova Scotia	CA	Exxon Mobil	US	Procter & Gamble	US	Wachovia	US
BP	UK	Home Depot	US	Royal Bank of Canada	CA		
CIBC	CA	National Bank of Canada	CA	Total	FR		

Governance Outlook for 2007

pages 8-9

Company	Countries	Company	Countries	Company	Countries	Company	Countries
AIG	US	BAA	UK	Endesa	SP	General Motors	US
AOL Time Warner	US	Banco Santander	ES	Ferrovial	ES	Nikko Cordial	JP
Autostrade	IT	Danone	FR	Gemstar Inc	US	Prudential Financial	US

Environment Environmental Management Systems

pages 10-11

Company	Countries	Company	Countries	Company	Countries	Company	Countries
Bank of America	US	CVS	US	Morgan Stanley	US	Woodside Petroleum	AUS
Brazil Eco-Diesel	BR	ExxonMobil	US	SAB-Miller	UK		
Citigroup	US	JPMorgan Chase	US	Wachovia	US		

Social Human Rights and Business

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Company	Countries	Company	Countries	Company	Countries	Company	Countries
Anglo American	UK	Freeport-McMoRan	US	Microsoft	US	Yahoo!	US
Anvil Mining	CA	Google	US	Peter Hambro	UK		
BHP-Billiton	UK	Hochschild Mining	UK	Rio Tinto	UK		
First Quantum	UK	Lonmin	UK	Vodafone	UK		

Country China

page 14

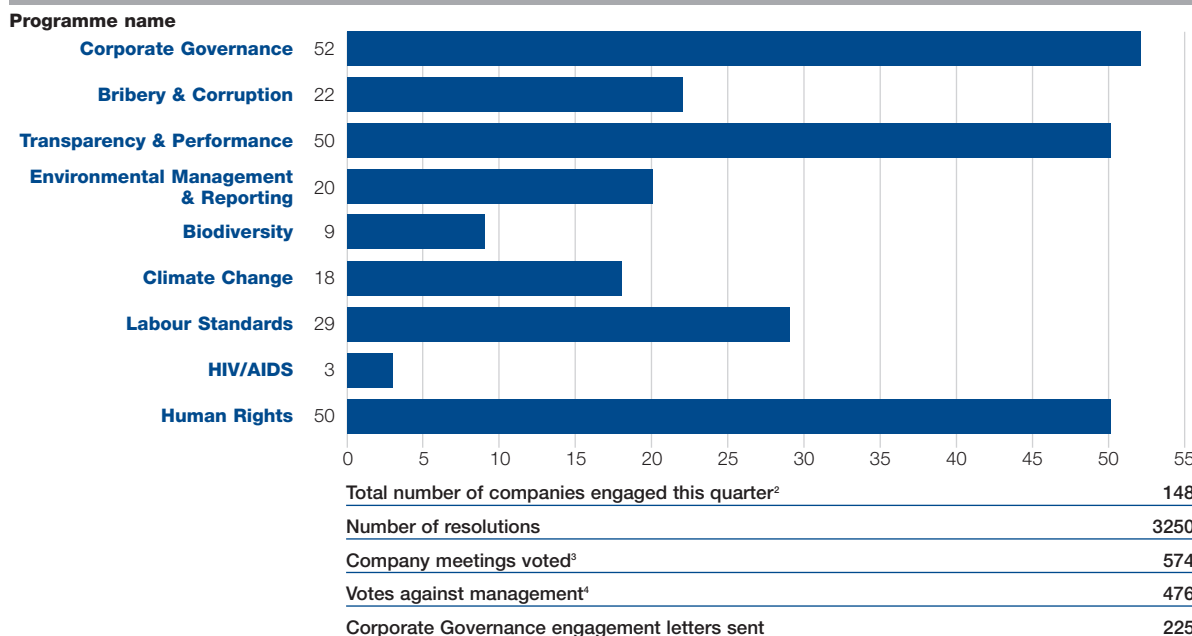
Company	Countries	Company	Countries	Company	Countries	Company	Countries
Aluminium Corporation	CN	China Oilfield	CN	CNOOC	CN	Sinopec Shanghai Petrochemical	CN
Bank of China	CN	China Shenhua	CN	Huaneng Power	CN	Tianjin Capital	CN
China Construction Bank	CN	China Sun Biochem	CN	Petrochina	CN		
China Life Insurance	CN	China Telecom	CN	Ping An Insurance Group	CN		

Activity report

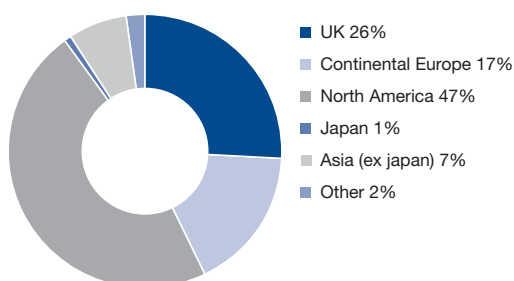
F&C’s responsible engagement overlay is unique in the depth and breadth of its engagement, as the quarterly statistics below demonstrate. Key features are:

- A 15-person team of Governance & SRI specialists, allowing full monitoring of the portfolios for environmental, social and governance (ESG) risks and the capacity for in-depth and prolonged engagement with individual companies where necessary Global engagement – in all markets
- Comprehensive voting – F&C votes all of its clients’ shares worldwide, as well as publishing the voting record each month.

