

reco[®] Report

F&C Investments

1st Quarter 2009



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 - Regulatory reform: Baby v. Bathwater
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- Labouring the point: What have 10 years of labour standards engagement delivered?

F&C
Investments

Expect excellence

Our philosophy

reo® stands for responsible engagement overlay

- Leveraging our clients' share ownership position to encourage companies to improve long-term business performance through better management of environmental, social and governance (ESG) risks
- Exercising our influence through voting and engagement, drawing on the skills of one of the largest specialist teams worldwide
- Implementing in full the UN Principles for Responsible Investment (PRI)

Why this report?

Our obligations to you

F&C represents you when speaking with companies about their environmental, social, and governance (ESG) practices. Your provider of pensions and investments has entrusted us with your portfolio, and tasked us with ensuring that the companies you hold adopt responsible practices and run their business with an eye to success over the long term.

As your representative, we have an important obligation to you – 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, including those related to ESG factors; and
- 3 protect financial returns over the long-term.

What does this mean in practice?

This means that as your representative, we engage in direct face-to-face dialogue with senior management of the companies in your portfolios, listen to what they have to say, communicate your concerns – and, when necessary, challenge them to do better.

This generally also means exercising our voting rights – your voting rights – at the annual and extraordinary shareholders' meetings of over 3,000 companies around the world.¹

Transparency: It cuts both ways

Just as we expect transparency from companies as part of their obligations as responsible corporate citizens, you should expect no less from us. As the ultimate owners of the companies in your savings and pensions portfolios, you are entitled to know what companies are doing in your name with the money you have entrusted to them – and you should likewise know how we have represented your interests in exploring these questions.

At F&C, we take our obligations to you very seriously. With this quarterly report, we tell you how we have asked questions and spoken up in your name to ensure that companies know and act on the concerns of their shareholders. An electronic copy of this report can be found at: www.fandc.com/gsi

reo® is operated on behalf of:



F&C in the spotlight...

“ The events of the last few months have confirmed that the soaring pay packages for top bank executives were driven by extraordinary risk-taking rather than real sustainable profits. Investors can be part of the solution, by spotting red flags and using their influence as shareholders to press for better governance practices. Now investors are faced with their next challenge: companies scrambling to raise capital in ways that neglect the rights of existing shareholders. We anticipate that our scrutiny of companies' activities will lead us to take a harder line in 2009 in many areas, to protect our investments and promote better governance practices. ”

Karina Litvack, quoted in *Professional Pensions*, 24 February 2009



Karina Litvack
Head of Governance
& Sustainable Investment,
F&C Management Ltd

In this report...

F&C is committed to promoting compliance with the principles of the UN Global Compact. Readers of this **reo**® report can look for the ♦ symbol to see where our engagement has covered the UN Global Compact Principles on Human Rights, Labour Standards, Environment and Anti-Corruption.



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Quarter in Review

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Company	Countries	Company	Countries	Company	Countries	Company	Countries
Alpha Bank	GR	Credit Suisse	CH	Lloyds Banking Group	UK	Société Générale	FR
Bank of America	US	Deutsche Bank	DE	Marubeni	JP	Standard Chartered	UK
Barclays	UK	Exxonmobil	US	Mitsubishi	JP	Tokyo Electric Power	JP
BBVA	ES	Goldman Sachs	US	Mitsui	JP	Total	FR
BNP Paribas	FR	GOME Electrical Appliances	HK	Morgan Stanley	US	UBS	CH
BP	UK	Hewlett Packard	US	National Bank of Greece	GR	Unicredit	IT
Bridgestone	JP	HSBC	UK	Occidental Petroleum	US	US Bancorp	US
Chevron	US	Intesa SanPaolo	IT	Royal Dutch Shell	UK	Wells Fargo	US
Commerzbank	DE	JPMorgan	US	Santander	ES		

Governance Australia

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Company	Countries	Company	Countries	Company	Countries	Company	Countries
Arrow Energy	AU	Leyshone Resources	AU	Sonic Healthcare	AU	Valad Property	AU
Billabong	AU	Queensland Gas Co	AU	Telstra	AU	Westfield Group	AU
Commonwealth Bank of Australia	AU						

Governance Emerging Markets

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Company	Countries	Company	Countries	Company	Countries	Company	Countries
China Mobile	CN	Novatek	RU	Samsung Electronics	KR	Sibir Energy	RU
LUKoil	RU	Rosneft	RU	Satyam Computers	IN		

Environmental Climate Change

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Company	Countries	Company	Countries	Company	Countries	Company	Countries
Banco Itaú	BR	E.On	DE	Novatek	RU	Rosneft	RU
BM&F Bovespa	BR	Exxonmobil	US	POSCO	KR	Ryanair	IE
BMW	DE	Natura Cosméticos	BR	Reliance Industries	IN	Total	FR

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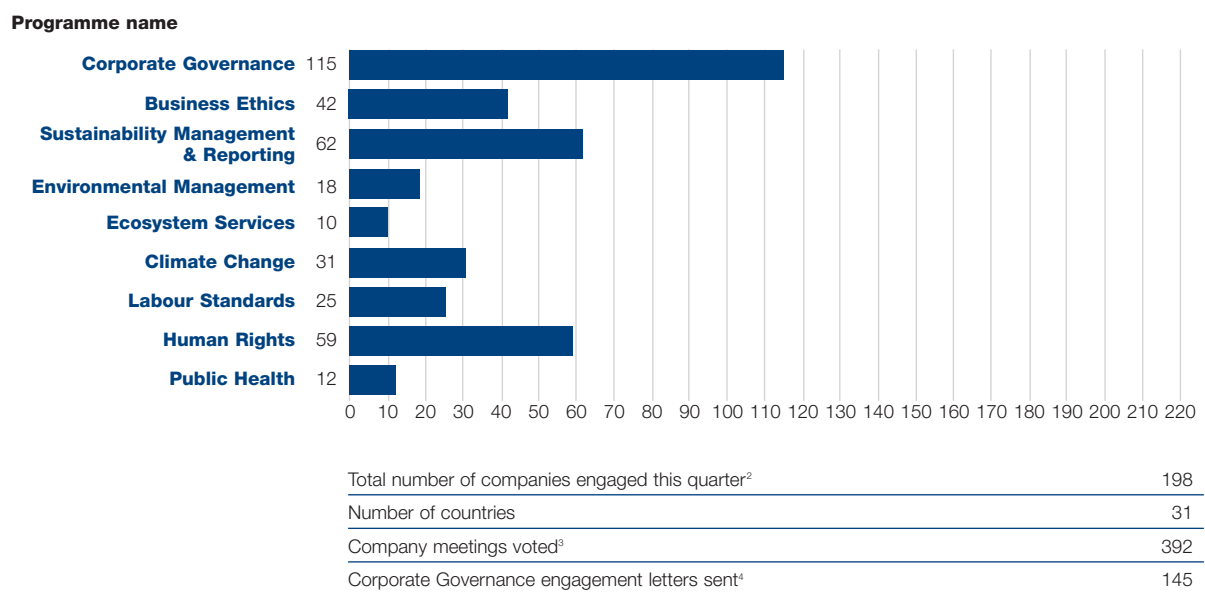
Company	Countries	Company	Countries	Company	Countries	Company	Countries
Abercrombie & Fitch	US	Esprit	HK	Lexmark	US	Ports Design	HK
Adidas	DE	Folli-Follie	GR	Lojas Americanas	BR	ST Microelectronics	CH
Apple	US	GAP	US	Mothercare	UK	Tullow Oil	UK
Arcelor-Mittal	LU	H&M	SE	Motorola	US	Wal-Mart	US
BP	UK	Hewlett-Packard	US	Nabors	US	William Demant	DK
Capital & Regional	UK	Kingfisher Group	UK	Nike	US	Yamaha	JP
Dell Inc	US	Land of Leather	UK	Nvidia	US		
EMC	US	Lend Lease	AU	Pepsico	US		

Activity report: How *reo*[®] helps implement PRI

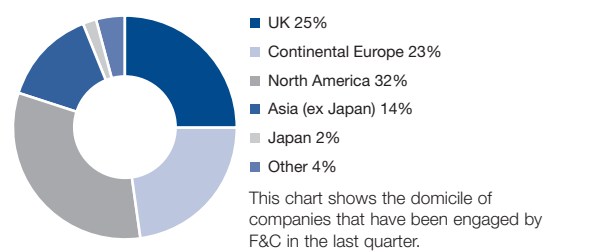
F&C's responsible engagement overlay is unique in the depth and breadth of its engagement, and in its ability to help clients implement the UN Principles for Responsible Investment (PRI). Key features are:

- A 16-person team of Governance & Sustainable Investment 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

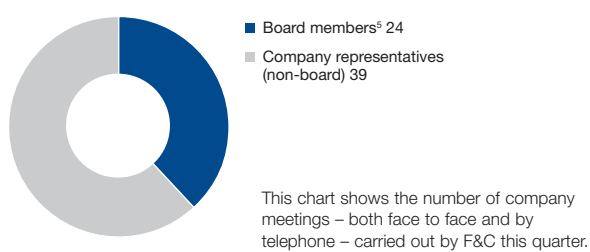
Number of companies engaged this quarter



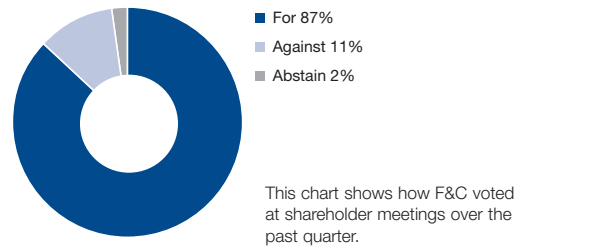
Geographical spread



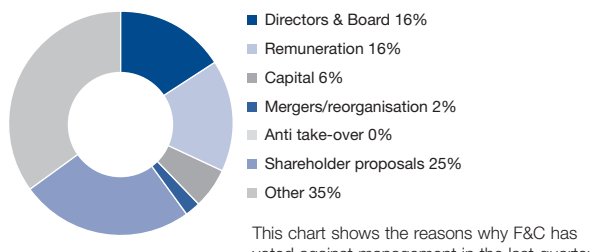
Number of company meetings



Resolutions at shareholder meetings



Reasons for VAMs



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 Data refers to the period from 01/12/08 to 28/02/09.
⁵ Includes Named Executive Directors in the US.



Quarter: In review

Global Round-up



Talking up Canadian tar sands in Paris

F&C met with **Total's** Head of Americas division in Paris to discuss how the oil company was addressing political and environmental challenges associated with its oil sands business. Our discussions, forming a part of our ongoing engagement work with oil sands operators, centred around Total's strategy for: greenhouse gas emissions[♦]; the impacts of new regulations; engagement with local communities across its global oil sands operations[♦]; and biodiversity issues such as land reclamation.[♦]



Convening with conglomerates in Japan

F&C headed to Japan under the auspices of the Asian Corporate Governance Association to meet with representatives of the government, stock exchange and major companies. We discussed the recommendations of the Japan White Paper on corporate governance published in May 2008, which F&C co-authored.⁶ While in Tokyo, F&C held detailed private meetings with the managements of **Bridgestone, Marubeni, Mitsui, Mitsubishi, and Tokyo**

Electric Power; discussions focused on the companies' approach to corporate governance, climate change[♦] and human rights.[♦] Detailed outcomes of meetings will be reported to **reo**® clients in Q2 2009.



Heading East to Qatar: F&C continues its global EITI outreach

F&C joined political, business and civil society leaders, including the presidents of **Liberia** and **Botswana**, oil ministers of **Nigeria** and **Iraq**, and top executives from **BP, ExxonMobil, Chevron, Shell, and Total**, at the international conference of the Extractive Industries Transparency Initiative (EITI), in Doha, **Qatar**. Launched by Tony Blair in 2003, the EITI commits oil and mineral-rich developing nations to publishing audited accounts of their extractive revenues, and to engaging with civil society, in order to curb corruption and mismanagement.[♦] F&C represented some 80 global investment institutions with assets of over \$14 trillion, and outlined how greater transparency lowers risk for investors and drives down the cost of capital for both oil and mining companies seeking equity, and sovereign issuers seeking debt financing.