Number of companies engaged this quarter

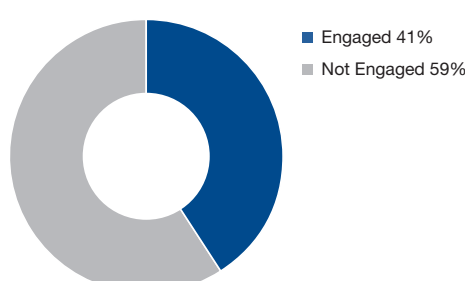


Geographical spread



This table shows the domicile of companies that have been engaged by F&C in the last quarter.

Engagement of FTSE-350 companies⁵



This table shows the proportion of the FTSE-350 Index, by market capitalisation, engaged by F&C in the last quarter.

2 Companies may have been engaged on more than one issue
 3 i.e. company meetings for which F&C has issued voting instructions
 4 Votes against management or abstentions
 5 By market capitalisation



Corporate Governance & Voting

Our objectives

- Ensure high standards of corporate governance in line with F&C Corporate Governance Guidelines with a focus on:
 - Board structure and composition
 - Remuneration
 - Appropriate internal controls and risk management systems
- Issue voting instruction on 100% of shares held.

Voting activity report

This table sets out the scale of voting for the past quarter. It is important to note that several votes in favour of management mask detailed dialogue, where, following compromise or mutual persuasion, we elected to support management.

Voting to date	Number	%
Total number of Meetings	574	
Number of countries in which we voted	43	
Number of resolutions	3250	100
Total votes for management	2651	81.6
Votes against management	173	5.3
Abstentions	303	9.3
No vote	123	3.8

Analysis of votes

Issue	% for	% against	% abstain	% no vote
Routine business	89	1	7	3
Directors and governance structure	85	9	6	0
Capital	81	8	10	1
Mergers/reorg	75	3	21	1
Remuneration	75	10	13	2
Anti take-over	0	0	0	0
Others	82	5	5	8

Shareholder resolutions number of votes for or against management

	for	against	abstain
	46	4	1

Engagement by F&C

Don't talk about money: French code on executive pay

French business organisations MEDEF and AFEP responded to the growing public disquiet with a new code of conduct that endorses the principle of aligning directors' and shareholders' interests. Following high-profile controversies, most notably that surrounding the €13 million severance package awarded to the ex-chairman of construction group **Vinci**, the code also urges remuneration committees to consider stakeholder and public views as part of their deliberations.

F&C has grown increasingly concerned that French companies are playing catch-up with international executive

pay levels without introducing corresponding standards on performance targets. We therefore particularly support the code's call to link stock options to performance. Moreover, we welcome the recommendation that performance targets be clearly disclosed, and include long-term targets to support the continued success of the company. We also believe that the appointment of genuinely independent directors provides a valuable safeguard.

F&C nevertheless met with AFEP to signal its concern that, taken alone, increased pay disclosure can trigger an undesirable 'ratcheting-up' effect by inducing boards to set pay levels in the top rather than median of their peer group. F&C's view is that the best counterweight to this is an advisory shareholder vote on remuneration.

They said...

“America's corporate boardrooms must step up to their responsibilities. You need to pay attention to the executive compensation packages that you approve. You need to show the world that American businesses are a model of transparency and good corporate governance.”

George W Bush, Speech to Federal Hall, New York, 31 January 2007

Who's watching the pay consultants?

Meanwhile in the US, the issue of excessive pay has risen up the political agenda, with George W Bush raising it in a speech in New York. In a further effort to chip away at the US tendency to overpay CEOs for mediocre performance, F&C joined the Treasurer of the State of Connecticut and a dozen other investors in contacting the 25 largest US corporations to address the question of executive pay consultants. We queried whether consultants to the compensation committee could truly be seen as independent in cases where they were also doing substantial other work for the company's executive management. With responses from 20 companies, investors were able to identify and share best practice such as **Wachovia** and **Proctor & Gamble**, which prohibit any other work by consultants, or **Cisco Systems**, which requires approval by the committee chairman for pay consultants to take on other projects at the company.

Most troubling to F&C is that there are a number of companies which employ best practice in the use of pay consultants, but still have systematic over-payment issues – namely, **Pfizer**, **ExxonMobil** and **The Home Depot**, all companies where F&C voted against members of the compensation committee in 2006.

They said...

“High, even very high, remuneration is normal... as long as it is in proportion to what [a director] brings back to the company.”

Laurence Parisot, head of Medef, quoted in *Financial Times*, “High pay defended by French businesses” 10 January 2007

Linking safety with pay in the oil sector

Where environmental or social issues are particularly important drivers of long-term company performance, F&C believes that companies should consider a formal link to executive pay. In the oil and gas sector, health and safety is one such issue, particularly as high-profile cases have raised concerns that health and safety investment may be compromised in the desire to improve short-term financial performance.