In other news:



Say on pay victory at Hewlett Packard

Following calls from investors including F&C, both **Hewlett Packard** and **Occidental Petroleum** announced that they would allow shareholders to cast a non-binding vote on executive pay policies and practices, starting in 2011 and 2010, respectively. F&C has been a leading advocate of "Say on pay" in the US since 2002, through direct dialogue with companies, a high-profile company-shareholder working group and consultation with the Securities and Exchange Commission. Amidst the backlash over soaring executive pay and its role in precipitating the crisis, these moves have raised expectations of greater board accountability on pay. F&C will publish further work on Say on pay in next quarter's **reo**® report.

boards to account. After lively debate, delegates had the opportunity to vote on key environmental, social and governance questions, with interesting outcomes: over 60% rejected caps on executive pay, but the same proportion also thought that equity holders in banks should, if necessary, have their investments written off entirely.⁷



Crunch time: What now for sustainable investment?

In February '09, F&C held a one-day conference in London to explore the implications of the credit crisis for sustainable investment. The event was chaired by Robert Jenkins, Chairman of F&C and of the UK Investment Management Association. His opening remarks challenged participants to learn the right lessons from the crisis, and to hold company



F&C's Chief Executive testifies before UK Parliament on the financial crisis

F&C Chief Executive Alain Grisay testified before the Treasury Select Committee of the UK's House of Commons in February 2009. He informed Members of Parliament how F&C had responded to the unprecedented conditions in the financial sector – and what lessons could be learnt to avert future crises. Grisay outlined F&C's actions to encourage sensible pay packages for top banking executives, which events have now demonstrated drove the extraordinary risk-taking that led to the current crisis.

[♦] This symbol indicates that F&C's engagement has covered the UN Global Compact Principles.

⁶ To see the full Japan White Paper, visit the F&C Literature page and click 'reo® publications': <http://www.fandc.com/new/Institutional/Default.aspx?id=80622#81279>

⁷ Video webcasts of the conference are available in F&C's website, <http://www.fandc.com/new/institutional/Default.aspx?id=89317>



Quarter in Review: Engagement highlights

Protecting shareholders in a downturn: No backpedalling please!

Following some very good progress over the last two years, regulators in Asia Pacific are facing increasing pressure from companies to relax governance standards and give them more room to manoeuvre in light of the downturn. However, F&C believes that now of all times, maintaining good governance principles is essential to safeguard investor trust and ensure companies get the support they need to weather the storm.

In 2007, Hong Kong was ranked as having the best corporate governance regime in the region⁸ – so F&C was alarmed to discover that the Hong Kong Exchange & Clearing (HKEx) was set to water down amendments aimed at curbing insider trading, following significant pressure from corporate issuers. Historically, directors in Hong Kong have been prevented from trading in the 30-day window prior to publishing their annual results – the so-called ‘director black-out period’. Following comprehensive public consultations in which F&C participated, HKEx announced a revision to the listing standard in November 2008 that would extend the director blackout period to cover the full window between the end of the financial year and the publication of the annual report. Given that Hong Kong-listed issuers sometimes

allow that period to stretch to as long as four months, the opportunities for inappropriate insider dealings are rife. But in early 2009, the HKEx suspended implementation of this new rule.

F&C wrote to the regulator urging it to retain the amendment as trading on insider information seriously undermines trust in markets and drives down valuations.⁹ Recent examples illustrate the destructive impact of insider trading: in November 2008, **GOME Electrical Appliances** shares were suspended from trading after its Chairman was arrested for stock price manipulation. Since then, the stock has fallen to near zero and was de-listed from the FTSE All-World index. F&C therefore strongly supports measures such as the director blackout period that deter such behaviour and bring Hong Kong-listed companies into line with global standards.

In late February, the HKEx announced a compromise: while implementation of the director blackout period would only come into force in April 2009, it would rise from 30 to 60 days prior to publication of the annual results. While this backpedalling is disappointing, the modest tightening in the listing standard is a step in the right direction. We will continue to press the stock exchange and securities regulator to bring local governance standards into line with global good practice.

Amidst credit crisis, F&C gears up for bank AGMs

In a November 2008 position paper,¹⁰ F&C identified the fundamental governance failures that lay at the heart of today’s financial crisis, and outlined a plan of action for the future. Four key themes emerged that will form the core of our discussions with banks: disposal of toxic assets and recapitalisation; reform of incentive structures to ensure pay-for-performance and appropriate risk-taking; more robust boards that hold executives to account; and regulation that sets good governance standards, encourages greater transparency, yet still allows for competition.

As media headlines alternate between ever-gloomier economic forecasts and ever-harsher condemnation of banks, F&C has focused on learning the right lessons from the global crisis. Alongside obvious failures – by bank risk managers, boards and regulators – investors too, are beginning to acknowledge the stronger role they could have played in holding companies accountable. Many classic warning signs were visible, in the form of weak boards and poorly-structured pay policies, which F&C and several others contested vigorously. But the fallout from the bursting of the credit bubble highlights that these efforts, however prescient, were not enough to avert the crisis that has engulfed global markets and pulled the ‘real economy’ down with it. Active share ownership must be practised by a much broader slice

of the market, and must form part of a comprehensive set of reforms undertaken at corporate and regulatory levels.

In that spirit, in advance of the 2009 annual general meeting (AGM) season, F&C wrote to over 20 of the largest global banks in its client portfolios to outline its key concerns and expectations regarding governance reform. We encouraged them to address our specific concerns in their proxy materials, and warned that our voting would reflect our assessment of progress made in correcting past weaknesses. The count-down to what is likely to be a controversial and high-profile voting season has begun.

Banks contacted during Q1:09

Alpha Bank	JPMorgan
Barclays	Lloyds Banking Group
Bank of America	Morgan Stanley
BBVA	National Bank of Greece
BNP Paribas	Santander
Commerzbank	Société Générale
Credit Suisse	Standard Chartered
Deutsche Bank	UBS
Goldman Sachs	Unicredit
HSBC	US Bancorp
Intesa SanPaolo	Wells Fargo

⁸ CG Watch 2007 published by CLSA and the Asian Corporate Governance Association, 17 September 2007

⁹ A recent report by broker CLSA highlights insider trading as one of the most telling signs of potential fraud or accounting irregularities. See Forensic Accounting: Special Report, CLSA, 25 February 2009

¹⁰ “Banks and the Credit Crunch – where do we go from here?” F&C, November 2008 is available on our website at www.fandc.com/governance



Outlook for 2009

Overview

F&C had predicted that 2008 would be a year of reckoning, as the credit crunch fed through into the real economy. But the scale of what happened took us, and the world, by surprise. Few predicted the mass bankruptcies, government bail-outs and precipitous lurch into recession that we have seen.

This transformation in economic circumstances also means a shift in the landscape for sustainable investment. Questions about corporate governance, previously seen as the preserve of the specialist, have moved centre stage. Yet at the same time, there are risks that companies fighting for survival will see sustainability management as an unaffordable luxury. F&C will be watching closely to see how these forces play out – and reminding companies that good management of environmental, social and governance risks will make them more resilient to the ups and downs of the global economy.

Regulation not suffocation

The speed and scale at which the financial crisis took hold points to systemic failings at the heart of the financial regimes of the world's major economies. As the crisis laid bare weaknesses in public oversight mechanisms, there is an obvious temptation to intervene via new regulation. However, while a fresh look at failed policies is needed, F&C believes caution is essential to avoid an excessive swing of the pendulum that attacks the symptoms but fails to address the causes.

Policymakers need to design regulatory regimes that will support long-term, sustainable growth in the financial sector, while more actively controlling systemic risk. That means making regulation smarter, not just tougher, and avoiding the temptation to make rushed, ill thought-out changes in response to public opinion or political pressure.

- F&C will actively use its influence to engage with regulators, seeking to ensure that regulatory reform is supportive of investor rights and long-term value creation

They said...

“ We've realised the disadvantages of getting it wrong are hugely bigger than the benefits you can get from attracting some business ”

Lord Turner, Chairman, UK Financial Services Authority
'FSA faces fight to regain global reputation', *Financial Times*, 19 March 2009.

States take a stake

The dramatic bailouts and recapitalisations of financial institutions throughout Europe and North America in 2008 reflected the urgency of ensuring liquidity and solvency in the midst of extraordinary market conditions. While the initial impact of this funding was to ensure greater near-term stability, it does raise questions about how the rights of minority shareholders will be respected when governments dominate the shareholder register.

For banks that have gone the route of partial state ownership, questions will grow about how governments will use their influence as owners. We believe that governments will recognise this reality, and accept that with the priority being to restore the economic system as a whole, it may take much longer than originally envisaged to get the banks back into a healthy enough shape to sell back their stakes to the private sector. The challenge for the banks' management is to strike the right balance between preserving value for investors, contributing to a revival of the broader economy on which investors' overall performance depends, and steering clear of political point-scoring as painful write-downs inevitably play a part in flushing toxic assets off their books.

- F&C will urge boards to be explicit about how they are balancing potentially competing interests, and protecting minority shareholder rights

Reforming the bonus culture

The crisis in the banking sector has highlighted the flawed 'bonus culture' that has seen rich rewards paid out over time frames that were not aligned to the period of value realisation for investors. The challenge is now for banks to develop appropriate incentive structures in light of the painful lessons learned over the last year, without compromising competitiveness.

Any reform must involve engagement that is carried out in a comprehensive and systematic manner with companies, investors and regulators; the aim is to devise rational systems that strike the right balance between attracting and retaining strong performers, while ensuring full alignment of interests between owners and managers.

No company can be expected to adopt practices that place it at a competitive disadvantage in the market for talent, so we need new best-practice norms that are broadly accepted across the industry. Shareholder scrutiny is vital in ensuring that reform sticks, and efforts to give shareholders in the US and elsewhere a "say on pay" must be redoubled to allow them to play this role.

- F&C will continue to encourage companies to give shareholders a vote on remuneration, and will seek opportunities to work with the new US Administration in making "say on pay" a regulatory requirement
- We will work with remuneration committees in investee companies as they seek to learn the lessons of the credit crunch and put in place more robust pay structures

Cutting costs, not corners

As the recession bites, companies looking to cut costs may see sustainability initiatives as an expensive optional extra. The tensions may play out most obviously in the hard-hit retail sector. As retailers slash prices and see sales volumes drop, they may feel less able to ask suppliers to implement environmental and social improvements. Yet these improvements can provide opportunities for cost savings – through improvements in absenteeism rates, for instance. And neglect of these issues carries a severe downside risk: retailers now can ill afford the kind of reputational hit that a scandal over child labour or poor working conditions can cause.

Overall, we believe that the economic downturn is likely to see a shake-out in sustainability practice. Forward-looking companies who understand how to make sustainability a profitable part of their core business will continue to make progress. Other companies, which have taken a more superficial approach, may now neglect the issue and fall further behind.

- F&C will encourage companies to demonstrate how they have incorporated sustainability as a key value driver for their core business strategy, rather than approaching it as a reputation-enhancing add-on

Averting a climate crunch

While the current crisis demands urgent attention, it is equally critical not to lose sight of other longer-term risks that have the potential to inflict serious damage to the global economy. The most urgent of these is climate change. Whilst the focus now must rightly be on preserving a viable, functioning global economy, the massive fiscal injections that form the cornerstone of government responses around the globe present an unprecedented opportunity to tackle the deeper environmental challenges that lie ahead.

The parallels between the credit crunch and the pending climate crunch are striking: both involve a failure of the market to recognise and adjust for clear warning signs of danger ahead. Just as alarm bells were sounded and ignored about excessive liquidity and the poorly-understood risk of complex derivatives, scientific evidence about the urgent need to tackle mounting carbon dioxide emissions has also been consistently dismissed or minimised. And as painful as this financial crisis promises to be, the next climate crisis could be far worse if we don't learn the right lessons about the destructive potential of market failure.