Most of the major oil companies have a direct link of this kind in place, and Lord Browne of **BP** was financially penalised after a poor safety performance in 2006. In contrast, **Total** has no such policy – a point that F&C

raised in meetings with company management, with a view to encouraging such an approach as a complement to the other measures the company is taking to improve its health and safety performance. Total was not convinced, believing that meaningful metrics are difficult to find in this area, and that it is therefore better to focus on process and culture.

Canadian banks: Balancing flexibility and shareholder rights

Five of Canada's six major banks held their annual meeting this quarter. A key voting item across all the banks was a request to allow the board discretion to amend equity incentive plans without the need for shareholder approval. These proposals are the result of new Toronto Stock Exchange rules that require boards to articulate which amendments require shareholder approval. Companies have until June 2007 to get shareholders' approval of these conditions, and if they fail to do so, any change, even if only administrative, will require prior approval.

F&C generally supports the right of boards to administer share-based pay plans and to be given the flexibility to do so effectively. However, changes to performance targets or vesting schedules should be left to shareholders to approve, as these are key features for aligning the interests of management and shareholders. We supported plans at three of the five banks (**Bank of Montreal**, **CIBC** and **Royal Bank of Canada**), where board discretion was subject to clear limitations in these areas, but abstained at the remaining two (**National Bank of Canada** and **Bank of Nova Scotia**).

F&C weighs in Down Under

As the **Australian Stock Exchange** (ASX) launched a review of its governance code, F&C submitted detailed comment on its new draft proposals⁷. We welcomed that companies should be required to report on their process for evaluating senior executives, but added that the outcomes of such a process should be reported on in a meaningful way. We also supported a proposal that companies should fully disclose their own internal ethical guidelines, as well as the significant risks to the business arising from environmental, social or governance matters.

F&C also took the opportunity to argue against a recent regulatory change that allows companies to give shares to executives without a shareholder vote, provided the company has bought shares in the market rather than issued new ones. We believe that any incentives schemes should be subject to a shareholder vote, regardless of how the shares are sourced.

The beginning of the end of shareblocking?

After Germany's decision in 2006 to end shareblocking, we are pleased that France has followed suit, with effect from 1st January 2007. We are now working to ensure that this legislation is implemented by companies and custodians, and that the procedures are in place to ensure that there are no impediments to the exercising of shareholder rights. And there is a prospect of action at EU level, which would bring the practice to an end across the whole region.

⁷ See F&C submission on <http://www.fandc.com/new/aboutus/Default.aspx?tid=63816>



Focus on The Governance Outlook for 2007⁸

Overview

F&C's fifth annual Voting and Governance Report analyses how it voted on over 30,000 proposals worldwide, giving an unparalleled insight into how a major global fund manager exercises its influence over the companies in which it invests. Below are the key issues F&C will be focusing on in the year ahead.

KYC: Know Your Company

Investors have long been pressing companies to give them sufficient information about the full range of factors that affect business performance. Many companies have obliged and raised their game on disclosure. But progress has been uneven across sectors and regions, and shareholders remain in the dark about potentially material risks.

For F&C, Asia is a particular area of focus: the expansion of investment flows to the region has not yet been accompanied by a shift away from an opaque reporting culture.

- In 2007 F&C will continue to engage with companies worldwide to encourage better disclosure, with a particular focus on pay policies, pensions and other "hidden" liabilities, as well broader social and environmental issues.
- F&C will also engage with policymakers in key markets by, for instance, working through the Asian Corporate Governance Association to improve disclosure standards.

SOX on the rocks

The trend for companies to list in London rather than New York intensified in 2006, and unsurprisingly, brought renewed criticism of the Sarbanes-Oxley Act. F&C is sympathetic to many of these concerns, and believes that SOX is an excessively rigid regime. But it should also be remembered that many of the improvements that SOX has brought about were much needed and long overdue, in particular the way the Act drives home the reality of the CEO's and CFO's personal responsibility for the actions of all employees involved in financial reporting.

Meanwhile in Japan, F&C will be looking carefully at how companies prepare for the new Financial Instruments and Exchange Law (informally known as "JSOX"). This should prompt some hard thinking about how well companies are run.

Waving the flag

Several European governments succumbed to nationalist pressure in 2006 by resisting cross-border mergers that would have seen the possible disappearance of iconic national brands. Citing national strategic interests, France, Italy, Spain and Poland leapt to the rescue of, respectively,

yoghurt and biscuit maker Danone, toll-road operator **Autostrade**, electric utility **Endesa**, and banking group **BPH**. The UK stood in sharp contrast, with a rash of successful foreign bids for UK firms, including **Ferrovial** for **BAA** and **Banco Santander** for **Abbey National**.

Political interference creates an unpredictable investment climate, where reading the political tea leaves becomes as important as the underlying drivers of value. This can only be bad news for the efficient operation of markets.