- F&C will continue to work with other investors and companies to call on governments to agree a bold plan of global action at the UN negotiations
- We will urge companies to develop effective climate change strategies, and prepare themselves for more stringent greenhouse gas regulations in the future



Focus on Corporate Governance: Australia

Our objectives

Enhance corporate governance standards in Australia in line with F&C's Corporate Governance Guidelines, with a focus on:

- Independent and balanced boards that safeguard investor interests
- Remuneration aligned with long-term value for investors
- Appropriate internal controls and risk management systems
- Improved levels of transparency and disclosure

Engagement by F&C

Report from down under

Australia's peak proxy voting season, which went into full swing at the end of 2008, saw F&C join in with increasingly active domestic institutional investors to press for improvements on the part of Australian corporates, especially given recently-introduced rules and guidelines that seek to raise the bar. The Australian Stock Exchange's (ASX) revised *Principles of Corporate Governance and Recommendations*¹¹ came into effect in January 2008, promoting an increased focus on risk management and internal controls, and a flexible "comply or explain" approach to corporate governance disclosure. This followed the 2007 launch of the Australian Council of Super Investors' (ACSI) Environmental, Social and Governance (ESG) Guidelines, highlighting the growing focus on sustainability issues, particularly climate change, across the Australian financial markets.

F&C's voting activity

During 2008, our voting activity reflected a hardening of our stance on key corporate governance standards, particularly disclosure and remuneration. We believe that with Australia's sound governance framework and mature capital markets, the time has come for companies to demonstrate that they are upholding good governance in line with international best practice, and for investors to hold them to account when they do not.

The numbers speak for themselves:

Total Australia: votes against management and abstentions ¹²	21% (2007: 16%)
Remuneration: votes against management and abstentions	38% (2007: 25%)
Board Structure: votes against management and abstentions	14% (2007: 16%)

As usual, whenever we voted against management or abstained, we followed up with a letter to each company to explain our rationale. Two key themes emerged:

Turning up the heat on pay for performance

After four years of voting and engaging with Australian companies on 'Say on Pay', we have seen limited progress – so this year F&C "took the gloves off" and voted against or abstained on 38% of votes. We are clearly not alone, as

the debate in Australia has now escalated a notch: spurred by public outrage at high pay packages in an economic downturn, politicians are debating whether votes on pay need to be binding to "have teeth". The UK experience suggests that non-binding votes can be effective in improving pay practices, provided companies voluntarily respond to investor discontent – but the jury is still out as to whether this can be replicated Down Under, and investor patience is being tested. Before resorting to this much harsher option, we believe all shareholders should identify and challenge weaknesses in pay plans, and vote actively and consistently where dialogue fails.

Our most common concerns, raised at companies such as **Billabong, Commonwealth Bank of Australia, Leyshone Resources, Queensland Gas Company, Telstra** and **Valad Property**, related to:

- Poor disclosure of performance metrics, making it impossible to assess their effectiveness;
- Weak performance conditions that failed to incentivise "pay for performance";
- Emphasis on short-term rather than sustainable long-term value creation.

Who's on board?

The question of appropriate balance and independence on boards, and especially key board committees, also continues to dog several companies, including **Arrow Energy, Sonic Healthcare, Westfield Group** where we voted against non-independent directors. We strongly believe that effective boards need to be majority independent, and that audit committee integrity is best preserved by full independence.

Next steps

After signalling our concerns on the ballot in 2008, we have recently written to **171 Australian companies** in our clients' portfolios enclosing F&C's updated Corporate Governance Operational Guidelines - Supplement on Australia and our annual Responsible Investment Report.¹³ Our letter laid out our key governance concerns –and also took this opportunity to raise another critical issue: as Australia recovers from deadly brush fires and its Parliament crafts the country's first-ever CO₂ emissions cap-and-trade system, we urged companies to ensure their business strategy positioned them effectively to address potentially stringent new climate change regulations.

¹¹ In 2007, F&C formally responded to ASX's consultation paper regarding the review of its Corporate Governance Principles. Our submission is on our website at: (<http://www.fandc.com/new/aboutus/Default.aspx?ID=82073>)

¹² F&C believes that an abstention is an important tool for investors on the ballot. We use it actively to signal our concerns and warn companies that, while we recognise that change can take time to implement, if progress is too slow, we will escalate to a vote against in subsequent years.

¹³ Available at: www.fandc.com/governance



Focus on Corporate Governance in Emerging Markets

Our objectives

Enhance corporate governance standards in emerging markets by:

- Exercising minority shareholder rights, specifically for companies with controlling shareholders
- Improving levels of transparency and disclosure, including on significant ESG issues
- Encouraging emerging market companies to improve their internal control systems and factor social and environmental risks into business planning
- Reducing bribery and corruption♦

Tempting growth, but minorities beware

As developed countries struggle under the weight of the global credit crisis, emerging markets are poised to play an increasingly important role in the global economy, and offer attractive investment opportunities thanks to their potential for high economic growth. But with these returns come significant governance risks.

The recent examples of India's **Satyam Computers** and Russia's **Sibir Energy** illustrate how unaccountable controlling shareholders can strip value away from minority holders. At **Satyam**, the company's Chairman and dominant shareholder stunned Indian markets by revealing a billion-dollar fraud that set investors wondering what other surprises lurked at fellow blue chip Indian companies. Similarly, AIM-traded **Sibir** used \$340 million of shareholder funds to purchase the distressed property portfolio of its 23% shareholder at inflated prices, defying protests from powerless minority investors and non-executive directors – and raising questions about the other reputational time bombs that may be ticking inside London's Alternative Investment Market.

Can investors press for change?

When the rule of law is weak, the courts corrupt and regulators ineffectual, there is little minority investors can count on to protect their interests. So can dialogue make a difference?

F&C believes investors must exercise their influence to drive **change**. Our recently-published report, **Corporate Governance in Emerging Markets: an Investor's Roadmap**,¹⁴ provides an overview of key governance risks in Brazil, China, India, Korea and Russia, and concludes with a simple framework for investor engagement. To deliver this message, we sent this report to nearly one thousand emerging market companies held in our clients' portfolios, and urged them to consider 22 good practice measures related to ownership structure, government relationships, shareholder rights, transparency and disclosure, board independence and effectiveness, and audit, control and risk management.

They said...

“The independent board members [of India's **Satyam Computers**] were supposed to defend the shareholders' interests, but they clearly didn't, in fact it seems they were looking after the chairman's interests.”

Premchand Paety, director of the Centre for Forecasting and Research consultancy in Delhi, *Financial Times*, 4 January 2009

Can engagement deliver results in emerging markets?

Specific examples of F&C's 2008 engagement in emerging markets included asking companies to:

- Address weaknesses in controls associated with related-party transactions;
- Bolster board independence;
- Implement business ethics systems that empower employees to resist unethical conduct;
- Explain how the board is monitoring compliance with ethics and legal standards;
- Make information on director candidates available in advance of the shareholders' meeting;
- Put directors up for election individually, rather than by slate;
- Publish a stand-alone corporate responsibility report;
- Factor environmental and social risks more actively in their strategy, risk management and business planning;♦
- Sign up to global initiatives such as the Carbon Disclosure Project, UN Global Compact♦ or the Extractive Industries Transparency Initiative.

For 2008, 71 emerging market companies have responded positively as expressed in terms of engagement milestones. For example, **China Mobile** has announced a three-year sustainability strategy,♦ **Samsung Electronics** has removed its Chairman, following his conviction for corruption,♦ and Russia's **Novatek** has expanded its board to accommodate new independent directors. Also in Russia, following our request, **LUKoil** and **Rosneft** have agreed to participate in international emissions trading programmes to generate revenues from CO2 emissions savings.♦

♦ This symbol indicates that F&C's engagement has covered the UN Global Compact Principles.
14 See <http://www.fandc.com/governance>



Focus on Climate Change

Our objectives

Encourage companies operating in Brazil, Russia, India and China (BRICs) to:

- Encourage adoption of clear, long-term government policies to facilitate a shift to a low-carbon economy
- Encourage companies to measure and minimise greenhouse gas emissions, and publicly report on their strategy to manage the risks and opportunities to their business posed by climate change.♦

Engagement by F&C

Background

2008 was a big year in climate change politics. The election of US President Barack Obama marked a turning point, ending the country's near decade of climate scepticism. After months of wrangling, the EU agreed a comprehensive Climate and Energy Package. China stepped forward as the flag bearer for emerging economies that must participate in any future treaty if dangerous climate change is to be avoided. All eyes are now on the critical United Nations climate change conference in Copenhagen in December 2009, as negotiators race to hammer out a successor agreement to the Kyoto Protocol.

At the same time, the economic downturn is inevitably having an impact on the evolution of climate change politics. Politicians are warier than ever of imposing costs on companies or consumers, focusing instead on energy efficiency measures that promise to save both carbon and money. Meanwhile, companies involved in clean technologies are facing capital shortages and delays – but the downturn presents opportunities too, as economic stimulus packages take on a decidedly “green” tinge.

F&C acts

F&C focuses its climate work on two areas: engaging companies in affected sectors, and engaging policymakers to facilitate carbon-friendly investment.

Engaging companies: who is ready for a low-carbon future?

As climate regulations ratchet up and the physical impacts of warming start to be felt, the impact of climate change is spreading across all sectors of the economy. With this in mind, when we wrote to 5,858 companies at the start of this year to set out our responsible ownership policies and practices, we urged all of them to develop climate change strategies in order to prepare for the inevitable effects of more stringent greenhouse gas regulations in the future.♦

In addition, we focused in on companies in sectors facing imminent climate change regulation – including transport and utilities. In the transport sector, we met the deputy CEO of low-cost airline **Ryanair** to discuss how the company was preparing to be included in Phase III of the EU Emissions Trading Scheme (ETS).♦ We also met with **BMW**, Europe's highest emitting carmaker, to understand how the company would meet forthcoming EU CO₂ targets.♦ The company has unveiled both a short and a long-term plan for reducing emissions from its fleet, with the long-term strategy of developing both hybrid and fully electric vehicles. The company's R&D effort is impressive – but they were relatively late in developing it, and questions remain about how successful the company will be in meeting the EU targets given that the bulk of their fleet is still likely to be composed of high-emitting vehicles.

The utilities sector continues to grapple with the enormous challenges posed by the ongoing use of coal. In the UK, the proposed construction of a new coal-fired power plant at Kingsnorth by German utility **E.On** has become a highly-charged political issue. We co-authored a group investor letter to the UK government, urging it to provide greater clarity on how ‘unabated’¹⁵ coal power generation could be consistent with the UK's greenhouse gas emissions targets.¹⁶♦ F&C had been discussing climate change strategy for some time with **E.On**, warning the company of the potential impact of new regulations on investment plans; following the investor letter and protests against the plant, **E.On** responded by itself asking the UK government to delay project approval until a consultation on carbon capture and storage (CCS) was complete, and has since submitted Kingsnorth as a candidate for a CCS demonstration project.♦

♦ This symbol indicates that F&C's engagement has covered the UN Global Compact Principles.

¹⁵ Unabated coal power generation refers to coal-burning plants that operate according to conventional technology that does not capture and safely dispose of emitted CO₂.

¹⁶ Letter from Institutional Investors Group on Climate Change to John Hutton, then Secretary of State for Business, Enterprise and Regulatory Reform, March 2008. Available at www.fandc.com/publicpolicy

Engaging policymakers: sustaining the momentum for change

F&C believes that regulatory clarity and certainty are essential to enable business to invest profitably in climate-friendly technologies, and that failure to act will cause serious economic disruption. Business must therefore be forceful and transparent in encouraging policymakers to stay the course for strong market-based action on climate change, despite the economic downturn.

They said...