Remuneration: Let there be light

Greater disclosure on remuneration is likely to raise tensions in 2007 on both sides of the Atlantic. In the US, new SEC guidelines on disclosure will fuel further public debate on the rapid escalation of executive pay. Yet ironically, greater disclosure could also put upward pressure on pay, as executives all demand to have their pay set at the top of the range disclosed by their peers at other firms. Safeguards against excess are, slowly, being accepted, as an increasing number of companies bow to pressure to put pay to a shareholder vote.

Meanwhile in the UK, the Association of British Insurers (ABI) has rightly sounded the alarm on companies topping up bonuses to compensate for share incentive schemes that have not been paying out due to poor company performance.

- F&C believes that pay needs to be aligned with corporate strategic objectives; this means a large proportion should be variable, measured against stretching and relevant targets, and reported transparently.
- F&C believes that while pay disclosure is necessary, accountability can only be safeguarded against the inevitable pressure to 'ratchet up' by giving shareholders a say on pay policies through an advisory vote.

They said...

"...Companies often hide behind confidentiality clauses to keep complex pay packages under wraps. No wonder F&C expects some squeals this year when new SEC rules start to lift the lid on America's stratospheric pay deals."

The Telegraph, "US companies hopelessly out of kilter on corporate governance", 22 February 2007

Who audits the auditors?

Reliable company accounts are the foundation of investment decision-making. But a string of financial restatements (**AIG, General Motors, Prudential Financial**) and other accounting scandals (**Nikko Cordial, Gemstar Inc**) have once again called into question the integrity of accounts. Other worries include variations in the standards of auditing applied across different regions, as well as continued concerns over conflicts of interest where auditors offer lucrative non-audit services to the same companies they audit.

Limited auditor choice is part of the problem. Auditor liability creates barriers to entry as small companies cannot easily bear these risks. For this reason, F&C is supportive of moves towards limiting liability, provided this is complemented by measures to keep audit quality high.

Still, investors cannot be expected to second-guess auditors' findings. Rather, they should insist that companies have strong, independent audit committees to safeguard their interests.

- F&C will continue to engage with regulators on audit liability and quality.
- F&C will continue to engage with companies in favour of independent audit committees, and to scrutinise appointment of auditors.

The new perils of the digital economy: Security vs. privacy

The relentless march of progress in the Technology, Media and Telecommunications (TMT) sectors is good news for consumers. But F&C research⁹ has highlighted that as the volume of data multiplies, so do the risks associated with Access, Security and Privacy. High-profile breaches at a number of companies demonstrate that security failures can lead to a loss of customer trust and vulnerability to litigation.

- F&C has distributed a recent report on Access, Security and Privacy to over 30 companies. We will continue to engage the sector on these risks, and also extend engagement to other affected sectors.
- F&C will participate in the development of industry standards in this area.

They said...

“More and more states see they can't do censorship themselves, they have to turn to private companies.”

John Palfrey, director of Harvard Law School's Berkman Center for Internet and Society, quoted in *Financial Times*, "Repressive governments widen stifling techniques", 14 March 2007

Climate change hots up

2006 was the year that climate change made it into mainstream political consciousness – and saw serious signs of interest from the financial markets. In 2007, the clamour for government action will continue. At the political level, Germany will be in the driving seat, as it holds the Presidencies of both the G8 and the EU.

Emissions trading will be a key theme in 2007, as European companies gear up for the second, tougher phase of the EU trading scheme and similar schemes spring up elsewhere. And politicians will start to hammer out a regime that will survive the expiry of the Kyoto Protocol in 2012.

- F&C will continue to press for decisive action at a political level in 2007, and engage with companies to encourage them to prepare effectively for a lower-carbon future.
- F&C will work through the Corporate Leaders' Group on Climate Change to mobilise action in the UK and EU.

We said...

“Companies – and whole sectors – could underperform if they are too slow in adapting to new legislation stemming from government efforts to reduce carbon emissions. Government support for alternative sources of energy globally, and the Emissions Trading Scheme in Europe, create huge new investment opportunities.”

Alain Grisay, *European Pensions & Investments News*, "Industry Voice - Seeing a sea change on ESG influence", 26 February 2007

London calling

The number of foreign companies listing in London continues to grow, as does the number of countries they come from – whether from post-communist Europe, Asia or Latin America. While the dynamism of the London market clearly benefits investors, its two-tier system, where foreign companies are not subject to the listings standards that apply to UK-domiciled companies, increases risks to investors¹⁰.

- F&C will continue to engage foreign-domiciled companies listing in the UK to encourage adoption of best practice, and work with fellow investors and the UK regulator to advance this agenda.
- F&C will continue to engage with regulators worldwide to encourage high-quality listings standards.

⁹ See full text of the report on <http://www.fandc.com/new/aboutus/Default.aspx?id=63889>

¹⁰ For a more detailed discussion of these issues, please see page 27 of our Annual Voting and Governance Report 2006, available on <http://www.fandc.com/new/aboutus/Default.aspx?id=63889>



Focus on Environmental Management Systems

Our objectives

We engage companies to:

- Introduce robust systems to identify environmental and social risk
- Develop effective management systems for those risks
- Disclose performance
- Formulate corporate strategy reflecting both risks and opportunities presented by changing regulatory standards and customer demands for sustainable products.

Engagement by F&C

US banks invest in environmental management

Friendly tellers, competitive interest rates and clever credit analysts are no longer all it takes to run a bank. Increasingly, leading banks set ambitious environmental and social standards for everything from minimising risks associated with deals to reducing the energy used to run branch offices. Most recently, fast-growing US bank **Wachovia** launched a new set of environmental management policies that focused on how to finance the forestry sector, as well as how to deal with climate change and its own environmental “footprint.” F&C attended a day-long workshop with bankers, clients and environmental advocacy organisations to discuss the bank’s approach to climate change, and provided in-depth feedback on its draft policies. We hope to work with Wachovia in 2007 as it implements these policies, trains its staff and issues its first-ever public report. In addition, we continue to work closely with **Citigroup**, **JPMorgan Chase** and **Bank of America** as they implement their own environmental management systems – most recently, collaborating with **Morgan Stanley** as it overhauled its 2002 environmental policy.

Environmental management: a cornerstone for growth

For many companies, growth is synonymous with ever more complex environmental management risks. Over 2006, F&C assessed the environmental management systems of over 140 companies prior to investing in them, and worked with a wide variety of companies, encouraging stronger, far-reaching systems to deal with new challenges, such as deforestation linked to agriculture, and water scarcity.

For example, we met with the chairman of **Brasil Eco-Diesel**, Brazil’s largest biodiesel producer, and urged the company to place strong environmental management at the heart of its rapid growth strategy, particularly for sourcing feedstock and manufacturing. The company committed to addressing these – over time it will reduce

the proportion of soybean oil used in biodiesel, support responsibly grown soy and manage its greenhouse gas emissions. F&C also met with **SABMiller**, a company that has expanded rapidly from its South African base to become a major international brewer. We welcomed its updated sustainable development priorities and sector-leading approach to water management, and recommended that SAB Miller better communicate how these priorities relate to its commercial strategy, which the company agreed to consider.

F&C also advised Australian oil and gas producer **Woodside Petroleum** that if it decides to develop the Tiof field in Mauritania, the project should incorporate the lessons from its nearby Chinguetti project. This includes undertaking an integrated Environmental and Social Impact Assessment, paying full regard to the importance of the marine ecosystem, and committing to no gas flaring. We also recommended that the company should produce a sustainability report, which it subsequently announced it will do.

When asking nicely doesn’t work: filing a shareholder proposal at CVS

Despite our best efforts to engage companies in constructive dialogue, some resist calls for transparent reporting of environmental, health and safety management systems. Such was the case with national US drug store chain **CVS**. After repeated fruitless attempts to learn how CVS managed sustainability, F&C filed a shareholder proposal, formally requesting a sustainability report. As a consumer-facing company operating in a sector where its competitors, including Wal-Mart and Target, either report or have committed to do so, CVS lags its peers. The threat of inviting the entire shareholder base to opine on this issue appears to have induced CVS to reconsider its disclosure policy. The invitation to dialogue remains open, and F&C will re-evaluate whether to present the shareholder proposal at the May annual meeting depending on progress.

As the planet fries, a thaw at ExxonMobil

After years of persistent pressure from F&C and others, **ExxonMobil** has shifted its position on climate change: it has moved from fervently opposing any and all forms of government control of greenhouse gases to actively engaging in the debate over which market-based mechanisms are preferable. Sadly for ExxonMobil, the company has entrenched its reputation among environmental organisations as a “Number One climate villain”, and will face an uphill battle to win over its critics. While the company has not quite made the leap that some in the oil and gas sector have in adopting a leadership role in solving the climate crisis, it does appear to be taking more positive steps to engage in the public conversation about the future of climate legislation in the US, namely by weighing the pros and cons of a flat carbon tax versus a cap-and-trade system. As part of this long overdue move, the company also appears to have suspended funding to several advocacy groups notorious for their denial of climate change and promotion of so-called “junk science.” For a company with a strong record on environmental health and safety performance, this move is a welcome change in aligning its public policy activity with its highly-respected approach to environmental management.

We said...

“...we remain concerned about the company’s support of organizations that are actively undermining the debate about climate change by questioning well-established science... we see that your membership in these groups is consistently reinforcing your negative image as a climate sceptic and impeding your efforts to be seen as a company striving for creative, long-term climate solutions.”

Excerpt of letter from F&C to ExxonMobil, 9 June 2006

“In Washington, business opposition to global-warming legislation is melting faster than the polar ice caps.”

Wall Street Journal, “Why Key Executives are Warning to Legislation on Climate Change,” 7 February 2007

[Chairman and CEO] Mr. Tillerson acknowledged a small role for alternative fuels in the future, saying he thought that ethanol and other types of biofuels have “an important role to play” given the projected growth in energy demand. He poked fun, however, at ethanol, calling it “moonshine.”... “I don’t have a lot of technology to add to moonshine.”... “The risks to society and ecosystems from climate change could prove to be significant,” [he] said. “So, despite the uncertainties, it is prudent to develop and implement sensible strategies that address these risks.” But at the end of speechmaking and answering questions, Mr. Tillerson expressed concern that policy makers could damage the world economy with precipitous environmental policies. He warned that future generations could be sorry for hasty policies taken today without more careful study.