“We know the country that harnesses the power of clean, renewable energy will lead the 21st century. And yet, it is China that has launched the largest effort in history to make their economy energy efficient. We invented solar technology, but we’ve fallen behind countries like Germany and Japan in producing it. New plug-in hybrids roll off our assembly lines, but they will run on batteries made in Korea. Well I do not accept a future where the jobs and industries of tomorrow take root beyond our borders – and I know you don’t either. It is time for America to lead again.”

Remarks of President Barack Obama to Joint Session of Congress, 24 February 2009

F&C speaks out in favour of sound, long-term climate legislation in collaborative initiatives, including the **Institutional Investors Group on Climate Change (IIGCC)**¹⁷ and the **Prince of Wales’s Corporate Leaders’ Group on Climate Change (CLG)**.¹⁸ We have supported the CLG in efforts to engage companies in emerging economies to become more involved in shaping public policy in their own countries.♦ Most recently, the CLG held a meeting in Brazil, which involved 30 business leaders in high-level discussions – including, at F&C’s suggestion, **Natura Cosméticos**, **BM&F Bovespa** and **Banco Itaú**. The leaders heard evidence from some of Brazil’s top climate change experts, and discussed how they might be able to support the government in developing strong, long-term policies.

We also met one-on-one with progressive companies in many emerging markets to urge them to work with their governments in developing climate policies. In India, we have been encouraged by the efforts of **Reliance Industries** to support the development of national climate change policies. We have urged companies in other emerging markets, such as Korean steelmaker **POSCO** and Russian oil and gas giants **Rosneft** and **Novatek**, to do the same.♦

Next steps

F&C focuses its climate work on two areas: engaging companies in affected sectors, and engaging policymakers to facilitate carbon-friendly investment.

In the year ahead, F&C will continue to push for strong climate change policies at the global and national levels. We will:

- Press for agreement to a robust global climate deal in Copenhagen in December 2009
- Support strong policies at national and regional levels, including plans in the US, Australia and elsewhere to set up national cap-and-trade systems♦

At the company level, we will:

- Continue to ask companies in affected sectors to develop a climate change strategy♦
- Encourage them to engage constructively in shaping public policy, and to disclose any lobbying or public policy activities that they are involved in♦

Recent developments: Obama’s ambitious climate agenda

In his first months in office, President Obama has made it clear that the transformation of America’s energy systems is a top priority. The fiscal stimulus package approved in February included \$43 billion in new spending on energy, including support for new technologies, such as advanced batteries and carbon capture and storage. Obama has now asked Congress to consider a national renewable energy target, and a national cap-and-trade scheme. The passage of legislation will be far from smooth, however, and there will be vigorous lobbying from high-emissions industries fearing rising costs.

F&C has been working to build political pressure for change: we wrote to US Congressional leaders, through the **Investor Network on Climate Risk**, to call for ambitious action on climate change, stressing that strong policies are essential to economic growth and prosperity.¹⁹♦ We have also been holding discussions with energy-intensive companies to discuss their role in influencing the fast-changing policy environment. We met the Head of Americas of **Total**, and the Chairman and Chief Executive of **ExxonMobil**, Rex Tillerson, to discuss their respective companies’ climate change strategy.♦ F&C welcomes the fact that both are, belatedly, taking a more constructive approach to the issue by accepting the need for some form of carbon pricing, but the real test will be whether this attitude prevails even if their preferred policy option – a carbon tax – is rejected by policymakers in favour of cap-and-trade.

♦ This symbol indicates that F&C’s engagement has covered the UN Global Compact Principles.

17 www.iigcc.org

18 www.cpi.cam.ac.uk/highlights/corporate_leaders_group_on_cli.aspx

19 Available at www.fandc.com/publicpolicy



Focus on Labour Standards in supply chains

Our objectives

F&C encourages companies to build secure and productive workplaces and supply chains through high labour standards,[♦] by:

- Adopting a code of labour standards based on the International Labour Organisation Core Conventions
- Developing a management system to implement the code
- Auditing compliance
- Working with suppliers to address long-term challenges
- Providing transparency

F&C Original Research

Risk Management in Suppliers' Factories: A view from 10,000 feet

Over the last decade, F&C has worked with companies to identify how labour practices affect economic performance, and how minimising labour risks in the supply chain can drive shareholder value. In its recent report,

Factory Labour Standards in Emerging Markets:

An Investor Perspective, F&C took a step back to assess the overall state of play for companies, examining both how 'standard practice' had evolved and improved, and what stubborn challenges remain. Experts agree that poor labour practices in factories around the world persist – from health and safety violations to excessive overtime and incomplete wages. However, we also noted increasingly robust efforts by name-brand industry leaders to attempt to reduce these risks. Through in-depth engagement with a number of companies in our client portfolios, we learned that:

- 1. The gap between the doers and the do-nothings is growing.** While many leading name-brand companies have robust labour standards programmes (e.g. **adidas** of Germany and **Nike** of the US), many companies have not taken even the first step of adopting basic supplier codes that follow international standards (e.g. **Ports Design** of Hong Kong and **Land of Leather** of the UK). We also found that medium-sized companies, those located outside of Europe and those who haven't been stung by campaign groups' allegations were much less likely to have set minimal labour standards – in contrast to their larger rivals, who insist that these measures prevent business disruptions, enhance productivity and protect brand value.
- 2. Disclosure is generally poor.** Companies are reluctant to make public disclosures about factory labour performance, whether strong or weak. While **GAP** in the US has blazed a trail by reporting on factory audits in great detail, few companies are able to provide sufficient

evidence to persuade investors that their policies and systems are working (e.g. **Yamaha** of Japan, **Esprit** of Hong Kong and high-end youth retailer **Abercrombie & Fitch** of the US). Data collection is under-developed and companies fear transparency will backfire.