New York Times, “Exxon Chief Cautions Against Rapid Action to Cut Carbon Emissions,” 14 February 2007





Focus on Human Rights and Business

Our objectives

Encourage companies operating in areas subject to weak rule of law, conflict or significant incidence of human rights abuses to manage the risks to their business through the adoption of:

- Human rights policies across international operations, subsidiaries and joint venture partners
- Guidelines for managing the security of employees and plant
- Procedures for community consultation, including indigenous groups
- Contributing to stabilising local conditions as agents of economic growth and through direct engagement with political entities.

Engagement by F&C

Human Rights have clear implications for profitability across the industrial spectrum, from the oldest of 'Old Economy' businesses like mining, to the newest providers of intangible services like Internet. F&C has led the way in engaging intensively with both these sectors.

Hollywood gets in on the act

As Al Gore's Oscar-winning *An Inconvenient Truth* capped a frenzy of media and government attention to climate change, Hollywood likewise discovered Human Rights, with the release of *Blood Diamond*, its latest blockbuster on 'conflict diamonds'. The film highlights the chaos enveloping Sierra Leone in the 1990's, as blood diamonds fed off and perpetuated the country's brutal civil war. "Blood" or "conflict" diamonds are the illicitly-mined and traded gems that have funded vicious conflicts in Africa and led to some of the world's most serious human rights abuses. Sierra Leone, along with countries such as the Democratic Republic of Congo, Angola and Colombia, are home to much of the world's still-untapped mineral wealth, yet remain extremely unstable and risky places to do business. F&C's engagement has particularly focused on the mining companies involved in securing key mineral rights and land in these weakly-governed regions.

F&C Acts: Update on sustainable mining

F&C's mining sector engagement has concentrated on how companies can develop sustainable and profitable operations, while still contributing to stabilising local conditions marked by conflict and weak enforcement of the rule of law. Two of the biggest challenges lie in maintaining good relations with local communities throughout the lifecycle of a project, and ensuring the safety and security of staff and physical assets.

Safety and security:

Mining companies face particular challenges where their security procedures involve relying on local or government security forces in countries with weak governance. In the light of numerous allegations of misuse of force and human rights violations, and consequent accusations of complicity on the part of the companies that rely on these forces, F&C

has engaged mining companies to develop strict guidelines for managing security. While most major mining companies have signed the Voluntary Principles on Security and Human Rights¹¹, F&C has turned its attention to encouraging companies to develop systems that translate this commitment into action. In particular:

- Following F&C's recommendations, **Lonmin** has improved its transparency with regard to security personnel selection, training and monitoring. The company now requires all security personnel to receive human rights training, including specific procedures for searching, charging and arresting individuals. The company also extends these training programmes to the local community to promote effective self-policing.
- **Freeport-McMoRan's** use of Indonesian military units at its mines has been the subject of significant controversy and an ongoing investigation for possible breaches of the US Foreign Corrupt Practices Act (FCPA) due to its relationship with the Indonesian military. In 2006, **Freeport** made the decision to utilise local police forces for its security instead of national army troops, in the hope of exercising greater influence over their actions. F&C has encouraged the company to provide training to all security personnel and ensure that it has effective community grievance mechanisms to help monitor the security forces' compliance with good practice. The company is currently implementing these systems, with a commitment to have them in place by the end of 2007.
- F&C has encouraged **BHP-Billiton** to extend its human rights awareness-raising programmes, which it has piloted at five operational mines, to exploration sites, as these sites have traditionally been the most vulnerable to security abuses. F&C has also recommended that the company disclose information regarding its recruitment, training and monitoring of security forces.

Community relations:

Mining operations can lead to displacement of vulnerable communities and associated unrest as companies explore for new assets. F&C has therefore been engaging companies

with a view to ensuring that the great economic benefits of mineral extraction, as well as metals processing, can be compatible with sustainable development. As a result:

- **Anglo American** has developed detailed policies and procedures aimed at minimising disruption to local communities and ensuring extensive consultation with those most affected. Other companies, however, such as **BHP-Billiton** and **Rio Tinto**, demonstrate less experience in such processes. While **BHP-Billiton** has recently responded to F&C's recommendation to introduce a new management standard addressing community displacement, F&C still awaits **Rio Tinto's** response.

Keeping watch on the 'juniors':

While the major mining companies have been scrutinised for their environmental, social and governance practices for a number of years, during 2006 F&C also turned its attention to the 'juniors' such as **Anvil Mining, First Quantum, Hochschild Mining** and **Peter Hambro**. F&C believes that engagement with these companies is essential, not only because their practices significantly lag the 'majors', but also because they own valuable assets that are likely to see them entering into joint ventures with the majors in the future or even becoming possible acquisition targets.

We said...

“Implementation of appropriate community consultation processes and solidifying relations with local communities from the earliest phases of the project is crucial to its long-term success... We encourage you to consider providing more information on these projects in your reporting... to provide investors with additional reassurance that the risks associated with operating in what are often perceived as difficult countries have been addressed.”

Extract of letter from F&C to Rio Tinto, May 2006

New technology – New human rights risks

Above ground and up in the ether, technology is also confronting the spectre of Human Rights, through its dual role in exposing customers to privacy threats and limiting individuals' access to information. This has sparked scrutiny from human rights watchdogs and the US Government alike, prompting industry giants such as **Google** to double up on efforts to lobby government to promote free Internet speech. F&C's recent report, *Managing Access, Security & Privacy in the Global Digital Economy*, highlighted the serious challenges and dilemmas faced by the technology, media and telecommunications (TMT) sector faces in responding to access, security and privacy risks. The study also identifies emerging areas of good practice, and has resulted in F&C presenting at a recent US State Department Conference and joining a multi-stakeholder initiative to bring together industry, civil society and academia to develop a response to these issues.

F&C Acts: Access, Security & Privacy (ASP) study opens doors

Principles for Free Expression and Privacy

F&C is the only European-based investor participating in the development of a set of voluntary *“Principles for Free Expression and Privacy”* that aim to establish a common set of standards for TMT companies operating in countries where freedom of expression and privacy lack adequate protection. Participants include **Google, Microsoft, Yahoo!** and **Vodafone**; leading human rights non-governmental organisations (NGOs), US investors and academics. As there are currently very few clear and pragmatic guidelines governing free expression and privacy on the Internet, F&C anticipates these *Principles* becoming the *de facto* standard for companies operating in a sector experiencing growth around the world. F&C is alerting TMT companies to these emerging guidelines and encouraging them to participate in their development, to ensure that they are workable in a business context.

US State Department Conference on Global Internet Freedom

In 2006, the US State Department established the Global Internet Freedom Task Force to monitor and advance Internet freedom around the world and tackle the challenge of Internet censorship. F&C was invited to speak on the investment impacts of Internet censorship at a high-level State Department conference attended by diplomats, corporate representatives, NGOs, representatives of Congress and industry trade organisations.

F&C emphasised the economic benefits of Internet freedom, and noted the significant business risks and opportunities that exist for companies seeking to do business online. F&C stressed the need to balance online security and privacy with free access to information, in order to create a trustworthy environment for online users. **Microsoft, Google** and **Yahoo!** also presented at the conference and called on the US government to support free expression and privacy in diplomatic relations with foreign governments.

F&C distributed its ASP study to conference participants and will continue to inform legislators, diplomats and other government representatives on the business implications of global Internet freedom.

“...the battleground on which the fight between freedom of information and censorship is now fought is corporate..... Information wants to be free, but does not always get the choice. When the internet operates as intended, censorship of anything from political tracts to sex tapes is difficult. But when those companies that provide pipes, routers, servers and internet services co-operate with governments, it can be done. Those who favour freedom should not let them co-operate lightly.”

Financial Times, “Cyberspace freedom is a tangled web”, 15 March 2007



Letters from China: Report on F&C's trip to Beijing

Our objective/s

- Engage Chinese companies and regulators on environmental, social and governance issues, so as to engage them in the process of building a more sustainable global economy.

Background

Pollution cloud over the economic miracle

Along with a sharp increase in living standards, China's unprecedented economic growth over the past decades has brought a deepening environmental crisis and an ever-widening gap between haves and have-nots. China is set to become the world's biggest emitter of greenhouse gases by 2009, even as it has failed to meet its own five-year targets for energy efficiency per unit of economic output. While China's one-child policy has curbed overpopulation, it has bequeathed a rapidly aging society lacking a functioning social security system.

Now that foreign investors are allowed to acquire significant shareholdings in state-owned enterprises, portfolio investment in China is soaring. Chinese companies must comply with a raft of good practices guidelines; yet despite advances, poor standards of transparency and accountability remain a major concern.

Engagement by F&C

Foreign investors seeking to enhance the value of their investments need to press for improvements in Chinese governance practices by actively exercising their voting rights, and engaging with regulators and custodians to overcome obstacles, argued F&C at the **Asian Corporate Governance Association's** annual conference in Beijing in October 2006. F&C then met with several Chinese companies to raise specific concerns on a one-to-one basis.

Who's minding the store?

F&C met with **China Construction Bank** and **China Sun Biochem** to highlight the need for greater board independence, because boards are less able to fulfil their vital oversight function if controlled by insiders. We likewise met with **Ping An Insurance Group** to encourage it to have an audit committee composed entirely of independent non-executive directors.

Playing by global rules in the global marketplace

The ongoing reform of the domestic banking system will transform China, not least because foreign banks entering the market will raise levels of competition and introduce new credit assessment practices. F&C encouraged **Bank of China** to adopt the Equator Principles, as well as to allocate board level responsibility for environmental, social and governance matters, especially given the board directors' experience at other Banks.

Chinese banks are aggressively expanding abroad, competing head-on with multinational banks – most notably in Africa, where they have been criticised for an apparent

willingness to offer 'soft loans' with minimal oversight of borrowers' governance practices. This has sent shudders through multilateral and commercial lending markets, as critics claim that China's no-strings-attached financing of African infrastructure projects is often proffered as the *quid pro quo for scarce oil and mining assets, and potentially undermining efforts to promote wider transparency efforts, including the Extractive Industries Transparency Initiative (EITI)*. In its capacity as Board member and the leading financial community proponent of the EITI, F&C met with **Petrochina, China Oilfield, CNOOC, and Sinopec Shanghai Petrochemical** to encourage them to lend their active support to the EITI. Responses from the companies have ranged from non-committal to cautiously supportive.