- 3. Going beyond the audit is a must:** Post-audit action plans, factory follow-up visits and working with factory managers directly drive improvements on the ground. Companies like Sweden's **H&M** and America's iconic **Wal-Mart Stores** have concluded that parachuting in for an audit does not, of itself, resolve systematic labour challenges. In response, Wal-Mart has begun to rely more on independent audits to conduct first-round factory visits, while deploying its own labour experts in the field to do remediation, supplier coaching and training. Companies are also increasingly recognising the unintended effects of their own purchasing practices on suppliers' behaviour: some are training their buyers and setting standards that help to counteract rather than exacerbate labour problems.
- 4. Companies are feasting on low-hanging fruit:** The good news is that suppliers appear to be making progress on health and safety, working hours and child labour in factories.[♦] The less good news is that stubborn challenges remain, such as wage levels, freedom of association, collective bargaining and the treatment of temporary, migrant and agency workers.[♦]
- 5. The whole may be greater than the sum of the parts:** The greatest supplier challenges, such as protecting migrant labour and respecting trade union rights, are entrenched problems that require ambitious solutions. Effective outcomes that avoid competitive disadvantage for leading companies may require competitors to work together via shared industry efforts, such as **SEDEX** and the **Electronics Industry Citizenship Code** (see below).[♦]

F&C's report makes several primary recommendations to companies with at-risk manufacturing supply chains, including:

- Build stronger internal management systems to ensure the security of the supply chain
- Get consumers bought in – raise their expectations for good labour practices
- Reach for higher-hanging fruit and take on the tougher problems
- Communicate transparently, warts and all

F&C used its report to articulate the links between shareholder value and strong factory labour standards, and shared it with retail and manufacturing firms around the world. In Q1 2009, we sent it to 88 companies, including Brazil's **Lojas Americanas**, Greece's **Folli-Follie** and US soft drinks and snack giant **Pepsico**; we hope it will provide a unique investor perspective on the need for greater action and transparency on supplier management.

They said...

“... the goal for many firms is no longer perfection, but more nuanced policies and a gradual raising of standards.... The firm's new thinking, says Dan Henkle, Gap's senior vice-president for social responsibility, is not simply about monitoring, but about collaborating with factory staff so that they too feel responsible for conditions on the factory floor. It's messier, costlier and longer-term than a quick audit — and it's potentially riskier from a p.r. standpoint. But this is CSR [corporate social responsibility] for grown-ups.”

“Manufacturing: The Burden of Good Intentions,”
Time magazine, 11 June 2008

F&C's company engagement

Lifting the veil of secrecy on suppliers

Companies with vast supply chains struggle to track and understand working conditions in factories, let alone report on these meaningfully to investors. Enter the **Supplier Ethical Data Exchange (SEDEX)**, a secure database for companies to store labour standards data from factories, including self-assessments, results of independent audits and factory improvements. F&C is a member of the SEDEX Advisory Board, believing it helps companies spot high-risk factories while providing suppliers with cost efficiencies. In our engagement with companies, we often suggest they participate in SEDEX, and have seen success with British retailers **Mothercare** and **B&Q**, the DIY subsidiary of **Kingfisher Group**. Currently, the initiative includes 255 member companies, and covers 20,000 sites and two million workers.

Collaboration: A low-tech solution for high-tech challenges

A number of companies have made the leap to join industry initiatives in order both to raise factory practices with a common set of standards, and to avoid duplicative supplier audits. In 2004, F&C worked with technology companies and other stakeholders to help develop the **Electronics Industry Citizenship Coalition (EICC)**, which enables name-brand firms to speak to their electronics suppliers with one voice. Since its launch, F&C has encouraged companies across the value chain to get on board, and has seen support skyrocket. Firms we had specifically engaged signed up, including data storage leader **EMC**, graphics technology firm **Nvidia**, printer-maker **Lexmark** and semiconductor manufacturer **ST Microelectronics**, among others. The greater the membership of EICC, the more likely its success, although companies must guard against free-riders who risk diluting its credibility if they fail to improve factory standards. In 2008, F&C encouraged signatories to report on suppliers' performance and discuss future strategies to raise standards – and was pleased to see leading technology companies, including **Motorola**, **Apple**, **Hewlett-Packard** and **Dell** report on their suppliers' performance and identify areas for improvement.

Minding the home front: Improving health and safety performance

Strong health and safety is essential to productivity and product quality. To promote better performance, F&C actively engaged companies to improve practices at their *own* factories, foundries, refineries and stores.

Arcelor-Mittal, the world's largest steel company, agreed to roll out its safety systems to all its 300,000-plus employees, including legacy Mittal operations with their track record of weaker performance. Following dialogue with F&C, **Tullow Oil** developed a process to apply the lessons learned from **BP's** disastrous Texas City refinery explosion – implementing regular workshops between site management and key personnel to strengthen on-site management and ensure continuous improvement.

Disclosure also drives health and safety improvements, and F&C was pleased that property companies **Lend Lease** of Australia and **Capital & Regional** of the UK agreed to enhance transparency around their safety records. However, other companies have been less responsive to our requests for health and safety performance data, such as US oil services company **Nabors** and Danish hearing aid manufacturer **William Demant**.

With the global financial crisis putting severe pressures on consumers, retailers and factories worldwide, F&C's view is that companies that manage labour standards effectively will benefit from more secure supply chains, productive factory workers and less industrial disputes, as well as loyal customers – ultimately making them better investments.

Winning gold with F&C

Delivering highly effective investment strategies is just one part of the service we provide. As principled asset managers, we are determined to lead our industry in all aspects of our business.

In 2006 – 2008, F&C were voted winners of the 'Gold Standard' in the Fund Management category. Only a few companies have been privileged enough to win a Gold Standard award, and as such, this is an exceptional achievement. The Gold Standard Awards aim to identify financial services companies that excel not just in service but in five key areas important to consumers of financial products and services:

Financial strength

Ability to meet and exceed customer expectations

Capability

Outstanding expertise and aptitude as a fund manager

Service

Ability to maintain and grow an effective post-sales relationship

Fair value

Assessing whether customers receive great value for money

Trust

Ability to instil confidence in consumers

As a result, the Gold Standards are one of the hardest, most sought after awards in the financial market place.



WINNER



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.

Please contact us for further details or visit our website at www.fandc.com

What could we do better?

We hope we have accurately reflected your concerns. Still, we want to be sure we get it right – 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:

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Important information. All data is as at 31 March 2009 unless otherwise stated.

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