Shining a light into the black box

With a few exceptions such as **CNOOC** and **Petrochina**, Chinese companies do not publish CSR reports, so F&C recommended that **Tianjin Capital Environmental Protection and Aluminium Corporation** report on the management of significant ESG risks. In light of the growing spread of HIV/AIDS within China, we encouraged **China Shenhua** and **China Life Insurance** to assess the potential risks to their business posed by the disease. We stressed the need for clear climate change policies to **Huaneng Power**, and recommended that **China Telecom** close the gap with its global peers by addressing social and environmental aspects in its supply chains and join the Global e-Sustainability Initiative (GeSI).

“Foreign strategic investors have a crucial role to play in upgrading the standards of corporate governance in China's state-owned enterprise. [...] They should actively participate in the ongoing governance debate in China the better to safeguard their own investments and to help state-owned enterprises move closer to international best practice. While a confrontational push for a major change of direction will achieve little, constructive input on how to move forward step by step can create real momentum for change.”

The McKinsey Quarterly 2007/1, "China's State-owned enterprises: Board governance and the Communist Party", Richard He Huang and Gordon Orr.



The Principles for Responsible Investment (PRI) From Theory to Practice

An important development in 2006 for the investment industry was the launch of the UN Principles for Responsible Investment (PRI). The PRI were designed to provide guidance to the institutional investment community on the incorporation of environmental, social and governance (ESG) issues into investment processes. As a pioneer in sustainable investment since 1984, F&C was one of the first signatories to the PRI. To date, the Principles have been signed by asset owners and investment managers representing more than \$5 trillion in assets under management. F&C has published a detailed note outlining how its systems, developed and improved over the last three decades, translate the six Principles into practice. A summary is provided below.

F&C's implementation of the six Principles

1. Incorporating ESG into investment analysis and decision-making processes

- As one of eight members of F&C's Investment Division Management Committee, the head of the Governance & Sustainable Investment (GSI) team reports directly to the Head of Investments, and works closely with other team heads to shape the group's overall fund management processes
- F&C's GSI team numbers 15 professionals exclusively dedicated to research, voting and shareholder engagement
- F&C's *Research Connectivity* process promotes communication between Equity, and Fixed Income and GSI research teams through a single shared research database and joint attendance at company meetings
- The GSI team awards over 5% of F&C's global broker commission pool and quarterly broker votes to reward high-quality, systematic ESG research coverage from sell-side analysts

2. Being active owners and incorporating ESG issues into ownership policies and practices

- Through *reo*[®], F&C leverages its share ownership position in companies to promote improved business performance through adoption of better ESG practices
- Since 2000, F&C has exercised its global voting rights across its entire holdings of over 4,000 companies across 50 countries, and publishes detailed monthly voting records on its website
- The GSI team produces thought-leading global and country-specific corporate governance policies, which are revised annually

3. Seeking appropriate disclosure on ESG issues by the companies in which we invest

- **A Vote with a Voice™** involves ongoing communication with investee companies, including advance notice of F&C's voting policies and intentions, reinforced by correspondence to explain specific votes against management following all annual meetings

- Participation in key public policy development through submissions to regulators, legislators and trade associations in the UK, US and European Commission on narrative reporting and disclosure; and development of important regional corporate governance codes including Australia, Japan and Russia

4. Promoting acceptance and implementation of the Principles within the investment industry

- Participation in more than 11 key investment industry bodies, including the ABI Investment Committee, the Advisory Committee of London Stock Exchange Primary Markets Group and the UK Social Investment Forum (UKSIF)

5. Working together to enhance our effectiveness in implementing the Principles

- Participation in numerous corporate or multi-stakeholder initiatives and networks to bring about more sustainable government policies and corporate practice, including the Corporate Leaders Group on Climate Change (CLGCC), the Board of the Extractives Industries Transparency Initiative (EITI) and the Working Group for Principles on Freedom of Expression & Privacy in the technology sector
- Participation in more than 12 joint international investor networks and initiatives to promote good governance and sustainable investment, including: International Corporate Governance Network (ICGN) and the Council of Institutional Investors (US)

6. Reporting on our activities and progress towards implementing the Principles


- F&C's responsible ownership philosophy is summarised in its *Policy and Principles for Corporate Governance* publication
- F&C's unique *Annual Voting and Governance Report* contains analysis of global voting results and discussion of F&C's position on key governance trends and challenges
- F&C was the first UK asset manager to provide full public disclosure of all global voting records on a monthly basis


Products

F&C offers a wide range of investment opportunities for pension funds, charities, financial institutions, corporations and other organisations. We offer segregated and pooled portfolio management through a range of onshore and offshore vehicles. These cover developed and emerging markets in equity, bond, cash and property funds.

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Important information. All data is as at 31 March 2007 unless otherwise stated.

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